Are There Any Limits To Mandatory Subordination Under Section 510(b) of the Bankruptcy Code?

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This article examines whether there is any practical limit to the mandatory subordination of securities related claims under Section 510(b) of the Bankruptcy Code.

Section 510(b) of Title 11 of the United States Code (the "Bankruptcy Code")[1] provides as follows:

> For the purpose of distribution under [the Bankruptcy Code], 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

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> 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.[2]

As stated by the courts, the statute requires the 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 its affiliates; (2) a claim for damages arising from a purchase or sale of such a security; and (3) a claim for reimbursement or contribution for a purchase or sale of such a security under Section 502 of the Bankruptcy Code.[3] Significantly, Section 510(b) does not mandate the *conversion* of a "claim" falling within its ambit into an equity interest — rather the section merely requires the *subordination* of certain claims to all claims or interests senior or equal to the security on which the claim is based, or, in the case of common stock, to the level of common stock.

THE "ARISING FROM THE PURCHASE OR SALE OF THE DEBTOR'S SECURITY" REQUIREMENT UNDER SECTION 510(B)

The courts have struggled to delineate the precise scope of mandatory subordination under Section 510(b). The central controversy concerns the Section's language requiring the damage claim to have "arisen from the purchase or sale of a security." The reported cases in which the litigants have sparred over the reach of the "arising from" language cluster around three recurring fact patterns. The first line of cases, which has generated the most litigation under Section 510(b), involves allegations of debtor fraud that occurred after the purchase or issuance of the debtor's securities, or the debtor's post-transaction breach of a related agreement.[4] A second line of cases involves attempts to subordinate a debtor's obligations under a commitment to repurchase its securities.[5] The third category of cases involves claims by officers, directors, and underwriters for expense and liability indemnification in connection with litigation involving the debtor's securities.[6]

Common to each line of cases are attempts by claimants to legally or

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factually separate or distance their claims from the actual securities purchase or sale transaction. As noted, some claimants have argued that the damages they sustained arose from debtor misconduct that had no connection to the original securities transaction. Other claimants have linked their claim to the debtor's later breach of a separate promise made at the time of the purchase and contend that the claim did not "arise from" the purchase of the debtor's security. Others have argued that Section 510(b) is limited to damage claims for the debtor's fraud and that their specific claims do not sound in fraud.

In response to those arguments, many courts have adopted a broad "but for" test that requires the subordination of any damage claim that would not have arisen *but for* the claimant's investment. If the "but for" test is without limit, a claim that has any nexus with a security may be at risk of subordination under Section 510(b). As discussed more fully below, the authors believe the better view is that the "but for" test should not be read to subordinate all claims that have their origin in a security of the debtor. A more careful analysis of (i) the facts of the cases adopting the "but for" test; (ii) the claims asserted in those cases; and (iii) the underlying policies animating Section 510(b) suggest that mandatory subordination is appropriate for only those damage claims that seek to recover for the diminution in value of the underlying security — not for every claim that involves, however remotely, the debtor's securities. Because the legislative history and policy considerations underlying Section 510(b) have played a significant and defining role in the development of the broad "but for" test, it is to those subjects that this article next turns.

THE LEGISLATIVE HISTORY OF SECTION 510 AND ITS UNDERLYING POLICY CONSIDERATIONS

Courts have observed that the language of Section 510(b), and specifically the phrase "arising from the purchase or sale of such a security," is ambiguous, particularly where the claim is not directly traceable to fraud at the time of the initial securities transaction; that is, where the claim involves later fraud by the debtor or where the debtor

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has breached an agreement ancillary to the underlying securities transaction.

When faced with statutory ambiguity, the courts seek clarification by reference to the relevant legislative history. As the Third Circuit noted in *Baroda Hill Investments, Ltd. v. Telegroup, Inc.*,[7] both the House Report on the 1978 Bankruptcy Revisions and the Report of the Commission on Bankruptcy Laws, whose proposed legislation was largely adopted by the 1978 enactment of the Bankruptcy Code, suggest that in enacting Section 510(b), Congress was focusing on claims alleging fraud or other violations of securities laws in the issuance of the debtor's securities.[8]

In enacting Section 510(b), Congress relied heavily on a law review article written by Professors John J. Slain and Homer Kripke — *The Interface Between Securities Regulation and Bankruptcy — Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*.[9] Slain and Kripke argued that stockholder claims for rescission should be subordinated to the claims of general unsecured creditors. If shareholder claims were treated on a par with general creditors, Slain and Kripke explained, the expectations of general creditors that they would be paid ahead of equity claims would be defeated.

