ALERTS

Second Circuit Affirms Mandatory Subordination of Employees' Securities Claims

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Claims held by employees of a Chapter 11 debtor based on "restricted stock units ('RSUs') … must be subordinated [under Bankruptcy Code § 510(b)] to the claims of general creditors because … (i) RSUs are securities, (ii) the claimants acquired them in a purchase, and (iii) the claims for damages arise from those purchases or the asserted rescissions thereof," held the U.S. Court of Appeals for the Second Circuit on May 4, 2017. *In re Lehman Brothers Holdings, Inc.*, 2017 U.S. App. LEXIS 7920, *6 (2d Cir. May 4, 2017). Affirming the lower courts, the Second Circuit stressed that the "claims asserted here … would not have arisen but for the claimants' agreement with [the debtor] to receive part of their compensation in the form of RSUs." *Id.* at *35.

"[C]orporate employers [often] compensate their high-ranking employees not only with cash, but also with equity in the [c]orporation. Such arrangements align the employees' financial incentives with those of the company: If the company succeeds, so too do its stakeholding employees; but if the company falters — even to and beyond the point of bankruptcy — its employees bear some of the loss." *Id.* at *4. The debtor here, had, in fact, "adopted this approach, compensating many of its employees in part with [RSUs], which gave them a contingent right to own [the debtor's] common stock at the conclusion of a five-year holding period. The holder of an RSU had risk and return expectations similar to those of a shareholder; he or she would ultimately benefit from any increase in the stock price or suffer from any decline." *Id.*

Relevance

Courts have broadly interpreted the nature and scope of claims arising from the purchase or sale of a security under Code § 510(b). Section 510(b) provides in relevant part that "a claim arising from the rescission of a purchase or sale of a security of a debtor or of an affiliate of the 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." The Code thus "mandates subordination of 'a claim … for damages arising from the purchase or sale of … 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). As the Second Circuit had previously explained, "Section 510(b) is to be construed broadly because it is a remedial statute intended 'to prevent shareholders from changing their claims into creditors' claims.'" *In re Med. Diversified, Inc.*, 461 F. 3d at 254. In "enacting § 510(b), Congress focused on the problem of claims alleging fraud or other violations of law in the issuance of the debtors' securities." *Id.* at 256. "Section 510(b) thus represents a Congressional judgment that, as between shareholders and general unsecured creditors, it is shareholders who should bear the risk of illegality in the issuance of stock in the event the issuer enters bankruptcy." *Id.*, quoting *In re Telegroup Inc.*, 281 F. 3d at 141. According to the Second Circuit, appellate courts uniformly subordinate the claims of "those who conclude the bargain to become investors or shareholders … ." *Id.* at 257.

More recently, the Second Circuit reaffirmed that Code § 510(b) confines "claims which are in essence claims corresponding to ownership of securities (debt or equity) … to their proper tier of the waterfall … ." *In re Lehman Brothers Inc.*, 808 F. 3d 942, 944 (2d Cir. 2015). Noting that § 510(b) "should be read 'broadly,'" the court affirmed the subordination of claims arising from securities of the debtor's *affiliate*. *Id.* at 950-51 (emphasis added).

Some courts, however, still struggle with the broad reading of § 510(b). For instance, the Ninth Circuit recently held that a claim based on the debtors' conversion of the claimant's stock was not subject to

subordination under § 510(b). *In re Khan*, F.3d 1058 (9th Cir. 2017) (2-1). According to the majority in *Khan*, the claimant's demand 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.

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 (Del. 2004). The creditor was an employee of the debtor who had bought a 1.5-percent 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 [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 also 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.

Analysis

The Second Circuit discarded as unnecessary part of the bankruptcy court's holding in *Lehman Brothers* that "the claimants may assert only proofs of interest — not proofs of claim ... ." 2017 U.S. App. LEXIS 7920, at *13. Still affirming the result below, the Court of Appeals narrowed its holding to mandate subordination "pursuant to section 510(b)." *Id.* at *15.

RSUs as Securities

According to the court, each RSU is a "security" under Code § 101(49), quoting the bankruptcy court's explanation: "a grant of an RSU constitutes a contingent right to participate in, receive [or] purchase [the debtor's] common stock … once certain employment-related conditions have been satisfied." *Id.* at *26, quoting 519 B.R. at 60. Moreover, reasoned the court, "these RSUs bear many of the hallmark characteristics of a security. Like many security holders, the RSU holders had limited voting rights and received any declared dividends in the form of additional RSUs. And of most significance, they had the same risk and benefit expectations as shareholders because the value of their RSUs was tied to the value of [the debtor's] common stock." *Id.* at *27. Unlike a creditor that can only recover its investment, "an RSU holder 'expect[ed] to participate in firm profits.'" *Id.*, quoting *Med Diversified* at 461 F.3d at 257.

Purchase of Security

Because the debtor "awarded the claimants the RSUs as compensation for their labor," reasoned the court, they received the RSUs through a "purchase or sale," as required by Code § 510(b). Indeed, the term "purchase" in § 510(b) "is properly construed broadly to include circumstances where a claimant has received equity securities in exchange for labor." *Id.* at *29. Here, the "claimants 'purchased' RSUs within the meaning of section 510(b) by agreeing to receive them, in lieu of cash, in exchange for a portion of their labor." *Id.* "By agreeing to work for [the debtor], the claimants voluntarily accepted that [the debtor] had the discretion to pay part of their total compensation in RSUs." *Id.* at *30.

Arising From the Purchase of the Security

Because the claims here were "claims for damages arising from the purchase of a security," as required by Section 510(b), regardless of how the claimant characterize them, the claims "arise … from a securities transaction so long as the transaction is part of the causal link leading to the alleged injury." *Id.* at *34, citing *Med Diversified*, 461 F.3d at 257-59 (§ 510(b) applies to a claim arising from a failed securities transaction even though the claimant never received shares in the debtor). In other words, these claims only arose because the claimants had agreed with the debtor "to receive part of their compensation in the form of RSUs." *Id.* at *35.

Claimants' Other Arguments

The court rejected the claimants' various "theories" opposing subordination. 2017 U.S. App. LEXIS 7920, at *35. First, as to the argument that the RSUs "never vested," the claimants "have already been paid the compensation they were due in the form of RSUs and, as a result, have no right to any other mode of performance [e.g., cash] [from the debtor]." *Id.* at *37. As for their "restitution" claim, the claimants "suffered no actual injury" merely because the debtor's common stock "had no value." *Id.*, at *38.

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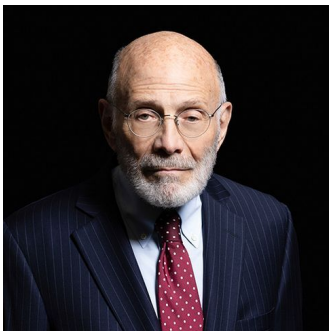

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