

STRANGE SUBORDINATIONS: CORRECTING BANKRUPTCY'S § 510(b)

by

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I. INTRODUCTION

The closer reading of a familiar rule often reveals numerous surprises. As I reached the subordination issues during my work on the next edition of Blumberg on Corporate Groups, the statutory provision regarding subordination of claims from the purchase of securities seemed to have more texture than it initially revealed, justifying a closer look. I never expected that each closer look into the operation of § 510(b) of the Bankruptcy Code would reveal one more peculiarity.

This Article begins with the paradoxical treatment of claims in the context of corporate groups. The paradox surfaces when comparing the inconsistent treatment of fraud claims in two transactions that have the same effect. Consider the two following transactions.

Sale of Stock: Parent, Inc. owns 100% of Sub, Inc. Parent sells all the common stock of Sub to Buyer, Inc. at an inflated price because of a misrepresentation. Buyer files a fraud action against Parent. Parent files for bankruptcy and invokes § 510(b), which states that “a claim . . . for damages arising . . . from the purchase of [a security of an affiliate of the debtor] . . . shall be subordinated.”¹ Accord-

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¹ 11 U.S.C. § 510(b) (1994). The full text of § 510 (b) subordinates several types of claims arising from a purchase. All types of subordinated claims are included in the references to “fraud claims” by this Article. Section 510(b) reads as follows:

For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement

ingly, if a parent corporation sells stock of a subsidiary, a plain reading of § 510(b) leads to subordination of any claims arising from the sale.² By comparison, consider the outcome when the sale of control is recast as a sale of assets.

Sale of Assets: Parent, Inc. causes a sale of all the assets of its wholly-owned subsidiary, Sub, Inc., to Buyer, Inc. The price Buyer pays is inflated because of a misrepresentation. Buyer brings a contract claim and a deceit claim against Sub, the seller of the assets. If Sub attempts to become judgment-proof by distributing the proceeds to the Parent as a dividend, it would be violating fraudulent transfer law and other creditor safeguards.³ The priorities to the proceeds would be as follows: (1) creditors of Sub (including Buyer), (2) preferred shareholders of Sub, (3) creditors of Parent secured by Sub's stock, (4) unsecured creditors, (5) preferred shareholders of Parent, and (6) the common shareholders of Parent.⁴

or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

Id. The definition of "affiliate" is in § 101(2). Affiliates include parent entities as well as subsidiaries. *Id.* § 101(2). In the case of both parent and subsidiaries, neither majority ownership nor de facto control are necessary. The Code uses a mechanical ownership threshold of 20% to define affiliation. *Id.*

² Only two reported cases dealt with § 510(b) in the context of subordination of claims from the purchase of affiliates' common stock. Both applied it as written and subordinated the claims of the defrauded buyers to the parents' general creditors. See *Jenkins v. Tomlinson (In re Basin Resources Corp.)*, 190 B.R. 824 (Bankr. N.D. Tex. 1996) (holding that claims of investors in oil exploration ventures against the organizer and parent of all ventures are subordinated to the general creditors of the parent); *CLC of America, Inc. v. Lake Shore Equip. Dists., Inc. (In re Wisconsin Barge Line, Inc.)*, 76 B.R. 142 (Bankr. E.D. Mo. 1987) (providing that claims of defrauded buyer of 100% of debtor's subsidiaries are subordinated to general creditors of the debtor).

³ See, e.g., UNIF. FRAUDULENT TRANSFER ACT §§ 4-5 (1994); REVISED MODEL BUS. CORP. ACT §§ 6.40, 8.33 (1995); DEL. CODE ANN. tit. 8, §§ 160, 173-74 (1998). All these provisions prohibit distributions that would render a corporation insolvent.