Slain and Kripke further argued that creditors rely on the absolute priority rule in case of bankruptcy and that by elevating claims arising from tainted security issuance to general creditor status places a burden on creditors that they have not agreed to assume, and should not be forced to assume. Although Slain and Kripke focused on rescission claims of "disaffected security holders," they made it clear that they looked with disfavor on all efforts by equity holders to recover their investments in bankruptcy at the expense of general creditors.

> We are only incidentally concerned with the precise predicate of a disaffected stockholder's efforts to recapture his investment from the corporation. For present purposes, it suffices to say that when the basis of the stockholder's disaffection is either the issuer's failure to comply with the registration requirements or the issuer's material misrepresentation, one or more state or federal claims may be made. Our purpose is to consider the impact of such claims on the distribu-

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tion of the corporation's assets in bankruptcy and the development of a plan of reorganization under Chapter X.[10]

Slain and Kripke suggested that the relative priorities of disaffected shareholders and general creditors be rethought in the context of appropriate risk allocation. They were concerned with two risks: (1) the risk of business insolvency from whatever cause; and (2) the risk of illegality in securities issuance.[11] They observed that both general creditors and stockholders accept the risk of business failure. In that event, the law gives priority to creditors. In exchange for undertaking a greater risk of insolvency, shareholders benefit from the leverage provided by general creditors. While creditors forego any return over fixed payment, they also do not participate in losses sustained by owners of equity interests. In essence, the creditor expects a fixed return, leaving the variable profit to stockholders, while the latter take the profit and provide a cushion of security for payment of creditor claims. Slain and Kripke observed that this difference in risk allocation is reflected in the absolute priority rule and they argued that "no obvious reason exists for reallocating that risk."[12] They further reasoned that to permit the rescission right to be enforced in bankruptcy was to reallocate the risk of illegal issuance to general creditors, which they concluded was improper because the stock was offered to the stockholders, not to creditors.

Many courts have found the legislative history helpful, but not dispositive.[13] Those same courts have, however, concluded that the legislative history is best illuminated by an examination of the policy considerations at the heart of the Slain and Kripke argument. Those policies in turn, as the courts have stated, inform the analysis as to whether claims asserted by stockholders, in whatever guise such claims are asserted, are subject to mandatory subordination under Section 510(b). As discussed below, the decisions imposing mandatory subordination under the broad "but for" analysis are most clearly understood in the context of the fundamental argument advanced by Slain and Kripke — discontented shareholders, having gambled for an equity return,[14] should not be allowed to recover their failed investment on a parity with general creditors.

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THE BROAD APPROACH TO SECTION 510(B); THE SO-CALLED "BUT FOR" TEST

The Third Circuit's decision in *Telegroup, Inc.*[15] may be the best example of how courts have broadly interpreted Section 510(b)'s "arising from" language. In that case, the claimants sought damages for the debtor's alleged breach of an agreement to use its best efforts to register its stock. In opposition to the debtor's effort to subordinate their claims under Section 510(b), the claimants argued that Section 510(b) should be construed narrowly and that only claims for actionable conduct that occurred at the time of the purchase of stock should be deemed to "arise from" that purchase. Because the actionable conduct in that case, that is, the debtor's breach of contract, occurred after the claimants' purchase, the claimants contended that the damages they claimed for the breach did not "arise from" their purchase of the stock.

The debtor, on the other hand, urged the court to construe Section 510(b) more broadly: claims for breach of a stock purchase agreement, which would not have arisen "but for" the purchase of its stock, arise from that purchase, even though the debtor's breach occurred after the transaction was completed. The court agreed with the debtor and held that a claim for breach of a stock purchase agreement requiring the issuer to use its best efforts to register its stock "arises from" the purchase of the stock for Section 510(b) purposes and therefore must be subordinated.[16]

The Third Circuit acknowledged that the "arising from" language in Section 510(b) was susceptible to two different interpretations and, therefore, ambiguous. On the one hand, the "arising from" language could be construed to apply only to fraud or illegality in the initial purchase transaction. Indeed, the Third Circuit cited several cases so holding. *See, e.g. In re Amarex, Inc.*,[17] holding that under Section 510(b), a claim does not arise from the purchase or sale of a security if it is based on conduct that occurred subsequent to the security's issuance; and *In re Angeles Corp.*,[18] holding that claims for breach of fiduciary duty do not arise from the purchase or sale of limited partnership interests where the wrongful conduct occurred after the sale of those interests. The decision in *Amerex, Inc.*

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was subsequently abrogated and the decision in *Angeles Corp.* has been seriously questioned by the Tenth Circuit in *Geneva Steel Company*.[19]

On the other hand, the Third Circuit observed, the language could be interpreted to encompass subsequent debtor misconduct or a breach of an agreement involving the debtor's securities, and several courts have so concluded. *See, e.g. In re NAL Financial Group, Inc.*,[20] holding that a claim for breach of stock purchase agreement and registration rights agreement occasioned by debtor's failure to register debentures "arises" out of the original purchase for Section 510(b) purposes; and *In re Granite Partners, L.P.*,[21] concluding that claims for damages sustained as the result of the debtor's fraud that enticed claimants to retain their position in debtor's security "arises from" the initial purchase.

