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Ninth Circuit Affirms Mandatory Subordination of Investor's Securities Claim in Individual Debtor's Reorganization Case

By Michael L. Cook*

This article discusses a recent U.S. Court of Appeals for the Ninth Circuit decision affirming the mandatory subordination of an investor's security claim in a debtor's reorganization, which is another example of the obstacles facing individual Chapter 11 debtors.

"[T]he claims of [an individual debtor's] general unsecured creditors are 'senior to or equal [to]'" a defrauded investor's security claim under Bankruptcy Code (the "Code") § 510(b), held the U.S. Court of Appeals for the Ninth Circuit recently in *In re Del Biaggio.*[1] The investor ("F") had filed a claim against the debtor based on his wrongful failure to fund, through his affiliated limited liability company ("LLC"), his share in an acquisition venture with F. The Ninth Circuit affirmed the lower courts' effective "superimpos[ing]" of the "capital structure [of the debtor's affiliate] . . . on the debtor to determine the correct level of priority."[2]

F's claim was thus rooted in damages he sustained by the conduct of LLC, the debtor's affiliate. The court relied heavily on a recent U.S. Court of Appeals for the Second Circuit decision, *In re Lehman Bros. Inc.*,[3] which found that "claims arising from securities of a debtor's affiliate should be subordinated" to all other "senior or equal" claims in debtor's bankruptcy case.

RELEVANCE

Bankruptcy Code § 510(b) provides in relevant part that "a claim . . . for damages arising from the purchase or sale of . . . a security [of the debtor] *or of an affiliate of the debtor* . . . shall be subordinated to *all claims or interests* that are *senior to or equal to the claim* . . . represented by such security."[4] As the

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1 *Liquidating Trust Comm. of the Del Biaggio Liquidating Trust v. Freeman (In re Del Biaggio*), 2016 U.S. App. LEXIS 15645 (9th Cir. Aug. 22, 2016).

2 *Id.*

3 808 F.3d 942, 946 (2d Cir. 2015).

4 Emphasis added.

Second Circuit noted, "[e]very other court that has applied § 510(b) to claims based on affiliate securities—when the debtor was a corporate entity—has required subordination."[5] According to the U.S. Court of Appeals for the Fifth Circuit in *American Housing*, § 510(b) "serves to effectuate one of the general principles of corporate and bankruptcy law: that creditors are entitled to be paid ahead of shareholders in the distribution of corporate assets."[6] This mandatory subordination clause "applies whether the securities were issued by the debtor *or by an affiliate of the debtor*."[7] Thus, "claims arising from equity investments in a debtor's affiliate should be treated the same as equity investments in the debtor itself—i.e., both are subordinated to the claims of general creditors."[8]

Del Biaggio, unlike *Lehman* and *American Housing*, is an individual debtor case. The Ninth Circuit's Bankruptcy Appellate Panel ("BAP"), an intermediate appellate court composed of three bankruptcy judges, had previously found that "§ 510(b) was ambiguous as to whether the law applies to individual debtors," holding "that applying the statute to individual debtors was outside of Congress's intent."[9] As shown below, though, the Ninth Circuit was "not persuaded,"[10] stressing that F held "a damages claim"; his "investments are securities"; and that the parties' investment entity "is an affiliate."[11]

FACTS

F and the debtor had originally been part of a group to acquire a professional hockey team. The group's acquisition vehicle was known as "Holdings," and the debtor agreed to invest in Holdings through LLC, his wholly-owned affiliate. F learned later that the debtor "never had the funds to support his [promised] guarantees and that the [funds the debtor] already invested was in fact money he had embezzled from his clients."[12]

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[5] 808 F.3d at 950, citing, among others, *Templeton v. O'Cheskey (In re Am. Hous. Found.)*, 785 F.3d 143 (5th Cir. 2015) (creditor's guaranty claim "arising from equity investments in a debtor's affiliate should be treated the same as equity investments in the debtor itself—i.e., . . . subordinated to the claims of general creditors").

[6] 785 F.3d at 153.

[7] *Id.* (quoting 4 COLLIER ON BANKRUPTCY ¶ 510.04[4] (16th ed. 2014) (emphasis added)).