⁴ When the preferred shareholders of Sub are satisfied, the remaining value is distributed to its shareholder Parent. If Parent has used this stock as collateral, however, the secured creditor would have priority in the liquidating dividend (which, as proceeds, would fall under U.C.C. § 9-306). After satisfaction of any secured creditors, the Parent's shareholders would still not be able to distribute the proceeds to themselves unless Parent's ordinary creditors and preferred shareholders were not jeopardized by this distribution (or, in case of a liquidation, unless they were satisfied). See *supra* note 3. Fraudulent transfer law and corporate law impose protection of creditors in continuing enterprises. See *infra* note 32 and accompanying text.

In the second example (sale of assets), the Buyer's claim has priority over claims of creditors of the Parent. By comparison, the effect of § 510(b) in a sale of stock is equivalent to a multiple subordination. The Buyer's claim loses its seniority vis-à-vis the preferred Sub stock and Parent creditors, is subordinated below the claims of the preferred Parent's stockholders, and, finally, is placed on equal footing with the claims of the Parent shareholders.

This Article argues that a literal reading of § 510(b) leads to four wrong results. Part II briefly discusses the history of the subordination of shareholders' fraud and rescission claims. Part III discusses the effect of § 510(b) on fraud deterrence during solvency. Furthermore, two errors that result from a literal application of the statute are discussed. The text of § 510(b) requires subordination to a level equal to common stock. This command, which is ignored by the courts, would have eroded the deterrence against fraud. The second error of a literal reading, which again is latent, regards the unjustified use of the "purchase or sale" language. Claims from (re)sales of securities to the issuing debtor should not be subordinated because they neither correspond to transactions in which the higher risks of securities with low priority are assumed by the defrauded sellers nor do they offer an easy venue for abuse of securities fraud litigation. Part IV engages the effect of § 510(b) on fraud deterrence during insolvency, but outside of bankruptcy. Section 510(b) eliminates deterrence and effectively creates an incentive to defraud buyers of securities other than common stock and buyers of common stock of subsidiaries. The courts have not yet corrected these two errors. Part V examines the avenues for repairing § 510(b) and proposes an interpretation that could remedy the major errors of the section more efficiently than an unlikely legislative correction.⁵ Part VI concludes by reviewing the spectrum of errors and remedies that the Article discusses.

II. SUBORDINATION OF SHAREHOLDERS' FRAUD AND RESCISSION CLAIMS IN AN HISTORICAL PERSPECTIVE

The general provision of § 510(b)—that shareholders' claims should be subordinate to creditors' claims—came with the adoption

⁵ A legislative correction of § 510(b) is unlikely because previous efforts to correct one of the errors discussed here were fruitless, perhaps because of the cohesion of the creditors' interest group that the corrections threaten. See *infra* note 18 and accompanying text.

of the Bankruptcy Code in 1978. However, the past discussion concerning the proper priority of shareholders' fraud and rescission claims never focused on the claims of subsidiary shareholders or on the claims by holders of securities other than common stock. Subordination of fraud claims was not the setting under which the issue was first litigated. In the nineteenth and early twentieth centuries, defrauded shareholders attempted to rescind the purchases of their stock either under common law or under the "blue sky" state securities laws. In these cases, some shareholder claims were protected by a common-law constructive trust that gave them priority over creditors, some were granted creditor seniority, and others were subordinated.⁶ Thus, during that time, case law proceeded on a case-by-case basis, with a resistance toward subordinating the claims of innocent passive investors. However, in 1973, Professors John Slain and Homer Kripke published an article supporting the subordination of shareholders' fraud and rescission claims based in part upon a reliance-like argument that shareholders' and creditors' expectations require subordination.⁷ In lack of noticeable opposition, Congress adopted the Slain and Kripke position with the enactment of the 1978 Code,⁸ a position