In attempting to reconcile the two competing interpretations, the Third Circuit observed:

> We conclude that the phrase "arising from" is ambiguous. For a claim to "aris[e] from the purchase or sale of…a security," there must obviously be some nexus or causal relationship between the claim and the sale of the security, but § 510(b)'s language alone provides little guidance in delineating the precise scope of the required nexus. On the one hand, it is reasonable, as a textual matter, to hold that the claims in this case [claims arising out of the debtor's failure to use its best efforts to register its stock] do not "arise from" the purchase or sale of [the debtor's] stock, since the claims are predicated on conduct that occurred after the stock was purchased. On the other hand, it is, in our view, more natural, as a textual matter, to read "arising from" as requiring some nexus or causal relationship between the claims and the purchase of securities, but not as limiting the nexus to claims alleging illegality in the purchase itself. In particular, the text of § 510(b) is reasonably read to encompass the claims in this case, since the claims would not have arisen *but for* the purchase of [the debtor's] stock and allege a breach of provision of the stock purchase agreement.[22]

As noted, the Third Circuit adopted the broader interpretation of

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Section 510(b) and subordinated the claims at issue to the level of the debtor's equity.

The Bankruptcy Court for the Southern District of New York in *In re Granite Partners, L.P.*,[23] also adopted implicitly the "but for" test in the construction of Section 510(b). In that case, the court addressed the issue of whether fraudulent maintenance claims arising from torts committed by the debtor subsequent to security issuance "arise from the purchase or sale of a security of the debtor." The creditors in that case acknowledged that claims alleging fraud in connection with the purchase of the debtor's securities fall squarely within Section 510(b) and are subject to mandatory subordination. They argued, however, that claims for damages sustained as the result of misrepresentations by the debtor that caused them to retain the debtor's securities were not governed by Section 510(b).

The bankruptcy court found the phrase "arising from the purchase or sale" ambiguous, at least with respect to claims other than fraudulent inducement claims.

> Something "arises" from a source when it originates from that source. The phrase "arising from" signifies some causal connection. A literal reading implies that the injury must flow from the actual purchase or sale; a broader reading suggests that the purchase or sale must be part of the causal link although the injury may flow from a subsequent event. Since the fraudulent maintenance claim cannot exist without the initial purchase, the purchase is a causal link. Reasonably well-informed persons could interpret Section 510(b) in either sense, and hence, the section is ambiguous.[24]

After resorting to the legislative history, which the court found helpful but not dispositive, and other analysis, the court held that fraudulent maintenance claims must be subordinated in keeping with the absolute priority rule.

> When an investor seeks *pari passu* treatment with the other creditors, he disregards the absolute priority rule, and attempts to establish a contrary principle that threatens to swallow up this fundamental rule

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> of bankruptcy law. In this case, he also disregards the purposes of Section 510(b).[25]

The court in *Granite Partners* ultimately concluded that "fraudulent retention" claims arise out of the purchase or sale of a security because the claim would not have arisen but for the initial purchase; that is, the purchase constituted a causal link to the resulting claim.[26]

Although *Telegroup* and *Granite Partners* and their progeny appeared to have embraced a broad, "but for" test to determine whether a claim is subject to subordination under Section 510(b), it does not follow that those decisions mandate that all claims with any conceivable nexus to the securities of the debtor or its affiliates are subject to mandatory subordination. A careful reading of these cases and the decisions of other courts denying Section 510(b) subordination suggests that something more is required than a simple "but for" connection between the creditor's claim and the debtor's securities.

LIMITS TO THE BROAD "BUT FOR" TEST MAY BE IMPLIED FROM THE DECISIONS ADOPTING THAT TEST

Significantly, the courts adopting the broader interpretation of Section 510(b) acknowledge that construction was not compelled by the text of the statute. Given the statute's ambiguity, the courts were required to examine the legislative history to ascertain the policy considerations underlying Section 510(b). Virtually every court adopting the broader construction understood those policies to preclude any attempt by a disappointed equity investor to convert its residual equity interest into a claim that might share in parity with general creditors.

The Third Circuit in *Telegroup* focused squarely on the policies underlying Section 510(b).

