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Super-Subordination, a Super Problem: A Call to Amend § 510(b)

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Section 510(b) mandates that securities-related claims be subordinated.[1] Just how far those claims are subordinated, however, is unclear in many situations due to § 510(b)'s lack of clarity[2] and outdated drafting,[3] which has led to bizarre and likely unintended outcomes in several cases.

The problems with § 510(b) are particularly acute when a court is required to determine whether and to what extent it must subordinate a claim arising from the purchase or sale of (1) a security other than common stock and/or (2) a security of a debtor's affiliate. The problems are further compounded when equityholders are entitled to a distribution because the subordinated securities-based claims may in fact be subordinated below the level of equity — potentially allowing equity owners to receive distributions before all claims are paid in full.

Subordination of Claims Based on Securities of Alternative Entities

Section 510(b) states, in relevant part:

> [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 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.[4]

When a claim is based on the purchase or sale of "common stock," regardless of the nature of the claim (*e.g.*, fraud, breach of contract, rescission, etc.), a court's analysis with respect to the level of subordination is relatively straightforward. The plain language of § 510(b) subordinates the claim to the same level of the debtor's common stock,[5] thereby preventing "disappointed equity investors from recovering a portion of their investment in parity with bona fide creditors in a bankruptcy proceeding."[6]

However, when the claim is based on any security other than "common stock," the analysis is more complicated. For example, claims that arise from the purchase or sale of limited liability company (LLC) membership interests or limited partnership interests do not fall within the ambit of "common stock" as that term is used in § 510(b). Therefore, the final clause of § 510(b) does not apply and any claims related to the purchase or sale of those interests would be subordinated, not to a level *pari passu* with common stock, but super-subordinated "to all ... interest[s] represented by such security."[7] The Ninth Circuit Bankruptcy

1 Courts have interpreted § 510(b) "broadly" to provide for subordination of securities-related claims regardless of the legal theory upon which the claim is based. *Rombro v. Dufrayne (In re Med Diversified Inc.)*, 461 F.3d 251, 259 (2d Cir. 2006) (subordinating claim for fraudulent inducement and breach of contract arising from purchase of securities); *see also Tekinsight Com. Inc. v. Stylesite Mktg. Inc. (In re Stylesite Mktg. Inc.)*, 253 B.R. 503, 510 (Bankr. S.D.N.Y. 2000) (claimant cannot avoid subordination by asserting constructive trust over funds paid for security, even when claims are based on fraud in inducement).

2 Courts have repeatedly recognized that § 510(b) is ambiguous. *See, e.g., In re Med Diversified Inc.*, 461 F.3d at 255 (finding that § 510(b) is "reasonably susceptible" to multiple constructions); *SeaQuest Diving LP v. S&J Diving Inc. (In re SeaQuest Diving LP)*, 579 F.3d 411, 418 (5th Cir. 2009) (finding § 510(b) ambiguous as it applied to pre-petition judgment on breach-of-contract claim); *Allen v. Geneva Steel Co. (In re Geneva Steel Co.)*, 281 F.3d 1173, 1178 (10th Cir. 2002) ("[W]ith respect to fraudulent retention claims ... the language of section 510(b) is ambiguous."); *Baroda Hill Invs. Ltd. v. Telegroup Inc. (In re Telegroup Inc.)*, 281 F.3d 133, 138 (3d Cir. 2002) (concluding that § 510(b) is ambiguous as applied to claim arising from breached stock purchase agreement).

3 Section 510(b) has not been amended since 1984 and has not been updated to account for the widespread use of alternative business entities. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 375 (1984).

4 11 U.S.C. § 510(b).

5 Even though determining the extent of subordination is relatively simple, the task of assigning a distribution percentage to the claim is anything but. There is no universal principle for converting a debt claim, which is expressed in dollars, into an equity interest, which is represented by a fixed number of securities.

6 *In re Telegroup Inc.*, 281 F.3d at 135.

7 11 U.S.C. § 510(b).

Appellate Panel in *USA Commercial Mortgage Co.*[8] noted this problem but took Congress at its word and applied § 510(b) as written, thereby arriving at this counterintuitive result.