⁶ Priority through a constructive trust was hindered in practice by the requirement of tracing the res of the trust. Cases giving defrauded security buyers constructive trust protection surfaced even after the adoption of the Code. See, e.g., *Drexel Burnham Lambert, Inc. v. Flight Transp. Corp.* (*In re Flight Transp. Corp.*), 730 F.2d 1128, 1137-38 (8th Cir. 1984) (constructive trust argument partially prevails over § 510). John J. Slain and Homer Kripke, in their article, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261 (1973), point to *In re Rhine*, 241 F. Supp. 86 (D. Colo. 1965), which granted constructive trust protection to quasi-equity investors in an unincorporated debtor. Creditor seniority was given to shareholder rescission claims in many cases, but depending on the theory that the court adopted, they might be subordinated to creditors who advanced credit after the equity investment with the idea that the credit was given in reliance on the existence of an equity cushion. See generally Kenneth B. Davis, Jr., *The Status of Defrauded Securityholders in Corporate Bankruptcy*, 1983 DUKE L.J. 1, 4-8. In *Oppenheimer v. Harriman National Bank and Trust Co.*, the court allowed a defrauded shareholder's claim to share at the same rank with creditor claims. 301 U.S. 206 (1937). However, the case cannot be read to conclude that shareholder claims must always be given creditor seniority. That the Supreme Court had no animus against subordination might be supported by the fact that it took no argument with the subordination of shareholder claims as recently as 1968 in *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 453 (1968).

⁷ See Slain & Kripke, *supra* note 6.

⁸ See Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, § 502 (codified at 11 U.S.C. § 502).

that had in the interim also been adopted by some courts.⁹ The dearth of litigation on this issue in the thirty years before the passage of the Code made the legal landscape appear unusually conducive to this new arrangement regarding the treatment of fraud and rescission claims.¹⁰

The thrust of Slain and Kripke's argument is founded on the bargain and reliance interests formed by creditors and equityholders. When equityholders claim damages due to fraud in the issuance of their securities, they convert all or part of their equity claim into a debt claim. Unless their fraud claims are subordinated, equity holders obtain the same level of seniority as creditors. Allowing equityholders to become creditors gives them the best of both worlds: a claim to the upside and participation with creditors in the downside. If the firm performs well, the increase in its value benefits shareholders exclusively. If the firm fails, shareholders exercise their fraud claims and receive a portion of the value of the failed firm, sharing with the creditors. Creditors, on the other hand, rely on the capital contributed by shareholders for the satisfaction of their claims. Allowing rescission claims to share the same priority as debt eliminates this safety cushion.

The fast expansion of securities fraud liability during the decade immediately preceding the appearance of the Slain and Kripke article did nothing to allay fears that, without subordination, shareholders could threaten creditors' expectations. To the contrary, the expansive securities fraud liability was the impetus for Slain and Kripke's subordination arguments. Their explicit argument was conclusory: that creditors should not bear the risk of securities fraud by their lender.¹¹ Implicitly, the reader ought to understand that if the opposing position was adopted (i.e., if

⁹ After the Slain and Kripke article, but before the passage of the Code, the following three decisions employed Slain and Kripke's position of subordinating fraud claims of innocent shareholders that had not enjoyed corporate assets as either securityholders or employees: *Aldrich v. Redington (In re Weis Securities, Inc.)*, 605 F.2d 590 (2d Cir. 1978), *cert. denied*, 439 U.S. 1128 (1979); *Jezariah v. Raichle (In re Stirling Homex Corp.)*, 579 F.2d 206 (2d Cir. 1978), *cert. denied*, 439 U.S. 1074 (1979); and *Thompson v. Tulchin (In re Cartridge Television, Inc.)*, 535 F.2d 1388 (2d Cir. 1976). After the passage of the Code, the new rule was applied to pre-Code cases by *Kira v. Holiday Mart, Inc. (In re Holiday Mart, Inc.)*, 715 F.2d 430 (1983); *In re THC Fin. Corp.*, 679 F.2d 784 (9th Cir. 1982); *Kelce v. United States Fin., Inc.*, 648 F.2d 515 (9th Cir. 1980).

¹⁰ I will use "fraud claims" and "fraud creditors" hereinafter to refer to fraud, rescission, and other claims arising from the purchase of securities.