> 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. Nothing in this rationale

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> would distinguish those shareholder claims predicated on post-issuance conduct from those shareholder claims predicated on conduct that occurred during the issuance itself. More important than the timing of the actionable conduct, from a policy standpoint, is the fact that the claims in this case seek to recover a portion of claimant's equity investment. In enacting § 510(b), Congress intended to prevent disaffected equity investors from recouping their investment losses in parity with general unsecured creditors in the event of bankruptcy. Since claimants in this case are equity investors seeking compensation for a decline in the value of Telegroup's stock, we believe that the policies underlying § 510(b) require resolving the textual ambiguity in favor of subordinating their claims. Put differently, because claimants retained the right to participate in corporate profits if Telegroup succeeded, we believe that § 510(b) prevents them from using their breach of contract claim to recover the value of their equity investment in parity with general unsecured creditors. Were we to rule in claimant's favor in this case, we would allow stockholders in claimants' position to retain their stock and share in the corporation's profits if the corporation succeeds, and to recover a portion of their investment in parity with creditors if the corporation fails.[27]

Similarly, the bankruptcy court in *Granite Partners* supported its decision to subordinate fraudulent retention claims on the risk allocation and differing expectations principles propounded by Slain and Kripke.

> First, from the creditors' point of view, it does not matter whether the investors initially buy or subsequently hold on to their investments as a result of fraud. In the either case, the enterprise's balance sheet looks the same, and the creditors continue to rely on the equity cushion of the investment.
>
> Second, a fraudulent retention claim involves a risk that only the investors should shoulder. In essence, the claim involves the wrongful manipulation of the information needed to make an investment decision. The [investors] charge that the debtors wrongfully

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> deprived them of the opportunity to profit from their investment (or minimize their losses) by supplying misinformation which affected their decision to sell. Just as the opportunity to sell or hold belongs exclusively to the investors, the risk of illegal deprivation of that opportunity should too. In this regard, there is no good reason to distinguish between allocating the risks of fraud in the purchase of a security and post-investment fraud that adversely affects the ability to sell (or hold) the investment, both are investment risks that the investors have assumed.[28]

As the bankruptcy court put it more succinctly, the legislative policy underlying Section 510(b) seeks to prevent investors from recovering on a claim based upon the loss of the investment.[29]

The Tenth Circuit, in *Geneva Steel Co.*,[30] also embraced this reasoning in holding that a debenture holder's fraudulent retention claim was subject to mandatory subordination under Section 510(b):

> While Slain and Kripke focused primarily on shareholder rescission claims, their larger concerns sprang from what they termed the disaffected stockholder's efforts to recapture his investment from the corporation.[31]

In *In re Geneva Steel Co.*, the Tenth Circuit used the risk allocation framework advanced by Professors Slain and Kripke to subordinate the claim before it in that case:

> We find the risk allocation argument persuasive in this case. Allen's claim, at its essence, accuses Geneva of manipulating information concerning his investment. He acquired and held that investment with the belief that its value would increase, though he no doubt recognized that for any number of reasons it might not; indeed, he recognized that it might even lose value. In contrast, a mere creditor of Geneva could expect nothing more than to recoup the value of goods or services supplied to the company. Yet now, having watched his investment gamble turn sour, Allen would shift his losses to those

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> same creditors. We think this effort clashes with the legislative policies that Section 510(b) purport to advance.[32]

The Ninth Circuit also used the Slain/Kripke risk allocation framework to determine that the claims asserted by the shareholders in that case should be subordinated under Section 510(b). In *In re Betacom of Phoenix, Inc.*,[33] the majority shareholders of a company acquired in a pre-bankruptcy merger with the debtor asserted claims for breach of the merger agreement and breach of fiduciary duty after the debtor failed to deliver the merger consideration (i.e., shares of its common stock) to the claimants. The debtor moved to subordinate the claims of the shareholder/claimants under Section 510(b). The bankruptcy court ruled that the claims asserted by the shareholders were equity interests in the debtors and subordinated the shareholders' breach of contract claims. On appeal, the district court reversed, holding that an actual purchase or sale of the debtor's securities is necessary to trigger subordination under Section 510(b). Because the shares of the acquirer were never delivered to the claimants, the district court reasoned that no actual purchase or sale had occurred for the purposes of Section 510(b).