In *USA Commercial Mortgage Co.*, an investor filed a proof of claim asserting damages for fraud and breach of contract arising from the purchase of the debtor's LLC membership interests, and the equity committee filed an adversary proceeding to subordinate those claims.[9] In analyzing the level to which the investors' claim should be subordinated, the court determined, just as many other courts had done, that the term "common stock" does not include LLC membership interests.[10] Indeed, as the court observed, had Congress intended to include interests in alternative business entities, it could have instead used the more-expansive defined term "equity security."[11] Since the court found § 510(b) to be "plain on its face" and there is no legislative history indicating that any securities other than traditional common stock should be given special treatment, the court held that § 510(b) required the investor's claims to be subordinated "to a level beneath all membership interests."[12] The court acknowledged that the resulting "effect of subordination may be functionally equivalent to disallowance (*i.e.*, no distribution on the claims)."[13]

There is no sound policy reason for this result, which could lead to unfair outcomes. Consider an LLC with $100 million in assets that is subject to a claim based on a $200 million judgment for a securities-related claim, but that has no other material debts. Under the plain language of § 510(b), as supported by the *USA Commercial Mortgage Co.* holding, the LLC could file for bankruptcy and then distribute all of its assets to equityholders without distributing a dime to the judgment creditors.

Subordination of Claims Based on a Security of a Debtor's Affiliate

Section 510(b) also mandates subordination of securities claims related to the securities "of an affiliate of the debtor,"[14] which are supposed to be subordinated to "all claims or interests that are senior to or equal the claim or interest represented by such security."[15] When the securities at issue are those of an affiliate and not the debtor itself, the statute begs the following question: What claims *against the debtor* or interests *in the debtor* are senior or equal to the claim or interest represented by the security *issued by the affiliate* on which the claim is based?

> **Congress should amend § 510(b) to bring its language into the 21st century and remedy the patent ambiguity when applied to claims based on the securities of the debtor's affiliate.**

A debtor that sells its majority interest in an LLC pre-petition may have claims filed against it by the buyer for fraud in connection with the buyer's purchase of the LLC membership interests. Some, such as the court in *In re VF Brands Inc.*, have argued that in this situation, the starting point of the determination of the "claims or interests that are ... equal to the claim or interest represented by such security" is general unsecured claims against the debtor.[16] In *VF Brands*, the court focused on the level of priority that a fraud claim against the parent/debtor would have "[i]n the absence of [§] 510(b)," rather than focusing on the priority level of the underlying security, and therefore, the court subordinated the securities-based claim against the debtor below general unsecured claims.[17]

The district court in *In re Lehman Bros. Inc.* reached a similar result, but through a different approach. The court held that a breach-of-contract claim against the debtor, arising from the debtor's breach of its obligation to purchase bonds issued by the debtor's affiliate, was subject to § 510(b).[18] While the *Lehman Bros.* court also determined that the starting point for "claims or interests that are ... equal to the claim or interest represented by such security" should be general unsecured claims against the debtor, the court arrived at that result by focusing on the priority level of the underlying security, rather than following the approach of *VF Brands*.[19] Specifically, the court held that "because the [affiliate's] bonds are unsecured debt instruments, the most natural way to read section 510(b) is that the claim 'represented by' such unsecured debt instruments is an unsecured claim."[20]

The *Lehman Bros.* opinion did not address the treatment of claims arising from the sale of equity interests of the subsidiary; however, a court

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8 *USA Capital Realty Advisors LLC v. USA Capital Diversified Trust Deed Fund LLC (In re USA Commercial Mortg. Co.)*, 377 B.R. 608, 620 (B.A.P. 9th Cir. 2007).
9 *Id.* at 611.
10 *Id.* at 619; *see also Gilmore v. Gilmore*, 2011 WL 3874880, at *5 (S.D.N.Y. Sept. 1, 2011) (distinguishing LLC membership interests from stock); *Robinson v. Glynn*, 349 F.3d 166, 173 (4th Cir. 2003) (holding that LLC interests are not "stock" because "the term 'stock' refers to a narrower set of instruments with a common name and characteristic"); *Great Lakes Chem. Corp. v. Monsanto Co.*, 96 F. Supp. 2d 376, 389 (D. Del. 2000) (analyzing whether LLC membership interests constituted "investment contracts" because, although LLC membership interests "are 'stock-like' in nature, [they] are not traditional stock").
11 *In re USA Commercial Mortg. Co.*, 377 B.R. 618 (comparing § 510(b), as enacted, to prior version of bill that used term "equity security"); *see also* 11 U.S.C. § 101(16) (defining "equity security" as, *inter alia*, "share in a corporation, whether or not transferable or denominated 'stock,' or similar security").
12 *In re USA Commercial Mortg. Co.*, 377 B.R. 617-20.
13 *Id.* at 620.
14 11 U.S.C. § 510(b).
15 *Id.*
16 *In re VF Brands Inc.*, 275 B.R. 725, 727 (Bankr. D. Del. 2002).
17 *Id.*
18 *In re Lehman Bros. Inc.*, 519 B.R. 434, 452 (S.D.N.Y. 2014).
19 *Id.* at 450.
20 *Id.*; *see also id.* n.94 ("I do so not by looking at the type of claim asserted, but rather by looking at the type of claim represented by the security.").

