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United States Court of Appeals for the Second Circuit Holds That Claims Arising from Securities of a Debtor's Affiliate Must Be Subordinated to Senior or Equal Claims of the Same Type as the Underlying Securities

On December 14, 2015, the United States Court of Appeals for the Second Circuit held that claims arising from securities of a debtor's affiliate must be subordinated to all claims or interests senior or equal to claims of the same type as the underlying securities in the bankruptcy proceeding. As a result, appellants' claims for contribution and reimbursement for losses incurred in the course of defending and settling securities fraud lawsuits brought by investors in securities issued by Lehman Brothers Inc.'s ("LBI") affiliate were subordinated to the claims of LBI's general unsecured creditors pursuant to Section 510(b) of the Bankruptcy Code. This decision, which the Court of Appeals based on precedent, textual support and legislative history, provides clarity with respect to the appropriate classification of claims in the affiliate securities context.

Background

LBI was lead underwriter for unsecured notes issued by Lehman Brothers Holdings Inc. ("Lehman Holdings"), its affiliate and parent. Between 2004 and 2008, LBI and the appellants in these cases (the "Junior Underwriters") launched 22 offerings of Lehman Holdings securities, totaling $32.4 billion. A Master Agreement Among Underwriters (the "Agreement") governed the relationship between LBI and the Junior Underwriters. The Agreement created a right of indemnification and contribution among co-underwriters for losses or liabilities resulting from securities fraud claims arising out of the offerings.

Following the bankruptcy of Lehman Holdings and the Securities Investor Protection Act ("SIPA") liquidation proceeding of LBI, investors in Lehman Holdings notes filed securities fraud lawsuits against the Junior Underwriters, alleging material misstatement and omissions in the offering documents. The Junior Underwriters stated that they incurred $78 million in the defense and settlement of those claims, and asserted claims for contribution or reimbursement against LBI, as lead underwriter of the notes. The SIPA trustee objected, arguing that the claims were subject to mandatory subordination pursuant to Section 510(b) of the Bankruptcy Code.[1] The Junior Underwriters argued that Section 510(b) could not be used to subordinate the claims in LBI's SIPA

[1] Section 510(b) of the Bankruptcy Code provides that a claim arising from rescission of a purchase or sale of a security of a debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security. 11 U.S.C. § 510(b).

proceeding because the securities were issued by Lehman Holdings, not LBI; therefore, because the securities were not part of LBI's waterfall, Section 510(b) did not apply to the Junior Underwriters' claims.

The United States Bankruptcy Court for the Southern District of New York held that the Junior Underwriters' claims must be subordinated to the claims of general unsecured creditors, reasoning that when considering affiliate securities, the claims represented by the parent securities were the claims for contribution themselves, which were general unsecured claims connected in subject matter to the underlying securities. The United States District Court for the Southern District of New York affirmed on other grounds, focusing on the type of security rather than the type of claim, and reasoning that any ambiguity in Section 510(b) lies not in whether claims based on securities of an affiliate are to be subordinated, but rather how such subordination will occur. The District Court held that unsecured, non-equity securities – like the notes at issue – represent unsecured claims. As a result, in the eyes of the District Court, claims involving such securities must be subordinated to general unsecured claims.

Decision

The Court of Appeals agreed with the reasoning of the District Court, holding that in the affiliate securities context, "the claim or interest represented by such security" in Section 510(b) means a claim or interest of the same type as the affiliate security. As a result, the Court reasoned the proper tier for the Junior Underwriters' claims for contribution against LBI is the same tier as the claims would be placed in the affiliate case of LBHI, which for the Junior Underwriters' claims would be at a level subordinated to other claims.