On further appeal, the Ninth Circuit reversed the district court's ruling and rejected the claimant's contention that Section 510(b) only applies to securities law claims. The Ninth Circuit also rejected the claimants' other attempts to distance their claims from the undelivered stock of the debtor. The court was persuaded by the risk allocation and equity cushion arguments advanced by Slain and Kripke. The court reasoned that because shareholders expect to take more risk than creditors in return for the right to share in profits, and creditors only expect repayment of a fixed debt, it is not fair to shift risk to creditors because creditors extend credit in reliance on the cushion of investment provided by shareholders. The court found that there is nothing in the Slain/Kripke analysis to suggest that Congress's concern with creditor expectations and equitable risk allocation was limited to cases of debtor fraud. Significantly, the court expressly acknowledged that the claimants traded their equity in the target for a chance of greater earnings of the combined enterprise. Because the claimants had undertaken equity risk with

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the expectation of receiving an equity return, the court found no rational basis on which to refuse subordination of the claims simply because the claimants had not alleged fraud or the securities transaction was never consummated.

AN ARTICULATION OF THE LIMIT TO THE BROAD "BUT FOR" TEST

The rationale employed by the various courts in subordinating claims that would not have arisen "but for" the initial investment suggests that if the claimant is not seeking to recover for any diminution in the value of the investment represented by the debtor's security, or did not assume the risks inherent in equity investments, its claim should not be subordinated. Indeed, several courts have refused to subordinate claims under Section 510(b) where the claimant disavowed any equity return or was seeking merely to recover on a claim evidenced by a security. These cases stand for the proposition that the "but for" test is not without limit and that not every claim that has its origin in the purchase or sale of a security of the debtor is subject to mandatory subordination under Section 510(b).

These limits to subordination under Section 510(b) were recently acknowledged and clarified by the Second Circuit in *In re Med Diversified, Inc.*[34] As a case of first impression for that court, the Second Circuit did not adopt an unlimited "but for" test but, citing to the reasoning provided by the Third and Ninth Circuits in *Betacom* and *Telegroup*, held that subordination under Section 510(b) is required *only if* a claimant (i) took on the risk and return expectations of a shareholder, rather than a creditor, or (ii) sought to recover a contribution to the equity pool relied upon by creditors in determining whether to extend credit to the debtor.[35]

In *Med Diversified*, the claimant, a former executive of the debtor, alleged that the debtor breached its termination agreement with the claimant by failing to issue its common stock to the claimant in exchange for the claimant's stock in another company. The trustee of the creditors' trust sought subordination of the claim under Section 510(b). The bank-

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ruptcy court sustained the trustee's motion for summary judgment and the district court affirmed the bankruptcy court's ruling. On further appeal, the Second Circuit affirmed, reasoning that because the claimant had bargained to become a stockholder of the debtor rather than a creditor, subordination of the claim was appropriate under Section 510(b). The *Med Diversified* decision may be compared favorably to a more recent decision by the Ninth Circuit in *In re American Wagering, Inc.*[36] In that case, the claimant divested himself of any equity interest in the debtor in exchange for a pure claim (pursuant to a money judgment) more than six years before the debtor filed for bankruptcy. On this basis, the Ninth Circuit found for the claimant, holding that subordination under Section 510(b) was inappropriate.

Even before these recent circuit decisions, courts have been limiting the scope of Section 510(b) subordination. For example, in *Montgomery Ward Holding Corp.*,[37] the debtor argued that a claim evidenced by a promissory note given in redemption of the debtor's stock "arises from" the purchase or sale of its securities within the meaning of Section 510(b). The bankruptcy court rejected this contention out of hand:

> Montgomery Ward's argument is premised on a distended interpretation of the causal relationship between the purchase or sale of the securities and the type of claim subject to subordination. The plain language of § 510(b) is more limited. It applies only to a claim that directly concerns the stock transaction itself, i.e., the actual purchase and sale of the debtor's security must *give rise* to the contested claim.
>
> The use of "damages" in § 510(b) support this conclusion. The term connotes a recovery broader than a simple claim on an unpaid debt. The term "damages" implies a tortious injury, as for example, one suffered from the fraudulent issue, purchase or sale of securities. It also serves to include claims by investors who technically do not have a claim for rescission but who still have a securities fraud claim.[38]

The bankruptcy court also supported its conclusion on the absence of the policy considerations underlying Section 510(b), noting that the claimant

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was not an equity holder trying to enhance his position, but rather attempting to enforce the sale of stock.

Similarly, the bankruptcy court in *In re Motels of America, Inc.*[39] concluded that the claims of a former employee/shareholder under agreements pursuant to which the former employee/shareholder was entitled to put stock to the debtor over a fixed term was not subject to mandatory subordination because the former employee/shareholder had given up rights and risks associated with equity ownership. Further, in *In re Wyeth Company*,[40] the bankruptcy court held that a former shareholder's claim on the debtor's note given in consideration for repurchase of the shareholder's shares is not subject to Section 510(b) subordination because, the court reasoned, the claimant was not an equity holder trying to "better his position" at the expense of general creditors. In *In re Stern-Slegman-Prins Company*,[41] the court rejected the debtor's contention that a former shareholder's claim for the debtor's failure to perform under stock redemption agreement arose out of the prior purchase of the debtor's stock for purposes of Section 510(b) subordination.

