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Alert

Second Circuit Affirms Mandatory Subordination of Underwriters' Contribution and Reimbursement Claims

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"Claims arising from securities of a debtor's affiliate should be subordinated" to all other "senior or equal" claims in the debtor's bankruptcy case, held the U.S. Court of Appeals for the Second Circuit on Dec. 14, 2015. *In re Lehman Brothers Inc.*, 2015 WL 8593604, at *3 (2d Cir. Dec. 14, 2015). Relying on Bankruptcy Code ("Code") Section 510(b), the Second Circuit affirmed the lower courts' mandatory subordination of contribution and reimbursement claims asserted by junior underwriters "held to account for the … losses" incurred by holders of notes issued by the debtor's affiliate and parent, Lehman Brothers Holdings Inc. ("Holdings"), a Chapter 11 debtor. Lehman Brothers Inc. ("LBI"), the debtor here, was the lead underwriter of its affiliate's notes and was the subject of a liquidation under the Securities Investor Protection Act of 1970 ("SIPA"), "essentially a bankruptcy liquidation." *Id.* at n.2, quoting *In re Adler Coleman Clearing Corp.*, 195 B.R. 266, 269 (Bankr. S.D.N.Y. 1996). In short, the court rejected the underwriters' argument that "because the … [affiliated parent's] securities were not … part of LBI's waterfall, § 510(b) did not apply to [their] claims." *Id.* at *2. "[I]n the affiliate securities context," reasoned the court, "the claim … represented by" a security that must be subordinated "means a claim … of the same type as the affiliate security." *Id.* at *3.

Relevance

According to the Second Circuit, "[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." *Id.* at *6, citing, among others, *In re Am. Hous. Found.*, 785 F.3d 143 (5th Cir. 2015) (creditors' 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"). Code Section 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* … or for reimbursement or contribution … shall be subordinated *to all claims or interests that are senior to or equal to the claim* … represented by such security" (emphasis added).

According to the Fifth Circuit in *American Housing Foundation*, Section 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." *Id.* at 153, quoting *In re American Wagering Inc.*, 493 F.3d 1067, 1071 (9th Cir. 2007). This mandatory subordination clause "applies whether the securities were issued by the debtor *or by an affiliate of the debtor*." *Id.*, quoting A. Resnick & H. Sommer, 4 *Collier on Bankruptcy* ¶ 510.04 [04] (16th ed. 2014) (emphasis added). 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." *Id.*

In *Lehman*, the underwriters' contribution and reimbursement claims were deemed to have arisen out of the noteholders' purchase of securities (notes) issued by LBI's parent/affiliate, Holdings.

Facts

The facts in this case "are undisputed." 2015 WL 8593604, at *3. Between 2004 and 2008, LBI was the lead underwriter for 22 offerings of Holdings securities totaling $32.4 billion. A December 2005 Master Agreement between LBI and the junior underwriters governed their relationship and "created a right of contribution among [them] for losses or liabilities resulting from securities fraud claims arising out of the [Holdings] offerings." *Id.* at *2.

After Holdings sought Chapter 11 relief and LBI commenced its SIPA case in September 2008, "investors in … [Holdings] notes" sued the junior underwriters for securities fraud, "alleging material misstatements and omissions in the offering documents." They did not sue LBI, however, because of its pending SIPA case. According to the junior underwriters, "they collectively incurred almost $78 million in the defense and settlement of" the claims asserted by the Holdings investors. As a result, the junior underwriters filed general creditor claims against LBI in its SIPA case, asserting "rights to contribution for their losses" under the terms of their agreement with LBI and under the Securities Act of 1933. The SIPA Trustee objected to the claims, asserting that they "were subject to mandatory subordination" under Code Section 510(b). *Id.*

The underwriters argued that their claims shouldn't be subordinated "because the securities were issued by LBI's *parent*, rather than LBI." *Id.* (emphasis in original). They conceded that Section 510(b) "expressly applies to securities issued by 'affiliate[s],' and that it requires … such claims [to] 'be subordinated to all claims … that are senior to or equal the claim[s] … represented by such securit[ies].'" *Id.* They argued, however, that their claims were not based on their ownership of Holdings securities and that LBI owned no securities issued by Holdings. "In other words, … because the … Holdings-issued securities were not otherwise part of LBI's waterfall, § 510(b) did not apply to" the contribution claims they asserted against LBI.

