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Fifth Circuit Expands § 510(b) Subordination in *In the Matter of SeaQuest Diving LP*

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Section 510(b) of the Bankruptcy Code requires the subordination of certain unsecured claims, and thereby changes the otherwise applicable priority of such claims. Section 510(b) states as follows:

For the purpose of distribution under this title, 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 to 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.¹



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Thus, the statute mandates subordination of three types of claims: (1) a claim arising from rescission of a purchase or sale of a security issued by the debtor or an affiliate; (2) a claim for damages

arising from a purchase or sale of such a security; and (3) a claim allowed under

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§ 502 of the Code for reimbursement or contribution on account of (1) or (2).² The legislative policy underlying § 510(b) is 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.³

occurred *at the time* of the stock purchase should be deemed to “arise from” that purchase. Since the debtor’s breach of contract occurred *after* the claimants’ purchase, the claimants argued their damages for the debtor’s breach did not “arise from” the claimants’ purchase of the stock. The Third Circuit subordinated the claims at issue to the level of the debtor’s equity.



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Similarly, in *In re Betacom of Phoenix Inc.*,⁵ the Ninth Circuit held that a claim arising from the debtor’s failure to deliver stock pursuant to a merger agreement was subject to mandatory

Feature

“Arising from” Is Broadly Interpreted

The Code does not define the term “arising from” and, consequently, the precise scope of mandatory subordination under § 510(b) is left to the court’s discretion. The recent trend among circuit courts has been toward an expansive interpretation of the “arising from” language. For example, in *Telegroup*,⁴ the claimants sought damages for the debtor’s alleged breach of an agreement to use its best efforts to register its stock. In response to the debtor’s effort to subordinate their claims, the claimants argued that only claims for actionable conduct that

subordination. In *Geneva Steel*,⁶ the Tenth Circuit ruled that a claim arising from post-issuance fraud of the debtor, which caused an investor to hold rather than sell his securities, was subject to mandatory subordination. Lastly, in *In re Med Diversified Inc.*,⁷ the Second Circuit held that a claim arising from breach of a stock exchange provision in a termination agreement was subject to mandatory subordination.

The Fifth Circuit’s decision in *In the Matter of SeaQuest Diving LP*⁸ is the latest example of a circuit court’s broad interpretation of § 510(b)’s “arising from” language. In a matter of first impression, the Fifth Circuit looked beyond a state

¹ 11 U.S.C. § 510(b).

² *In the Matter of SeaQuest Diving LP*, 579 F.3d 411, 418 (5th Cir. 2009) (citing *In re Geneva Steel Co.*, 281 F.3d 1173, 1177 (10th Cir. 2002)).

³ *Baroda Hill Invs. Ltd. v. Telegroup Inc. (In re Telegroup Inc.)*, 281 F.3d 133, 142 (3d Cir. 2002).

⁴ *Telegroup*, 281 F.3d 1173.

⁵ *In re Betacom of Phoenix Inc.*, 240 F.3d 823 (9th Cir. 2001).

⁶ *Geneva Steel*, 281 F.3d 1173.

⁷ *In re Med Diversified Inc.*, 461 F.3d 251 (2d Cir. 2006).

⁸ *In the Matter of SeaQuest Diving LP*, 579 F.3d 411 (5th Cir. 2009).

court judgment based on a settlement among the parties to unwind a failed joint venture agreement and ruled that § 510(b) required mandatory subordination of the claim based on the judgment.

Formation of SeaQuest and Basis of S&J's Claim

The debtors, Seaquest Diving LP (SeaQuest Diving) and its general partner, SeaQuest General Holding LLC ("SeaQuest Holdings" and, together with SeaQuest Diving, "SeaQuest"), provided underwater oilfield services to offshore oil and gas companies. SeaQuest was formed after S&J Diving LP (S&J) and its president and owner, Stanley Jones, joined efforts with three individuals with industry expertise and contacts. S&J contributed substantially all its corporate assets, valued at approximately \$6 million, in exchange for all the Class A shares in SeaQuest Diving, a limited partnership. The Class A shares were entitled to preferential distributions under the limited partnership agreement because of S&J's substantial capital contribution. The three individuals, contributing only their knowledge and labor, each received an equal number of Class B shares in SeaQuest Diving. The three individuals, along with Jones, each received a 25 percent membership interest in SeaQuest Holdings in exchange for \$250. The parties executed several instruments to memorialize the agreements among them.