The district court decision in *Raven Media Investments, LLC v. DirecTV Latin America, LLC (In re DirecTV Latin America, LLC)*[42] best reflects the view that the "but for" test is appropriately applied to only those claims for diminution in the value of the debtor's securities, or where the claimant undertook equity risk. In *DirectTV*, the court reversed the bankruptcy court's subordination pursuant to Section 510(b) of a claim under a put agreement that had been automatically exercised prior to bankruptcy.

In that case, the claimant held a four percent membership interest in a limited liability company that ultimately filed for bankruptcy relief. Under the agreement pursuant to which the claimant was admitted to the LLC, the claimant was restricted in his right to transfer his LLC interest, the claimant's LLC interest was subject to rights of first refusal in favor of other LLC members, and the claimant was required to sell his interest on the same terms and conditions available to the majority members. Further, the claimant was required to sign an irrevocable proxy in favor of the other members with respect to matters requiring supermajority vote. The claimant was not obligated to make capital contributions, and

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he did not receive notice of LLC meetings or of the decisions made at those meetings, or notice of exercise of his proxy. He did not receive a position on the executive committee and was not consulted with respect to the affairs of the LLC.

The LLC and the claimant entered into a separate put agreement that gave the claimant the option to put his interest to the LLC during a 10-day period three years after execution of the put agreement. If the put was exercised, the LLC was required to pay the claimant a base purchase price plus interest of approximately five percent. The LLC's obligation to pay the claimant could also be triggered by certain "put acceleration events."

The LLC stipulated that a put acceleration event occurred more than two months before its bankruptcy filing. Under the put agreement, the option was deemed to have been automatically exercised upon the occurrence of the put acceleration event. The bankruptcy court subordinated the claimant's claim under the put agreement as a claim arising from the purchase of the LLC debtor's securities. On appeal, the district court reversed.

The district court found that central to the Third Circuit's decision *In re Telegroup, Inc.* was the distinction between equity investors and creditors that justified the subordination of certain claims in bankruptcy. Because shareholders choose to participate in profits, they implicitly assume a greater share of the risk of insolvency, including the risk that claims arising out of decline in the value of their equity interests may not share ratably with general creditors. Significantly, the district court did not believe that all equity related claims must be subordinated.

> Nonetheless, simply being a holder of equity interest would be too broad of a basis to justify subordination of claims, just as limiting subordination to only tort claims would prove too narrow. As a result, the Third Circuit applied a hypothetical securities fraud test to the shareholders' claims. In *Telegroup*, the post-issuance breach alleged by the shareholders was the debtor's failure to use good faith efforts to register the stock. The court reasoned that the same essential claim could be brought as securities fraud if, at the time of pur-

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> chase, the shareholder was told the company was using its best efforts to register the stock. In the latter case, the shareholder's claim would be subordinated. The court held that since the asserted contract claims were indistinguishable from a hypothetical securities fraud claim, they too were within the scope of § 510(b).[43]

Given the transaction structure, the district court found that the claimant did not seek to hold, nor did it hold, an equity interest in the debtor. The court concluded that although the claimant nominally held equity, it did not possess the "characteristics" consistent with that status. The court also observed that unlike in *Telegroup*, where the claimant's claim could have hypothetically been restated as a securities claim, the claimant in *DirectTV* had no such hypothetical securities fraud claim. The court also noted that the claim was not predicated upon diminished equity value.

CONCLUSION

Based on the foregoing survey of the relevant cases, the legislative history of Section 510(b) and its underlying policy considerations, we believe the "but for" test for determining whether a claim falls within the ambit of Section 510(b) should be appropriately limited to claims seeking to recover the decrease in value of investments in a debtor's security, or where the claimant is seeking to transform a residual equity interest into a general unsecured claim. If, on the other hand, the claim is for damages resulting from the debtor's breach of an agreement whose subject matter happens to be the debtor's security, but the claim does not seek to recover for a decrease in the value of the security or to transform an equity security interest into general claim, the claim should not be subordinated under Section 510(b), even if the claim would not have arisen "but for" the purchase of the debtor's security.

NOTES

[1] 11 U.S.C. §§ 101-1532.
[2] 11 U.S.C. § 510(b).

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[3] *See Richard M. Allen v. Geneva Steel Co.* (*In re Geneva Steel Co.*), 281 F.3d 1173, 1177 (10th Cir. 2002); *Brian Weissmann v. Pre-Press Graphics Co., Inc.* (*In re Pre-Press Graphics Co., Inc.*), 307 B.R. 65, 71 (N.D. Ill. 2004); *Montgomery Ward Holding Corp. v. Schoeberl (In re Montgomery Ward Holding Corp.*), 272 B.R. 836 (Bankr. D. Del. 2001).