The Court of Appeals justified its conclusion on several bases. First, it analyzed the text of Section 510(b) of the Bankruptcy Code. While noting that the phrase "represented by" from the statute is largely unhelpful, the Court of Appeals concluded that "[i]f the security is an unsecured debt instrument, the claim that is represented by that security is a general, unsecured claim."[2] The Court of Appeals found the Junior Underwriters' construction of Section 510(b) (of the phrase "claim or interest represented by such security" as meaning claim or interest based on ownership of such security) to be too narrow, because it would operate only in two hypothetical instances: when a debtor's and its affiliate's estates are substantively consolidated in bankruptcy,[3] and when the debtor had guaranteed payment on the securities of its affiliate. The Court of Appeals declined to adopt the Junior Underwriters' narrower construction of the affiliate provision, noting both the absence of a textual hook to do so and that Second Circuit precedent suggests that the provision should be read broadly.[4]

The Court of Appeals further noted that the (albeit limited) legislative history supports a construction of Section 510(b) that reaches affiliate securities. Congress expressly included claims based on affiliate securities in drafting the statute, and expanded Section 510(b)'s reach in 1984 with the addition of claims for reimbursement and

[2] *Citing* Collier on Bankruptcy, 510.04[1] (16th ed. 2009).

[3] With respect to this hypothetical, the Court of Appeals agreed with the District Court, which stated that it is unlikely that Congress relied on substantive consolidation to provide meaning to the "affiliate" language, given that such consolidation is not explicitly provided for in the Bankruptcy Code.

[4] *See In re Med Diversified, Inc.*, 461 F.3d 251 (2d Cir. 2006).

contribution.[5] Both of these changes were meant to broaden – not narrow – the statute's reach. Finally, the Court of Appeals noted that the original enactment of Section 510(b) was motivated by an influential law review article[6] calling for reinforcement of the absolute priority rule[7] and mandatory subordination in a debtor's bankruptcy proceeding of claims alleging fraud and similar violations in the issuance of the debtor's securities. The article gave two policy rationales for subordination: the "risk-allocation rationale," which addresses the dissimilar risk and return expectations of shareholders and creditors, and the "equity cushion rationale," which addresses the reliance of creditors on the equity cushion provided by shareholder investment. The Court of Appeals stated that risk allocation, in particular, serves as an effective rationalization for subordination in situations where an affiliate's securities provide the basis for the claim, because the purchasers of the securities issued by the affiliate have taken on the risk-return expectation of investors, while the debtor's creditors have not.

Based on the above, the Court of Appeals held that claims arising from securities of a debtor's affiliate are to be subordinated to all claims or interests senior or equal to claims in the bankruptcy proceeding that are of the same type as the underlying securities (generally secured debt, unsecured debt and common stock). In reaching its decision, the Court of Appeals noted that in certain cases, a bankruptcy court may have to, for example, add tiers to the waterfall or group multiple levels of priority in order to superimpose the capital structure of the affiliate onto that of the debtor, but in doing so, indicated its belief that the Bankruptcy Court is well-suited to make such classification and determination,[8] and that its approach works in broad strokes while preserving the flexibility needed by the Bankruptcy Court.

Discussion

In interpreting the phrase "the claim or interest represented by such security" contained in Section 510(b) in the affiliate context, the Court of Appeals focused on the broad purpose of the statute. The opinion cited an Enron decision which stated: "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."[10] The Court of Appeals further stated that, in order to prevent such bootstrapping from being effected indirectly, the statute likewise subordinates claims for contribution and reimbursement based on payments made to disappointed investors.

5 The Court of Appeals cited to other decisions concluding that the reimbursement and contribution amendment was a logical extension of the original risk-allocation rationale, and that Congress intended to ensure that the risks associated with the issuance of stock and securities were placed on the underwriter, who is in a better position to evaluate such risks, as opposed to general unsecured creditors (citing *In re Mid-Am. Waste Sys., Inc*., 228 B.R. 816, 824 (Bankr. D. Del. 1999).

6 Slain & Kripke, *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).

7 The absolute priority rule provides that creditors recover in full before equity holders recover any of their investment.

8 The Court of Appeals pointed out that similar choices are made in chapter 11 reorganizations, in which bankruptcy judges determine whether securities are "substantially similar" to other securities and, as such, should be classified together.

The Junior Underwriters were unable to convince the Court of Appeals to limit the affiliate provision contained in Section 510(b). Instead, the Court of Appeals held that affiliate securities are within the reach of Section 510(b) based on the text, the legislative history, and the purposes of the statute. This decision provides some clarity for the application of Section 510(b) in an affiliate context.

[10] *In re Enron Corp*., 341 B.R. 141, 158 (Bankr. S.D.N.Y. 2006).

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