¹¹ See Slain & Kripke, *supra* note 6, at 298.

creditors were ultimately liable for fraudulent behavior by corporate debtors via unsubordinated fraud claims), then creditors would theoretically monitor corporate debtors in order to prevent securities fraud. Underlying Slain and Kripke's conclusory assertion, then, are the arguments that securities fraud liability provides sufficient deterrence and that the additional monitoring by the creditors is unnecessary.

Subsequent to the adoption of the Code, a critique of Slain and Kripke reveals the purely redistributive nature of subordination.¹² The critique can be expanded convincingly. Depending on the rule (subordination or not), creditors will adjust their expectations about the value of their claims against firms even before the firms financially fail. If subordination was repealed, existing debt would lose value and existing equity would gain value. In essence, therefore, the reliance interests and the "best-of-both-worlds" concerns are denominated in the value of the different securities. If the value (and the productivity on which value depends) of firms does not change depending on the rule, a change in the rule cannot be justified because it simply reshuffles firm value between creditors and equityholders.

The productivity (and value) of firms would change if the risk of securities fraud depended on whether fraud claims were subordinated. Thus, the question returns to the adequacy of deterrence that securities fraud liability provides. Suppose that lenders are in an excellent position to prevent securities fraud by borrowers. Nevertheless, lenders would not have the incentive to prevent the fraud if they were unaffected by the securities fraud that their borrowers committed. A rule that motivates lenders to monitor corporate borrowers, such as not subordinating securities fraud claims, would then be desirable because it would reduce securities fraud and increase the total value of firms. However, there is little reason to believe that securities fraud liability underdeters issuers or that lenders are in a better position to prevent it.¹³

¹² See Davis, *supra* note 6, at 34-36.

¹³ By contrast, the nonsubordination of shareholder claims may entice creditors to conceal securities fraud. See *id.* at 50. If, for example, the basis for securities fraud liability is that a senior executive borrows funds surreptitiously from the corporation, creditors who fear that securities fraud liability will erode their claims may prefer to ignore the transactions to the misappropriator's benefit. Consider the example of a corporation that has \$15 million in assets remaining after the insider has "borrowed" significant funds. Because the insider

Effectively, the paucity of subordination litigation preceding the adoption of the Code in 1978 allowed Congress to write on an essentially blank slate. Once the rule has been set, changing it without exceedingly strong proof is unjustified. Therefore, this Article does not engage the question of subordination generally.¹⁴ But, the lack of litigation regarding the errors that this Article identifies indicates that expectations underlying subordination should still be fluid, and that the correction of § 510(b) is easily justified. Moreover, the history of the adoption of § 510(b) shows that the language extending subordination to the claims of the subsidiaries' shareholders and subordinating the claims of each class of creditors to a level junior to each class's claims was an oversight.

The House Report regarding the Bankruptcy Reform Act of 1978 never mentions the subordination of subsidiary shareholder claims. As for the subordination of fraud claims by claimants other than common stockholders, it states that:

[T]he bill subordinates in priority of distribution [fraud and] rescission claims to all claims that are senior to the claim . . . on which the [fraud or] rescission claims are based. Thus, a [fraud or] rescission claim resulting from the purchase of a subordinated debenture would share in the proceeds of the estate before equity security holders but after general unsecured creditors.¹⁵

The Senate Report does include, probably reflexively, the "or of an affiliate" language. "The subsection also requires the court to subordinate in payment any claim . . . arising from the purchase or sale of a security of the debtor or of an affiliate . . . to all claims and

"borrowing" was not disclosed, shareholders can create a \$5 million securities fraud liability. If stockholders share in creditor recoveries without being subordinated, creditors will weigh the amount that can be recovered from the insider against the prospect of \$5 million more of claims sharing in the assets. If the corporation will recover \$1 million and creditors are owed \$20 million in total, creditors will compare receiving 100% of \$15 million to 20/25 of \$16 million, or \$12.8 million, and will prefer to sweep the insider loan under the proverbial rug.