[4] *See e.g. Baroda Hill Investments, Ltd. v. Telegroup, Inc.* (*In re Telegroup, Inc.*), 281 F.3d 133 (3d Cir. 2002)(claim for debtor's failure to use best efforts to register stock); *In re Geneva Steel Co.*, 281 F.3d 1173 (10th Cir. 2002)(claim that creditor was induced by fraud to *retain* position in debtor's securities); *In re Enron Corp*., 341 B.R. 141 (Bankr. S.D.N.Y. 2006); *In re NAL Financial Group, Inc.*, 237 B.R. 225 (Bankr. S.D. Fla. 1999)(claim for breach of stock purchase agreement and registration rights agreement occasioned by debtor's failure to register debentures); *In re Granite Partners, L.P.*, 208 B.R. 332 (Bankr. S.D.N.Y. 1997)(claim for fraudulent retention).

[5] *See, e.g. In re Montgomery Ward Holding Corp*., 272 B.R. 836 (involving claim based on a promissory note issued by the debtor to consummate the repurchase of its own stock); *In re Motels of America, Inc.*, 146 B.R. 542 (Bankr. D. Del. 1992)(involving claims of former employee/shareholder under agreements pursuant to which former employee/shareholder was entitled to put stock to the debtor); *In re Wyeth Co*., 134 B.R. 920 (Bankr. W.D. Mo. 1991)(involving former shareholder's claim on debtor's note given in consideration for repurchase of shares); *In re Stern-Slegman-Prins Co.*, 86 B.R. 994 (Bankr. W.D. Mo. 1988)(former shareholder's claim for debtor's failure to perform under stock redemption agreement).

[6] *See, e.g. In re Mid-American Waste Systems, Inc.*, 228 B.R. 816 (Bankr. D. Del. 1999)(subordinating indemnification claims of officers, directors and underwriters incurred in defense of securities litigation); *In re Public Service Co. of New Hampshire*, 129 B.R. 3 (Bankr. D.N.H. 1991)(involving officer's and director's liabilities and expense indemnification claims arising out of securities litigation in connection with the issuance of debentures with warrants); *Official Comm. of Unsecured Creditors v. Paine Webber Inc.* (*In re De Laurentiis Entertainment Group, Inc.*), 124 B.R. 305 (C.D. Cal. 1991)(underwriter's claim for reimbursement of expenses incurred in defense of a securities lawsuit in connection with debtor's issuance of securities).

[7] *In re Telegroup, Inc.*, 281 F.3d 133.

[8] *See* Report of the Comm'n on the Judiciary, Bankruptcy Law Revision,

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H.R. Rep. No. 95-595, at 194 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6154 ("A difficult policy question to be resolved in a business bankruptcy concerns the relative status of a security holder who seeks to rescind his purchase of securities or to sue for damages based on such a purchase: Should he be treated as a general unsecured creditor based on his tort claim for rescission, or should his claim be subordinated?"); Report of the Comm'n on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, pt 2. at 116 (1973)(commenting that the proposed provision "subordinates claims by holders of securities of a debtor corporation that are based on federal and state securities legislation, rules pursuant thereto, and similar laws").

[9] 48 N.Y.U. L. REV. 261 (1973). *See* H.R. REP. NO. 95-595, at 196 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6156-57 (summarizing the argument in the Slain/Kripke article and stating that "[t]he bill generally adopts the Slain/Kripke position"); *id.* at 194 ("The argument for mandatory subordination is best described by Professors Slain and Kripke."); *see also In re Betacom of Phoenix, Inc.* 240 F.3d 823, 829 (9th Cir. 2001)("Congress relied heavily on the analysis of two law professors in crafting the statute."); *In re Granite Partners, L.P.*, 208 B.R. at 336 ("Any discussion of section 510(b) must begin with the 1973 law review article authored by Professors John J. Slain and Homer Kripke…"); *accord In re Enron Corp.,* 341 B.R. 141, 163 (Bankr. S.D.N.Y. 2006).

[10] Slain & Kripke, *supra* note 9, at 267.

[11] Slain & Kripke, *supra* note 9, at 286.

[12] Slain & Kripke, *supra* note 9, at 287.

[13] *In re Telegroup, Inc.*, 281 F.3d at 139; *Pippin v. Kaiser Group Int'l, Inc.* (*In re Kaiser Group Int'l*), No. CIV.A. 01-508-JJF, 2001 WL 34368405, *4 (D. Del. Nov. 29, 2001); *In re Mid-American Waste Systems, Inc.*, 228 B.R. at 826.

