Lehman Ruling Sets Stage For Future Subordination Contests
By John Stigi and Christopher Bosch

In the case In re Lehman Brothers Holdings Inc., 855 F.3d 459 (2d Cir. 2017), the U.S. Court of Appeals for the Second Circuit affirmed a district court order subordinating the claims of former Lehman Brothers employees for undelivered equity-based compensation to those of the defunct bank's general creditors. The court determined the compensation benefits were securities that had been purchased by the former employees when they agreed to receive them in exchange for their labor and the asserted damages arose from those purchases, requiring the claims' subordination under the Bankruptcy Code. The decision is important to employees and employers weighing the value of hybrid compensation packages and creditors seeking to safeguard their priority position among bankruptcy claimants.

In Lehman, claimants received, as part of their compensation package, restricted stock units (RSUs) that gave them a contingent right to own Lehman common stock at the conclusion of a five-year holding period. However, RSUs that remained unvested when Lehman filed for bankruptcy became effectively worthless, leading affected employees holding these RSUs to feel shortchanged. Seeking relief, claimants filed proofs of claim in Lehman's bankruptcy proceeding for cash payments equivalent to the amounts previously paid to them in RSUs. Lehman in turn filed omnibus objections to the claims on the grounds that, as the claims arose from the purchase or sale of securities, 11 U.S.C. § 510(b) required that they be subordinated to the claims of Lehman's general creditors.

Section 510(b) of the Bankruptcy Code provides in part that, in bankruptcy proceedings, claims for damages arising from the purchase or sale of a security of the debtor must be subordinated to all claims or interests that are senior to or equal the claim or interest represented by the security. This section safeguards the "absolute priority rule" in bankruptcy, which holds that creditors are entitled to be paid ahead of shareholders in the distribution of corporate assets. In other words, security holders may not gain parity with creditors simply by alleging claims arising from the purchase of the securities.

The U.S. Bankruptcy Court for the Southern District of New York sustained Lehman's objections. The U.S. District Court for the Southern District of New York affirmed, and the claimants appealed to the Second Circuit.

The Second Circuit affirmed. It held that, pursuant to Section 510(b), the former employees' claims were subordinated to general creditor claims because (1) the RSUs are securities, (2) the claimants acquired them in a purchase, and (3) the claims for damages arose from those purchases.

In determining the RSUs are securities, the court turned to 11 U.S.C. § 101(49), which sets forth 15 interests that are included in the definition of "security" and seven interests that are excluded. The court explained that the inclusive list is not exhaustive and contains a residual clause that covers any "other claim or interest commonly known as 'security.'" 11 U.S.C. § 101(49)(A)(xiv). The court held that while RSUs arguably qualify as securities pursuant to one of Section 101(49)'s specific examples, they nonetheless qualify as securities pursuant to the

residual clause as they possess hallmark characteristics of securities, including voting rights, receipt of dividends, and of most significance, the "same risk and benefit expectations as shareholders." However, the court cautioned that not all RSUs are necessarily created equal, leaving open the possibility that other interests may fall outside the definition of securities under different facts.

The court then concluded the RSUs were "purchased," a term that has been construed broadly in this context to include the receipt of equity securities in exchange for labor. This "bargained-for exchange," the court affirmed, was the result of claimants' "economic decision based on rational self-interest" and therefore qualified as a purchase for purposes of Section 510(b).

Finally, the court held that the damages arose from the purchase of RSUs. The court reasoned that the asserted claims would not have arisen but for the claimants' agreement with Lehman to receive part of their compensation in RSUs, demonstrating the requisite causal link.

The claimants advanced several other arguments that the court found unpersuasive. First, the claimants argued that Lehman had an obligation alternatively to perform their obligations by paying cash in exchange for the claimants' labor because the promised RSUs never vested. However, the court held the claimants received all the compensation they were due under the governing employee incentive agreement in the form of the RSUs themselves.

Second, the claimants asserted that they are entitled to restitution since Lehman repudiated its contractual obligation to issue stock to RSU holders when it filed for bankruptcy, entitling the claimants to the reasonable value of the services they rendered to Lehman. The court held that such a claim requires a legal injury that was lacking where the RSUs the claimants were entitled to receive were no longer of value.

Finally, the claimants argued that a decision by Lehman to remove certain contractual provisions relating to RSUs that stated RSUs were to be subordinated to creditor claims in bankruptcy evinced Lehman's intent to treat RSU holders as general creditors in the event of bankruptcy. The court dismissed this argument as resting entirely on speculation.

The Second Circuit's broad interpretation of Section 510(b)'s operative terms and its focus on the comparative risk-reward expectations of RSU holders and creditors suggest that employee compensation plans tied in some manner to securities will be at the center of future bankruptcy subordination contests.

The perhaps fundamental question in these cases will be what the competing claimants bargained for. In Lehman, the employees bargained for contingent rights to receive stock on a date subsequent to an unexpected bankruptcy that rendered that future benefit valueless. While the employees were in essence paying into the bargain with their labor as they waited, they did not bargain for the receipt of concrete value in the interim period. This is distinguishable from the facts of In re American Wagering Inc., 493 F.3d 1067 (9th Cir. 2007), a case in which a financial adviser was promised a commission of 4.5 percent of the final value of a company's stock upon completion of an initial public offering. Although the financial adviser's compensation was related to equity, he in fact bargained for a cash value based upon a fixed value of equity, not the

equity itself. As a result, his claim was deemed a prepetition debt due and owing, rather than an equity claim, and therefore not subordinated.

“It is black letter law that claims are analyzed as of the date of the filing of a petition, not as of a hypothetical date in the past.”[1] As in Lehman, if a party seeking to share pari passu with creditors in bankruptcy is found to have maintained the risk-reward posture of a security holder (as that concept is broadly construed under Section 510(b)) at the moment a bankruptcy petition was filed, his or her claims will be subordinated. If, however, a claimant does not seek fulfillment of a promise for equity,[2] or converted from the “risk/return position of an equity investor” to a “fixed, pre-petition debt due and owing” prior to filing, subordination may be avoided.[3] An employee claimant’s fate in court, therefore, will rest heavily on the terms of applicable compensation agreements and prepetition actions taken with regard to the value the claimant asserts he or she is owed.

The decision in Lehman appears to reaffirm courts’ willingness to broadly construe the concepts of security, purchase and causation that are central to the claim subordination mandate of Section 510(b). The ruling has important implications for a number of potential stakeholders, including employees with similar equity-based compensation interests, employers seeking to utilize creative equity-based benefits in hybrid compensation packages, and creditors concerned with preserving the seniority of their claims in bankruptcy.

John Stigi is a partner at Sheppard Mullin Richter & Hampton LLP in the firm's Los Angeles office. Christopher Bosch is an associate in the firm's New York office.

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[1] In re Marketxt Holdings Corp., 361 B.R. 369, 389 (Bankr. S.D.N.Y. 2007)

[2] See, e.g., Am. Wagering, 493 F.3d at 1072.

[3] See In re SeaQuest Diving LP, 579 F.3d 411, 423 (5th Cir. 2009)