Nevertheless, Davis proceeds to argue that creditors are the least-cost-avoiders of securities fraud because they, unlike public shareholders, can bargain for access to the corporate records and, thus, prevent fraud if fear of securities fraud liability gave them the incentive. *See id.* Of course, Davis does not take his thesis to its conclusion, which is that for the creditors to have full monitoring incentives, shareholder fraud claims must be senior to creditor claims.

¹⁴ For a brief justification of this position see *infra* note 40 and accompanying text.

¹⁵ H.R. REP. NO. 95-595, at 196 (1977), *reprinted in* 1978 U.S.C.A.N. 5963, 6156-57 (footnote omitted).

interests that are senior to the claim . . . represented by the security."¹⁶ The Senate Report copies almost verbatim the Code's language, including the use of "purchase or sale" and "debtor or affiliate," which is problematic.¹⁷ The report does not mention that fraud claims are subordinated not only to senior claims but also to the claims of the same class of creditors.

An error was inferred from the inaccuracy of the House and Senate Reports with respect to the subordination of fraud claims by classes other than common stock. Since the reports described subordination only with respect to claims of senior classes, the subordination to claims of the same class may have been inadvertent. Accordingly, at least twice an attempt was made to pass a corrective amendment restoring same-class fraud claims to equal priority with the class.¹⁸ No corrective attempt has succeeded.

Given the failure of the attempts to correct the aforementioned error of § 510(b), one could speculate about the likelihood that Congress would correct other similar errors. Accepting that blocking legislation is easier for interest groups than instituting it, and supposing that the correction was blocked by creditor interest groups, might lead one to the conclusion that any other error in § 510(b) could also be perpetuated if it favors creditors. The errors emphasized in this Article are indeed to the advantage of creditors of the parent because the errors cause other claimants' fraud claims to be excessively subordinated. It is important to keep in mind the odds of legislative correction when considering, as this Article suggests, the alternative remedy of correction through judicial interpretation.

Having reviewed the context in which § 510(b) was adopted and left uncorrected, this Article next turns to the errors of § 510(b). All four errors erode the deterrence of fraud, but they are placed in two categories. Part III engages the reduced deterrence

¹⁶ S. REP. NO. 95-989, at 74 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5860.

¹⁷ The use of "purchase or sale" causes the problematic subordination of fraud claims in cases of repurchases by the corporation of its securities. *See infra* Part III.B. and text accompanying notes 22-24. The use of "debtor or affiliate" causes the problematic subordination of fraud claims against parents for sale of their subsidiaries' stock. *See infra* Part IV.B. and text accompanying notes 29-39.

¹⁸ *See* S. 658, 96th Cong. (1980); Staff of Senate Comm. on the Judiciary, 97th Cong., 1st Sess., Amendment to S.658 (Committee Print No. 2, 1981); *see also* Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code*, 56 AM. BANKR. L.J. 293, 300 n.33 (1982).

that adhering to the letter of § 510(b) would have produced outside of bankruptcy if the courts did not ignore its language. Part IV discusses the much more severe problems § 510(b) creates during insolvency, when it furnishes incentives for defrauding security purchasers that have yet to be corrected by the courts.

III. FRAUD INCENTIVES DURING SOLVENCY

Although insolvency clearly erodes the deterrence that the tort system provides, we generally expect the tort system to have its full deterring impact during solvency. The system achieves deterrence only if the tort victims' claims have clear seniority to the claims of the decisionmakers. Thus, corporate management acts on the shareholders' behalf during solvency, and, in the event of dissolution, shareholders claim the residual value after all creditors are paid, including tort victims.

Section 510(b) breaks this smooth surface with two paradoxical subordinations. It erodes the deterrence against defrauding shareholders by reducing the shareholders' claims, and it erodes the deterrence against defrauding shareholders who sell their shares back to the firm by also subordinating and reducing their claims.