Almost immediately thereafter, Jones and his three new partners began disagreeing regarding the operation of SeaQuest. A lawsuit ensued, but was settled the following day and dismissed. Pursuant to the parties' settlement agreement, among other things, the debtors would buy out S&J.

The parties failed to consummate the buyout, and SeaQuest filed a second lawsuit against S&J and Jones. Approximately one week later, the parties reached a second settlement. The second settlement provided that (1) S&J would no longer be a member of SeaQuest Holdings or a limited partner of SeaQuest Diving; (2) the contribution agreement pursuant to which S&J transferred assets to SeaQuest in exchange for equity would be rescinded such that SeaQuest and S&J would retain all their respective contributed assets; (3) the parties would enter into an asset-sale agreement whereby S&J would sell some of its formerly contributed assets to SeaQuest for \$3.1

million; (4) SeaQuest would reimburse S&J for overhead expenditures made on SeaQuest's behalf in the sum of \$2.3 million; and (5) SeaQuest would pay S&J "an amount that is the equivalent of what would have been called priority return under the partnership agreement had S&J not rescinded its partnership interest in that entity."

The transaction contemplated by the second settlement also did not occur, and S&J filed a counterclaim against SeaQuest to enforce the settlement agreement. The Texas state court entered judgment in S&J's favor, rescinding the contribution agreement and awarding S&J \$2,604,000 in actual damages, plus attorneys' fees and other costs. Six days later, SeaQuest filed for bankruptcy.

Bankruptcy Court Subordinates S&J's Claim

SeaQuest and two creditors commenced an adversary proceeding to subordinate S&J's claim under § 510(b). The bankruptcy court granted SeaQuest summary judgment. The bankruptcy court found that (1) S&J's claim constituted a right to payment adjudicated by the state court judgment; (2) the state-court judgment represented a determination of rescission of the limited partnership and limited liability agreements and related obligations to merge businesses and acquire securities; (3) because the state-court judgment and the claims it adjudicated arose from the rescission of these securities transactions, § 510(b) applies; (4) the rescission is not the equivalent of a redemption of stock by SeaQuest; and (5) the S&J claim must be subordinated pursuant to the statute's plain language. S&J appealed and the district court certified the bankruptcy court's order for direct appeal to the Fifth Circuit. The Fifth Circuit affirmed the bankruptcy court.

S&J's Claim "Arises from" the Rescission of a Purchase or Sale of SeaQuest's Securities

The Fifth Circuit first had to decide whether S&J's claim arose from rescission of a purchase or sale of a debtor's security so as to mandate subordination of the claim under § 510(b). The court quickly concluded that the "claim" includes a state court judgment under § 101(5)(A) of the Bankruptcy Code and that S&J's limited partnership interest qualifies as

a "security" for purposes of § 510(b).⁹ The court then noted that the plain language of § 510(b) does not distinguish between rescission by the court and rescission by the parties, and concluded that the parties' second settlement agreement resulted in rescission of the limited partnership and limited liability agreements under Texas law.