The bankruptcy court rejected their arguments, and ordered the underwriters' claims to be subordinated to the claims of LBI's other unsecured creditors. It reasoned that the contribution "claim[s] … represented by" the Holdings securities were "general unsecured claims, connected in subject matter to the underlying securities." *Id.*, quoting 503 B.R. at 784-85, 787.

The district court affirmed on a different ground. Instead, it "focused on the type of security rather than on the type of claim," reasoning that "any ambiguity in the [Code] lies not in *whether* claims based on securities of an affiliate are to be subordinated but *how* that subordination is to occur." *Id.*, quoting 519 B.R. at 449-51 (emphasis in original). The district court thus held that "unsecured, non-equity securities [— like the notes issued by Holdings —] … represent unsecured claims, meaning that claims involving such securities must be subordinated to [other] general unsecured claims." With affiliate securities, reasoned the district court, "the type of security dictates the level of subordination whether or not that security represents an actual claim in the debtor's case." *Id.*

The Second Circuit

Adopting the district court's analysis, the Second Circuit agreed with the subordination of the underwriters' contribution claims. Because the claims arose from the affiliate's issuance of the security (i.e., the notes), the underwriters' unsecured contribution claims were "of the same type as the underlying securities" issued by Holdings, LBI's affiliate. *Id.* at *3.

Applying the terms of Section 510(b), the court also found that the contribution claims asserted by the underwriters are "represented by such security." *Id.* It explained that "[i]f the security is an unsecured debt instrument, the claim that is represented by that security is a general unsecured claim." *Id.*, quoting 4 *Collier on Bankruptcy* ¶ 510.04[1] (16th ed. 2009). Because "claims relating to affiliate securities … are expressly included" in Section 510(b), subordination here was mandatory. The court thus rejected the underwriters' argument that "the phrase 'claim … represented by such security' [must] mean a claim … *based on ownership of* such security in this' case." *Id.* at *4 (emphasis in original).

The legislative history of Section 510(b), said the court, further supported its analysis. First, "Congress expressly included claims based on affiliate securities." *Id.* Also, "Congress further expanded § 510(b)'s reach in 1984, with the addition of claims for reimbursement and contribution." *Id.* Finally, case law in the Second Circuit and elsewhere "endorses a 'broad' interpretation of" Section 510(b). *Id.* at *5, citing *In re Med Diversified, Inc.*, 461 F.3d 251, 255, 259 (2d Cir. 2006); *In re Telegroup, Inc.*, 281 F.3d 133, 135-36 (3d Cir. 2002).

In sum, the securities of Holdings, the debtor's affiliate, provided "the basis for the claim[s] asserted by the Underwriters." *Id.* at *6. "Congress has already determined that" the "risk-allocation rationale" [i.e., the different risk and return expectations of investors and creditors] supported the subordination of the underwriters' unsecured contribution claims here.

Comment

The *Lehman Brothers* decision is consistent with the Second Circuit's own precedent and decisions by other federal courts of appeals. At bottom, the underwriters' contribution claim is rooted in the losses sustained by noteholder investors in the debtor's affiliate. *Med Diversified*, 461 F.3d at 246 (claims subordinated; issue was "whether a claim for fraudulent inducement and breach of contract for failure to issue common stock in the debtor in exchange for the plaintiff's shares in another company was one 'arising from' an agreement to purchase or sell a security"; reading "arising from" broadly, *held* claimant took on "risk and return expectations of a shareholder" because he "bargained not for cash but to become a stockholder in the debtor"); *Telegroup*, 281 F.3d at 142 (claims subordinated; arose from breach of agreement to use best efforts to register stock; claimants were "equity investors seeking compensation for a decline in the value of" the debtor's stock; although claimants never intended to buy a long-term stake in debtor, claims subordinated because "claimants retained the right to participate in corporate profits" of debtor; Code Section 510(b) prevents claimants from using breach of contract claim to recover value of equity investment "in parity with general unsecured creditors"); *In re Geneva Steel Co.*, 281 F.3d 1173, 1180 (10th Cir. 2002) (subordinated claim for fraud; shareholder deceived into holding and not selling his securities; claimant sought to shift losses onto creditors; fraudulent retention claim based on "a risk only the investors should shoulder"); *In re Betacom of Phoenix, Inc.*, 240 F.3d 823, 830 (9th Cir. 2001) (subordinated claim arising from breach of obligation to deliver stock under merger agreement; "investors and creditors have different expectations"; investor has "greater financial expectations" than a creditor).

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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