A. *Reduced Deterrence against Defrauding New Shareholders*

Section 510(b) reduces the seniority of claims arising from the purchase of common stock to a seniority equal to that of other common shareholders.¹⁹ The problem regarding deterrence arises because the fraud claims of common stockholders have the same seniority as common stock. Before studying the deterrence that this type of subordination induces, an examination of its exact consequences is required.

When a liquidated claim²⁰ has the same seniority as an unliquidated claim and a liquidation occurs in which there are insufficient funds to pay all claims of a certain class, the claimholders will share ratably in the available funds, each receiving the same number of cents on the dollar. If, however, we try to apply this concept to the command of § 510(b)—that claims arising from the purchase of common stock are subordinated to equal seniority

¹⁹ 11 U.S.C. § 510(b) (1994) ("such claim has the same priority as common stock").

²⁰ A liquidated claim is one that has been reduced to a specific monetary amount.

with common stock claims—we run into the problem that the claims of the common shareholders are not liquidated, but instead they are claims to the residual value.

Two possible approaches could remedy the problem. One implies ignoring the command of equality and giving supremacy to the idea that the common stockholders have a claim to the residual value. Accordingly, the subordinated fraud claim is paid first in its entirety before the residual goes to the shareholders. But if one tries to implement the equal seniority of § 510(b), the first step must be to reduce the shareholders' claims for the residual to a liquidated amount, without making provision for the subordinated claim. Then, following liquidation of the shareholder claims, the subordinated claim is added and the sum is ratably satisfied by the residual value. An example will clarify.

Ratable Satisfaction of Liquidated Equity Claims. Incorporated, Co. is in liquidation and has a \$10 million securities fraud claim against it, arising from the issuance of common stock. After all other claims are satisfied, equity of \$30 million remains for distribution to the shareholders and the securities fraud claimants. This \$30 million becomes the liquidated claim of common stockholders. Then, \$40 million of claims have the priority of common stock. These claims run against \$30 million of assets, implying a pro rata distribution of seventy-five cents on the dollar. The fraud claimants receive \$7.5 million.

In practice, the “equal seniority” of § 510(b) is without hesitation interpreted as “immediately senior to common stock.”²¹ Fraud claims receive priority contrary to the language of § 510(b).

A simple exercise shows that if the courts were to follow the “equal seniority” command, the ratable subordination it implies would undercompensate the fraud victims and fail to bring them to the position they would have enjoyed had the fraud never occurred, thus reducing the deterrence that fraud liability should provide.

Mitigation of Claim through Ratable Satisfaction. Again, imagine that Incorporated, Co. has managed to defraud a group of shareholders holding fifty percent of Incorporated common stock by persuading them to overpay by \$10 million. After liquidation, the residual assets available for the equityholders are \$30 million.

²¹ See, e.g., *In re Drexel Burnham Lambert, Inc.*, 140 B.R. 347 (S.D.N.Y. 1992) (providing that a reorganization plan that places rescission claims senior to equity is approved without discussion of the issue).

According to the previous example, ratable distribution implies seventy-five cents on the dollar, or \$7.5 million for the subordinated claim and \$11.25 million for fifty percent of the equity claim, totaling \$18.75 million for the defrauded shareholders.

Note that if Incorporated had not induced the fraudulent contribution, then only \$20 million in residual assets would be available for distribution to the shareholders. Those shareholders holding fifty percent of Incorporated common stock previously assumed to have been defrauded would receive \$10 million at the end of liquidation.

Consider, finally, that Incorporated did induce the fraudulent contribution, thus leaving \$30 million after payment to other creditors, and the claims of the defrauded shareholders receive priority. Then, the shareholders holding fifty percent of Incorporated common stock would receive \$10 million in satisfaction of their fraud claims and \$10 million as part of the residual distribution following liquidation, for a total of \$20 million. Thus, by giving priority to the claim for fraud the defrauded shareholders receive \$1.25 million more than if the fraud claim had been satisfied ratably.