Next, the court stated that because SeaQuest did not advance any case law that subordinated claims stemming from post-issuance rescission of a contract by consent, it would turn to cases involving the "damages category" for guidance. The Fifth Circuit agreed with the predominant view that any analysis of § 510(b) "must begin with the 1973 law review article authored by Professors John J. Slain and Homer Kripke, entitled *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. Rev. 261 (1973)."¹⁰ The court stated that when drafting § 510(b), Congress "relied heavily" on this article.¹¹ Slain and Kripke's subordination theory was founded on the allocation of risks between investors and creditors:

Both investors and creditors accept the risk of enterprise insolvency," but to differing degrees, as reflected in the absolute priority rule. While the creditor anticipates repayment of a fixed debt, the investor anticipates a potentially unlimited share of future profits. In exchange for this "unique right to participate in the profits," the investor risks the loss of his capital investment, which provides an "equity cushion" for the repayment of creditors' claims. In contrast, the investors alone bear the risk of illegality in the issuance of securities" because it would be improper to reallocate the risk to creditors who (1) never bargained for an equity position in the debtor and (2) extended credit to the debtor in reliance on the equity cushion provided by the investors.¹²

The court then noted that despite the legislative history's emphasis on rescission and damages claims stemming from securities fraud, the

⁹ *SeaQuest*, 579 F.3d at 418.

¹⁰ *Id.* at 420.

¹¹ *Id.*

¹² *Id.* (citing *In re Granite Partners LP*, 208 B.R. 332, 336 (Bankr. S.D.N.Y. 1995)).

Ninth Circuit found in *Betacom* that Congress did not necessarily limit its concern with “creditor expectations and equitable risk allocation” to debtor fraud cases.¹³ Rather, its broader concern was the alienated shareholders’ effort to “recapture their investment from the debtors, regardless of the exact nature of their claim.”¹⁴

The Fifth Circuit remarked that the Second, Third, Ninth and Tenth Circuits have adopted a broad interpretation of the damages category and, although those cases were not factually analogous, they were pertinent “to the extent they clarify the scope and policy of § 510(b).”¹⁵ The court concluded that the circuit courts uniformly agree that a claim arising from the purchase or sale of a security can encompass a claim based on post-issuance conduct, such as breach of contract. Therefore, the court concluded that the rescission category also covers claims arising from post-issuance conduct because the “scope of rescission and damages categories should be construed consistently” and “Slain and Kripke’s two policy rationales for mandatory subordination apply equally to rescission claims arising from securities fraud and rescission claims arising from the mutual agreement of the parties.”¹⁶

Applying its conclusion to the facts before it, the *SeaQuest* court found that S&J’s claim is based on unpaid damages arising from the rescission of the purchase of SeaQuest’s equity interests. Therefore, the claim must be subordinated to the claims of unsecured creditors. Furthermore, although S&J was not a limited partner at the time of SeaQuest’s bankruptcy, § 510(b) can apply even to claimants who are not actual shareholders.

Looking Behind the Judgment

Finally, S&J argued that even if the rescission category is not limited to claims based on securities fraud, its claim was not subject to mandatory subordination because its equity interest in SeaQuest was converted into a judgment before the bankruptcy filing. The court declined to accept S&J’s argument that “the equitable nature of a claim is lost once it is converted to a... judgment.”¹⁷ The court reasoned that if it was precluded from looking behind the judgment, subordination of a rescission

or tort claim predicated on securities fraud improperly would depend on whether the claimant held a pre-petition judgment on the claim.

Conclusion

The *SeaQuest* opinion clearly has enlarged the scope of § 510(b) of the Code. First, although not terribly controversial, the Fifth Circuit held that § 510(b) applies not only to judicially-ordered rescission, but also to rescission by agreement. Second, according to the Fifth Circuit, the bankruptcy court is not foreclosed from looking behind a pre-petition judgment to determine whether it arose from a rescission of a debtor’s security or the purchase or sale of a debtor’s security. If a nexus or causal relationship between the judgment and the purchase or sale of a security is established, the claim likely will be subordinated. Lastly, claims based on a contractual debt or promissory note may fall within the ambit of § 510(b), particularly where the promissory note was not issued in exchange for the redemption of stock. ■

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¹³ *SeaQuest*, 579 F.3d at 420-21.

¹⁴ *Id.* at 421 (citing *Granite Partners*, 208 B.R. at 337).

¹⁵ *SeaQuest*, 579 F.3d at 421.

¹⁶ *Id.* at 422.

¹⁷ *Id.* at 424.