ALERTS

Second Circuit Affirms Dismissal of Debtor's Attempted Subordination of Former Corporate Parent's Claim

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The U.S. Court of Appeals for the Second Circuit recently dismissed a corporate debtor's attempt to subordinate its former corporate parent's contract damage claim on the ground that it was a securities fraud claim. *CIT Group Inc. v. Tyco Int'l., Inc. (In re CIT Group Inc.)*, 2012 WL 3854887 (2d Cir. Sept. 6, 2012), *affirming* 460 B.R. 633 (Bankr. S.D.N.Y. 2011). When dismissing the debtor's subordination complaint, the bankruptcy court had found that the former parent's claim was *not*, as the debtor had asserted, a securities fraud claim falling under Bankruptcy Code ("Code") § 510(b) ("for damages arising from the purchase or sale" of the debtor's securities). *Id.*, at *1. The Court of Appeals essentially agreed with the bankruptcy court that the former parent's tax sharing agreement with the debtor was not "an equity interest," but "rather a creditor claim." *Id.*, at *2. In sum, reasoned the court, the former parent never assumed the risks of a shareholder.

Background

Bankruptcy Code § 510(b), entitled "Subordination," automatically subordinates, in relevant part, securities fraud claims for rescission, damages, or reimbursement or contribution: "[f]or the purpose of distribution . . ., a claim arising from rescission of a purchase or *sale of a security of the debtor* or of an affiliate of the debtor, [or] *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 to the

claim or interest represented by such security." [Emphasis added.] Thus, any other claims or interests "senior or equal to" the claim represented by the security will prime the securities fraud claim.

A purchaser of securities from the debtor who has been defrauded will typically try to bootstrap its claim so as to be treated like other creditors in a bankruptcy case. When enacting Code § 510(b), however, Congress allocated the risk of an illegal securities offering to the purchasers rather than to creditors, requiring automatic subordination of these claims. *See* H. R. Rep. No. 595, 95th Cong., 1st Sess. 195 (1977).

Facts

The former parent and the debtor subsidiary ("CIT") had entered into a tax agreement years prior to bankruptcy in the context of an initial public offering ("IPO") of all of the debtor's common stock. *Id.*, at *1. Among other things, the parent agreed to indemnify the debtor subsidiary against any tax burdens arising from the debtor's pre-IPO merger with an affiliate, while the debtor subsidiary had agreed to repay the corporate parent for the debtor's use of an affiliate's tax benefits to offset taxable revenues. As part of the consummated IPO, the corporate parent had, of course, given up any "direct or indirect equity interest in" the debtor. During its later Chapter 11 reorganization, CIT rejected the tax sharing agreement with its former parent under Code § 365(a). The parent then filed a damage claim under Code § 365(g) for the debtor's breach of that agreement.

Procedural Summary

The debtor sued its former parent, seeking a judgment subordinating the parent's claim to that of other creditors, relying on Code § 510(b), alleging that the parent's claim was a "claim . . . for damages arising from the purchase or sale" of the debtor's shares, and was thus subject to subordination. After the bankruptcy court granted the former parent's motion for summary judgment dismissing the debtor's subordination complaint, the bankruptcy court, at the debtor's request, certified a direct appeal to the Second Circuit.

The Court of Appeals

The court summarily affirmed the bankruptcy court, "substantially for the reasons stated in its thoughtful and comprehensive Dec. 21, 2011"

decision. *Id.*, at *2. First, "the purpose of [Code §] 510(b) was to prevent disfavored equity claims in bankruptcy from being disguised as higher-priority creditor claims." *Id.*, at *1. In an earlier case, *In re Med Diversified*, 461 F.3d 251, 256 (2d Cir. 2006), the court said that claims should be subordinated if the claimant "(1) took on the risk and return expectations of a shareholder, rather than a creditor, or (2) seeks to recover a contribution to the equity pool presumably relied upon by creditors in deciding whether to extend credit to the debtor." Applying the reasoning of *Med Diversified*, the bankruptcy court in *CIT* agreed that "the Tax Agreement has a nexus to the issuance of the stock in the IPO in that both were agreed to in connection with the spinoff of [the debtor] from [its former corporate parent]." 460 B.R. at 639. Nevertheless, the existence of a "mere 'connection' between the claim and the purchase or sale of a security [was] not enough to support a finding that the claim 'arises from' the purchase or sale and should be subordinated unless the purposes of the statute would be served thereby." *Id.*, at 639. Because it found that the Tax Agreement was not an equity interest in the debtor, "but rather a creditor claim," the court declined to subordinate the claim. *Id.*, at 644.

Finally, explained the bankruptcy court, "there is nothing inherent in an inter-affiliate tax agreement that would justify treating [the former parent's] interest like equity. In general, tax sharing agreements are enforced in bankruptcy and create contractual debtor-creditor relationships." *Id.*, at 642 (citations omitted).

Comment

1. The *CIT* decision follows not only the reasoning of the "leading case and only published decision of the Second Circuit," *Med Diversified*, 460 B.R. at 637, but also rulings in other circuits. In *Med Diversified*, in contrast, the 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." 461 F.3d at 255. Reading the words "arising from" broadly, the court found that the claimant in *Med Diversified* had taken on the "risk and return expectations of a shareholder" because he "bargained not for cash but to become a stockholder in the debtor . . . ." *Id.*, at 256. Although the debtor in *Med Diversified* never issued any stock to the plaintiff, "Congress and the courts have clearly elevated the issue of risk . . . to the fore," requiring subordination of the plaintiff's claim under Code § 510(b). *Id.*, at 259.

Accord, In re Telegroup, Inc., 281 F.3d 133, 142 (3d Cir. 2002) (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 § 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 because "investors and creditors have different expectations;" investor has "greater financial expectations" than a creditor).

2. *CIT* is also consistent with decisions of other courts holding Code § 510(b) *not* applicable. *See*, e.g., *In re Nations Rent, Inc.*, 381 B.R. 83, 92 (Bankr. D. Del. 2008) (claims not for "damages . . . arising from or caused by fraud, a securities [law] violation or . . . in connection with the issuance of stock;" claimants *not* "investors," but were seeking "bargained for sales price."); *In re Direct TV Latin Am., LLC*, 2004 WL 302303, *4, *11 (D. Del. 2004) (no subordination of claim arising from membership interest put agreement when value of put tied to arbitrary number, not debtor's enterprise value; claimant had no right to participate in management or any other indicia of share ownership; claimant never sought "equity interest" in debtor). To paraphrase Freud, sometimes a claim is just a claim.

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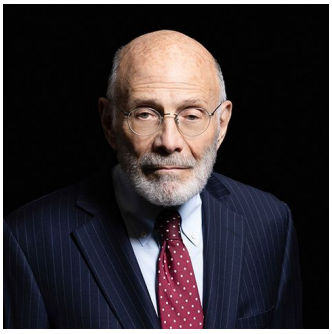

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