applying the analysis of *Lehman Bros.* should conclude that "claims or interests that are ... equal to the claim or interest represented by such security" are equity interests in the debtor and subordinate below that level.[21] In fact, this was the position taken by the debtors in *In re Arcapita Bank B.S.C.(c)*.[22]

In *Arcapita Bank*, the debtors sought to extend the holding in *USA Commercial Mortgage Co.* and subordinate a creditor's claims, which arose from the sale of the debtors' former subsidiary, to a level below each of the debtors' other equity classes.[23] The creditor had asserted a fraud claim of $120 million against two of the debtors (the subsidiary's former parent and against that former parent's ultimate holding company), based on actions taken in connection with the sale of the subsidiary's LLC membership interests. The debtors classified the creditor's claims in a "super-subordinated" class at a level below other subordinated claims and below each of the debtors' equityholders, and the creditor objected.[24] By classifying the claims as super-subordinated claims, the debtors positioned themselves to make a distribution to equity ahead of these claims. After the conclusion of the briefing and argument, which surveyed the opinions applying § 510(b) and the inconsistent ways that the courts have backed into results, the parties settled before the court issued its opinion.[25]

Need for Amendment

The limited case law on this issue appears to focus on achieving a certain result, followed by inconsistent analyses attempting to justify the result. Therefore, case law provides little guidance as to how certain claims subject to § 510(b) should be treated in a plan or how the parties may predict the outcome of litigation as to the subordination of claims under § 510(b). The present uncertainty should be remedied by Congress.

Although the issues addressed herein do not frequently arise, it is actually for that very reason that § 510(b) needs to be amended. Given the scant case law on point, parties are faced with great uncertainty in addressing certain claims subject to § 510(b). As shown in the *Arcapita Bank* case, this uncertainty can result in a positive outcome for a debtor. However, that uncertainty is unnecessary and can be easily remedied.

First, Congress should clarify that where a securities claim relates to a residual equity interest in the debtor, the claim should be subordinated to a position that is *pari passu* with such equity in the debtor regardless of whether the interest is common stock, preferred stock, a membership interest, a limited partnership interest or any other residual interest in an entity. This is especially important given that alternatives to corporate business structures are much more commonplace today than when § 510(b) was last amended in 1984.

Second, Congress should provide clarity regarding the level of subordination for claims against a debtor arising from the securities of the debtor's affiliate. For example, if the level of a "claim or interest represented by such security" is supposed to mean the priority level of the securities as if such securities were the debtor's securities (as the *Lehman Bros.* court interpreted § 510(b)), then Congress should amend the statute to expressly say so. Alternately, Congress should expressly specify other "new" priority levels.

Conclusion

Section 510(b) is hopelessly ambiguous and unpredictable in any situation except as to claims against a debtor arising from its common stock. If the claims against the debtor arise from an interest other than common stock and/or are based on a security issued by the debtor's affiliate, then the treatment of the claims is almost guaranteed to lead to litigation. Although not addressed in the recent Final Report and Recommendations from the ABI Commission to Study the Reform of Chapter 11 in December 2014,[26] Congress should amend § 510(b) to bring its language into the 21st century and remedy the patent ambiguity when applied to claims based on the securities of the debtor's affiliate. Until then, "super-subordination" remains a very real possibility. abi

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21 Unless the equity interests in the debtor are "common stock," the resulting claims should have the same priority as that common stock.

22 *In re Arcapita Bank B.S.C.(c)* (Bankr. S.D.N.Y. Case No. 12-11076 (SHL)).

23 Confirmed Second Amended Joint Plan of Reorganization of Arcapita Bank B.S.C.(c) and Related Debtors under Chapter 11 of the Bankruptcy Code (with First Technical Modifications), *In re Arcapita Bank B.S.C.(c)* (Bankr. S.D.N.Y. Case No. 12-11076 (SHL)), Docket. No. 1265, at 14.

24 *Id.* at 14.

25 Order Authorizing and Approving Tide/Hopper Settlement, *In re Arcapita Bank B.S.C.(c)* (Bankr. S.D.N.Y. Case No. 12-11076 (SHL)), Docket No. 1721.

26 *Final Report and Recommendations of the ABI Commission to Study the Reform of Chapter 11* (Dec. 8, 2014), *available at* commission.abi.org.