Thus, the against-the-text application that § 510(b) enjoys is desirable because it produces as much deterrence as when the corporation is solvent. One more wrinkle of § 510(b) as applied to solvent firms must be addressed before we can proceed to its consequences during insolvency.

B. Reduced Deterrence against Defrauding Shareholders who (Re)Sell their Stock to the Corporate Debtor

The phrasing of § 510(b) is evidence of the infectious nature of statutory composition. In a vast number of other instances the law treats purchases and sales similarly.²² However, no reason justifies the similar treatment of purchases and sales in the context of subordination of claims arising from security transactions. Nevertheless, § 510(b) is infected and includes the language that equalizes the treatment of purchases and sales.

The “purchases or sales” language of § 510(b) improperly applies to repurchases by the corporation of its own stock. Sellers’

²² A Lexis search of all codes (library CODES, file ALLCDE) for the phrase “PURCHASE OR SALE” produces 5,024 hits.

claims of fraudulent activity in connection with stock repurchases are subordinated under § 510(b): "[A] claim . . . for damages arising from the . . . sale of [a security of the debtor] . . . shall be subordinated . . ." ²³ Thus, if a shareholder sells shares back to the corporation at a fraudulently depressed price, the fraud claim arising from the sale will be subordinated.

As already discussed, part of Slain and Kripke's justification for subordinating fraud claims of purchases is that the purchaser assumes the risk (i.e., the low seniority) associated with the security being bought. ²⁴ This reasoning, however, is reversed in the case of sales. ²⁵ The sellers of the stock no longer desire the risk and the low priority associated with the security. Moreover, subordination of claims that arise in connection with stock repurchase also dilutes the deterrence of fraud if § 510(b) is read literally and the sellers' fraud claims are not given seniority to common stock claims. Thus, for sellers' claims, not only do the arguments of Slain and Kripke not apply, but also the text of the Code, if it were interpreted literally, would reduce deterrence against fraud.

Having identified these two errors in the literal application of § 510(b), it is important to note that they do not often arise in practice. The principal errors, which have not yet been addressed, regard how § 510(b) eliminates deterrence against fraud during insolvency of the corporation, while it remains outside of bankruptcy.

IV. FRAUD INCENTIVES DURING INSOLVENCY

Section 510(b) eliminates deterrence against securities fraud in two settings in which the corporation is balance-sheet insolvent (i.e., has more debt than assets). In combination with the fact that during insolvency directors' fiduciary obligations shift in favor of creditors, a lack of deterrence and the existence of some gain from the fraud create a virtual fiduciary obligation upon the board of directors to defraud in the two following situations: (1) the board of

²³ 11 U.S.C. § 510(b) (1994).

²⁴ See Slain & Kripke, *supra* note 6, at 286-88.

²⁵ A court recognized that the logic of § 510(b) does not apply to sales to the corporation. See *Nugent v. American Broadcasting System, Inc. (In re Betacom, Inc.)* 225 B.R. 703 (Bankr. D. Az. 1998), where the debtor used § 510(b) in an attempt to subordinate the fraud claims of ex-shareholders who sold their stock. The court interpreted § 510(b) narrowly so that it would not apply to that transaction.

an insolvent corporation is effectively obligated to defraud buyers of the securities that are at that time the claimants to the firm's residual value; and (2) the board of an insolvent parent is effectively obligated to defraud buyers of their subsidiaries' stock. The following discussion analyzes these two oddities.

A. *The Incentive to Defraud Buyers of Debt Securities Claiming the Residual*

Changes in the value of solvent firms accrue to shareholders because their claims are the most junior. Thus, they have the expected incentives to avoid the liability on which the tort system relies to deter fraud. Insolvency changes this picture. When the value of the business or its assets falls below its total liabilities, changes in the value of the firm accrue to the next most junior class of claimants. Shareholders are out of the money in that they receive no distribution in a hypothetical, instantaneous liquidation. This would create a major concern, not only for the tort system, but also for every decision that the board of directors makes. To resolve this distortion, the fiduciary duties of the board of directors change in the event of insolvency.