[14] I have found no published opinion or professional commentary that attempts to make a fine distinction between "equity return" and "non-equity" or "fixed return." All the published materials that I have consulted appear to assume without discussion that the entitlement to share in the variable profitability of a commercial enterprise is the factor that distinguishes equity interests from fixed obligations. Consistent with this reasoning, deeply subordinated contractual obligations that do not participate in the profitability of an enterprise are "fixed return" obligations, notwithstanding their inferior position in the enterprise's capital structure.

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[15] *In re Telegroup, Inc.*, 281 F.3d 133.
[16] *In re Telegroup, Inc.*, 281 F.3d at 136.
[17] *In re Amarex, Inc.*, 78 B.R. 605, 610 (W.D. Okla. 1987).
[18] *In re Angeles Corp.*, 177 B.R. 920, 926 (Bankr. C.D. Cal. 1995).
[19] *In re Geneva Steel Co.*, 281 F.3d 1173.
[20] *In re NAL Financial Group, Inc.,* 237 B.R. 225.
[21] *In re Granite Partners, L.P.,* 208 B.R. 332.
[22] *In re Telegroup, Inc.*, 281 F.3d at 139 (emphasis added).
[23] *In re Granite Partners, L.P.*, 208 B.R. 332.
[24] *In re Granite Partners, L.P.*, 208 B.R. at 339.
[25] *In re Granite Partners, L.P.*, 208 B.R. at 344.
[26] *See also In re Enron Corp.*, 341 B.R. at 159 (claims for fraudulent retention of debtor's stock options "arises from" purchase of security and should be subordinated under section 510(b)); *In re WorldCom, Inc.*, 329 B.R. 10, 15-17 (Bankr. S.D.N.Y. 2005)(section 510(b) applies to investor's claim even if damages were sustained as a result of fraud that induced investor to hold, rather than sell, the debtor's security); *In re Geneva Steel Co*., 281 F.3d 1173, 1182 (10th Cir. 2002)(holding that section 510(b) is not limited to "issuance and sale," but applies to claims arising subsequently); *In re Int'l Wireless Communications Holdings, Inc.*, 279 B.R. 463, 469 (D. Del. 2002)(concluding that "the fact that the Debtors' alleged breach occurred subsequent to the issuance of the stock in this case is insufficient to remove Appellant's Claim from the scope of Section 510(b)"); *In re Kaiser Group Int'l*, 2001 WL 34368405 at *3 (noting that "Section 510(b) should be construed broadly to include claims arising from subsequent events if they are causally linked to the initial purchase or sale of securities"); *In re NAL Financial Group, Inc.*, 237 B.R. at 231 (adopting broader reading of section 510(b) and holding that claimants claim for debtor's failure to register debentures would not have arisen but for claimant's purchase of the debentures in the first place).
[27] *In re Telegroup, Inc.*, 281 F.3d at 142.
[28] *In re Granite Partners, L.P.*, 208 B.R. at 342.
[29] *Id.* at 337.
[30] *In re Geneva Steel Co.*, 281 F.3d at 1182.
[31] *Id.* at 1179 (internal citations omitted).
[32] *In re Geneva Steel Co.*, 281 F.3d at 1180.
[33] *In re Betacom of Phoenix, Inc.*, 240 F.3d 823.

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[34] *In re Med Diversified, Inc.*, 461 F.3d 251, 259 (2d Cir. 2006).
[35] *Id.* at 257.
[36] *Racusin v. American Wagering, Inc.* (*In re American Wagering, Inc.*), 465 F.3d 1048 (9th Cir. 2006).
[37] *In re Montgomery Ward Holding Corp.*, 272 B.R. 836.
[38] *In re Montgomery Ward Holding Corp.*, 272 B.R. at 842 (internal citations omitted). Note that *Montgomery Ward's* restrictive interpretation of section 510(b) has been called into doubt by at least one court. *See In re Pre-Press Graphics Co., Inc.*, 307 B.R. at 78.
[39] *In re Motels of America, Inc.*, 146 B.R. 542.
[40] *In re Wyeth Company*, 134 B.R. 920.
[41] *In re Stern-Slegman-Prins Company*, 86 B.R. 994 (Bankr. W.D. Mo. 1988).
[42] *Raven Media Investments, LLC v. DirecTV Latin America, LLC (In re DirecTV Latin America, LLC*), CIV.A. 03-981-SLR, 2004 WL 302303 (D. Del. Feb. 4, 2004).
[43] *In re DirecTV Latin America, LLC*, 2004 WL302303 at *3.

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