[8] *Id.*

[9] *In re Del Biaggio,* 2016 U.S. App. LEXIS 15645, at *13 (citing *Khan v. Barton (In re Khan)*, 523 B.R. 175, 183 (B.A.P. 9th Cir. 2014)).

[10] 2016 U.S. App. LEXIS 15645, at *14.

[11] *Id.* at *9.

[12] *Id.* at *5.

F then charged the debtor with fraud for misrepresenting his ability to invest about $40 million in equity through LLC and to pay part of the cost of debt financing. After defaulting on his obligations to Holdings, the debtor later filed a Chapter 11 petition and was convicted "for various financial frauds and sentenced to an eight-year prison term."[13]

F "filed a general unsecured claim against [the debtor's] bankruptcy estate seeking damages of an undetermined amount arising from [the debtor's] fraud in the [proposed investment] transaction," later seeking "damages of $38,632,075," which included his own "initial $31-million investment . . . the $5 million of subordinated debt he [had been forced to issue] to [the investment company] . . . and the $2,632,075 paid in [a capital call]." In response, the liquidating trust for the debtor's estate sought subordination and disallowance of F's claim, relying on Code § 510(b).

The district court affirmed the bankruptcy court's subordination of F's claim. Both courts relied on the "plain language of the statute"; F's "investor" status in bargaining "for both a greater share of profits and a greater share of risks" than the debtor's unsecured creditors; and the "conclusion that notes or shares issued by a subsidiary create no claim to the assets of a parent."[14]

ANALYSIS

According to the Ninth Circuit, F's "damages claim is clearly one 'arising from' the sale or purchase of securities in Holdings."[15] His "claim is really no claim at all but for his investment in Holdings." Nor did the court have to review the statute's legislative history, for the language was clear.[16] Finally, because "Congress included within § 510(b)'s ambit claims arising from the purchase of the securities of an *affiliate* of the debtor," it would be inequitable to allow F's investor claim "to stand on par with" the debtor's unsecured creditors.[17] Section 510(b) is thus "not limited to corporate debtors."[18] Regardless of the nature of F's claim—an affiliate's security or a claim represented by that security—under "any legitimate reading of § 510(b), the

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[13] *Id.*

[14] *Id.* at *7.

[15] *Id.* at *11.

[16] *Id.* at *14.

[17] *Id.* at *15–16 (emphasis in original).

[18] *Id.* at *19.

claims of [the debtor's] general unsecured creditors are 'senior or equal [to]' [F's] claim."[19]

COMMENT

Del Biaggio is one more example of the obstacles facing individual Chapter 11 debtors. Although F's claim was subordinated to the claims of the debtor's unsecured creditors, it may still be valid, meaning that, in at least five Circuits, the debtor must still pay that claim in full, to the extent valid, before retaining any of its property. These Circuits, plus "a sizeable majority of the district, bankruptcy appellate and bankruptcy courts," have agreed that "the absolute priority rule continue[s] to apply in Chapter 11 reorganizations . . . ."[20] In short, creditors still have the better hand in individual Chapter 11 cases.

Aside from the individual debtor issue, *Del Biaggio*'s reasoning is consistent with that of other Circuits, including *Lehman*.[21]

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[19] *Id.* at *26–27.

[20] *Zachary v. Cal. Bank &Trust*, 811 F.3d 1191 (9th Cir. 2016); *accord Maharaj v. Stubbs & Perdue, P.A. (In re Maharaj)*, 681 F.3d 558, 563, 575 (4th Cir. 2012); *Ice House Am., LLC v. Cardin*, 751 F.3d 734, 740 (6th Cir. 2014); *In re Lively*, 717 F.3d 406, 410 (5th Cir. 2013); *Dill Oil Co. v. Stephens (In re Stephens)*, 704 F.3d 1279, 1287 (10th Cir. 2013).

[21] *See, e.g.*, *Rombro v. Dufrayne (In re Med Diversified Inc.)*, 461 F.3d 251, 255, 259 (2d Cir. 2006); *Templeton v. O'Cheskey (In re Am. Hous. Found.)*, 785 F.3d 143 (5th Cir. 2015); *In re THC Fin. Corp.*, 679 F.2d 784, 786 (9th Cir. 1982).