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Alert

Fifth Circuit Subordinates Claim for Deemed Dividends

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"… [P]ayments owed to a shareholder by a bankrupt debtor, which are not quite dividends but which certainly look a lot like dividends, should be treated like the equity interests of a shareholder and subordinated to claims by creditors of the debtor," held the U.S. Court of Appeals for the Fifth Circuit on Sept. 3, 2019. *In re Linn Energy, LLC*, 2019 WL 4149481 (5th Cir. Sept. 3, 2019). According to the court, subordination of a purported creditor's claims "was appropriate" when "deemed dividends gave the [creditor] benefits normally reserved for equity investors." Affirming the lower courts, the Fifth Circuit found the creditor-shareholder's claim to be for "damages" involving "securities," "aris[ing] from" a "purchase or sale" and having a "nexus with those securities." Because the estate had "limited assets," the "subordination order effectively gutted the [creditor-shareholder's] chances to receive any money." *Id.* at *2.

Relevance

Courts have broadly interpreted the nature and scope of claims arising from the purchase or sale of a security under Bankruptcy Code ("Code") § 510(b). That section provides in relevant part as follows: "a claim arising from the rescission of a purchase or sale of a security of a debtor or of an affiliate of a debtor, [or] for damages arising from the purchase or sale of such security … shall be subordinated to all claims or interests that are senior or equal to the claim or interest represented by such a security, except that if such security is common stock, such claim has the same priority as common stock." Code § 510(b) thus "mandates subordination of 'a claim … for damages arising from the purchase or sale of … a security [of the debtor].'" *In re Med. Diversified, Inc.*, 461 F.3d 251, 253 (2d Cir. 2006). Courts typically ask whether the claim in question has a "nexus" with the purchase or sale of a security. *In re Am. Hous. Found.*, 785 F.3d 143, 155 (5th Cir. 2015); *In re Telegroup Inc.*, 281 F.3d 133, 138 (3d Cir. 2002). On that basis, appellate courts routinely subordinate the claims of "those who conclude the bargain to become investors or shareholders …." *Id.*, at 257.

Facts

The shareholder claimant in *Linn*, "C," received "deemed dividends, … akin to settlement payments whose amount was tethered to the value of" distributions paid to other shareholders of the debtors and their predecessors. C's interest originated with shares he inherited in 1930, a later 1986 settlement and a later 2013 transaction in which the debtors "purportedly promised to undertake and continue" the payment of deemed dividends to C. When the payments stopped, the parties litigated during 2014 and 2015, with C asserting "tort claims [for] misrepresentation, elder abuse, and breach of fiduciary duty." 2019 WL 4149481, at *2.

The debtors filed Chapter 11 petitions in 2016. C "filed claims for almost $10 million in unpaid deemed dividends." *Id.* The lower courts subordinated C's claims.

The Fifth Circuit

The "policy goals of [Code §]510(b) are clear, but applying the statute is more complex," said the court. *Id.*, at *4. In its view, "the deemed dividends gave [C] benefits normally received for equity investors …." "Policy goals" thus helped drive the court's interpretation and application of the law to the "particular facts" here. *Id.*, citing *Am. Hous. Found.*, 785 F.3d at 154-55 (policy goals of the statute support subordination).

Damages. The Code does not define "damages," but the term connotes, in the context of § 510(b), "some recovery other than the simple recovery of an unpaid debt due upon an instrument." *Am. Hous. Found.*, 785 F.3d at 154. Because C was seeking compensation "for fraud or breach of fiduciary duty," his claims for damages fell within the scope of § 510(b). 2019 WL 4149481, at *4. In fact, C argued that "its interest ... is more akin to a creditor's contractual right to payment than the equity interest of an investor." *Id.* C thus sought "damages within the meaning of the … Code." *Id.*

Securities of the Debtor. The Fifth Circuit rejected C's argument that its "interest in receiving dividend payments" and "deemed dividend payments" did not constitute a "security." According to the court, "the deemed dividend interest owned by [C] is a security interest under the residual clause of" the Code's definition of a "security": "if a claimant's interest does not fit any of the specific examples provided in the Code and is not explicitly excluded from the definition of 'security,' it will be considered a security if it is any 'other claim or interest commonly known as 'security.'" *Id.* at *5, citing Code § 101(49)(A)(xiv). Interests are therefore securities if they "bear hallmarks of interests commonly known as securities." *Id.*, quoting *Lehman Bros. Holdings, Inc.*, 855 F.3d 459, 475 (2d Cir. 2017). When a claimant "ha[s] the same risk and benefit expectations as shareholders," it holds a security, regardless of the form of the equity interest. *Id.*

C "held greater financial expectations than that of a creditor during his lifetime. The upside of his deemed dividend payments was theoretically limitless, as it tracked the value of the corporation. Further, because he risked receiving nothing at all if the corporation went bankrupt or if the corporation chose not to issue dividends, [C] faced many of the same risks as a traditional shareholder." 2019 WL 4149481, at *5. Treating C's interests "as securities comports with the broad reading courts have given Section 510(b)." *Id*., citing *Lehman Bros.*, 855 F.3d at 474. In short, "the deemed dividends only entitled [C] to receive profits whenever shareholders of [the debtor] were receiving profits." *Id.*

Purchase or Sale of a Security. But for the 1930 stock bequest to C and the later 1986 and 2013 transactions, C "would not have a right to demand the deemed dividends in the bankruptcy" case here. Id. at *6. "Each of those transactions counts as a purchase or sale … of securities of the Debtors." *Id.* "[S]ome nexus or causal relationship" thus existed between C's claims and, at the very least, the 2013 transaction. *Id.*, citing *Am. Hous. Found.*, 785 F.3d at 155.

Applying the policies underlying Code § 510(b), C's claims sought "to recover a portion of [C's] equity investment." *Id.* Although the deemed dividend payments due C did not "fit perfectly in the investor box," C's interest "was certainly more like an investor's interest than a creditor's interest." *Id.* C's claim could therefore not be treated at the same level as creditors' claims. To do so "would undermine the … Code's absolute priority rule." *Id.*, at *7.

Comments

Linn is consistent with relevant decisions in other circuits. "Section 510(b) is to be construed broadly because it is a remedial statute intended 'to prevent shareholders from changing their claims into creditors'.'" *In re Med. Diversified, Inc*., 461 F.3d 251, 254 (2d Cir. 2006).

Some courts, though, struggle with the broad reading of § 510(b). For instance, the Ninth Circuit recently held that a claim based on a judgment arising from the debtors' conversion of the claimant's stock was not subject to subordination under § 510(b). *In re Khan*, 846 F.3d 1058 (9th Cir. 2017) (2-1). According to the majority in *Khan*, the claimant's judgment for money damages "has nothing to do with his investment, other than the fact that he had purchased the now-purloined securities many years earlier." *Id.*, at *1064. Despite a "broad interpretation" by courts, "there is a limit to the reach of § 510(b), which stops short of encompassing every transaction that touches on or involves stock in a corporation." *Id.* Still, the Ninth Circuit acknowledged its "broad interpretation" of § 510(b) in *In re Del Biaggio*, 834 F.3d 1003, 1009 (9th Cir. 2016), but stressed the claim there was based on an "investment" and "the amount … invested."

A Delaware district court also held that an employee's contractual claim was not an "equity interest subject to subordination" under Code § 510(b) and affirmed the bankruptcy court's refusal to subordinate it. *In re Cybersight LLC*, 2004 WL 2713098 (D. Del. 2004). The creditor was an employee of the debtor who had bought a 1.5% membership interest in the debtor LLC. After his employment was terminated in 1999, the debtor was "obligated to" buy his equity interest at its fair market value under the terms of the debtor's LLC agreement. To determine the fair market value of that equity interest, the parties entered into an arbitration, where the creditor received an award of $1.291 million, which was confirmed by a state court judgment on March 26, 2001. The debtor later filed a Chapter 11 petition more than a year later, on April 5, 2002. Most important, according to the court, the creditor's "equity stake in the [debtor] extinguished pre-petition and with it [the creditor's] ability to participate in any of [the debtor's] profits or losses." *Id.*, at *3. In short, the employee creditor's "former equity interest … has been converted into a fixed debt obligation." *Id.*, at *4 n.2.

The Ninth Circuit had earlier denied a request to subordinate a financial adviser's claim for pre-bankruptcy services when his compensation was tied to the value of the debtor's stock. *In re Am. Wagering*, 493 F.3d 1067 (9th Cir. 2007). According to the Ninth Circuit, the financial adviser was never a shareholder. Rather, the debtor's stock value was simply the basis for calculating his compensation. *Id.*, at 1073.

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