After the corporation becomes insolvent, the board's fiduciary duties shift to the creditors.²⁶ This mitigates the distorted decisionmaking caused by insolvency. Under these changed conditions, the board will not only make proper managerial decisions, but their incentive to avoid tort liability is also largely restored. In cases in which the board's duty is transferred to subordinated creditors, the restoration of the incentive to avoid additional liability is complete because any tort liability would be senior to them. A dollar more of debt to general creditors leaves a dollar less of firm value available for the subordinated creditors. Even when the board's obligations are to general creditors, unless

²⁶ See, e.g., *In re PNP Holdings Corp.*, No. 96-35835, 1998 U.S. App. LEXIS 5481 (9th Cir. Mar. 18, 1998); *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982); *Davis v. Woolf*, 147 F.2d 629, 633 (4th Cir. 1945); *In re Western World Funding*, 52 B.R. 762, 763 (Bankr. D. Nev. 1985). Support is also offered in *Alexander v. Hillman*, in which directors are treated as "trustees for creditors and shareholders." 296 U.S. 222, 240 (1935). Whether shareholders are indeed not recipients of a duty after insolvency is less clear than it should be. See generally Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485 (1993); David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461 (1992).

the firm is very deeply insolvent, the board's incentives approximate the incentives of solvent firms. Take the example of a corporate liquidation in which creditors expect to receive ninety cents on the dollar for their claims of \$10 million. An additional \$1 million liability that results from a securities fraud claim will produce \$11 million of claims running against \$9 million of assets, for an 82% distribution. The claim reduced the value of creditors' ultimate distribution from \$9 million to \$8.2 million, indicating that the \$1 million liability costs the creditors \$800,000. While some reduction in deterrence occurs, the fundamental incentive to avoid liability is still firmly in place. Deeply insolvent corporations would face significantly less deterrence, but they are unlikely to remain outside bankruptcy. Once inside bankruptcy, tort claims receive administrative expense priority, making them senior to the unsecured creditors and restoring deterrence. Indeed, the Supreme Court opinion that elevated tort claims to administrative expense priority alludes to the need for deterrence.²⁷ Thus, in every state along this path of deterioration of corporate wealth, deterrence remains in force. This would not be true, however, if the tort claims were to be subordinated to the class in whose benefit corporate decisions are made. Despite the efforts to avoid such situations, § 510(b) creates two situations in which deterrence is diminished.

An example easily illustrates how deterrence disappears with subordination. Suppose a misrepresentation has a beneficial effect on the corporation and increases its value by \$10 million, but, given the trading volume in its stock, it also creates securities fraud liability to the class of shareholders who trade during the period that the misrepresentation distorts its stock price. For example, the parent might state that it is close to getting approval for a new drug in the hope that other companies delay research into this type of therapy so that the drug it is developing is the first on the market.

²⁷ See *Reading v. Brown*, 391 U.S. 471, 483 (1968) ("[I]f a receiver or debtor in possession is to be encouraged to obtain insurance in adequate amounts, the claims against which insurance is obtained should be potentially payable in full."). The incentives to obtain insurance against liability are directly related to the deterrence that the liability creates. The terms of the insurance contract will typically require appropriate care and efforts to prevent the liability. Similar deterrence incentives may be built into the pricing of insurance, with premiums increasing as care decreases. Finally, the level of care that will be chosen by one who self-insures (i.e., who chooses to bear the risk of liability) will only be appropriate if the liability is felt to its full extent.

The false impression pushes up the stock price by \$5 during the three months it takes to determine the falsity of the statement. During this period three million securities change hands, creating a \$15 million liability. A solvent parent corporation will be deterred from making the misrepresentation. Let us consider, however, a deeply insolvent parent.

Because the parent is insolvent, the value of its stock is nominal, and because the \$10 million advantage would not render the corporation solvent, the misrepresentation does not influence its stock value. It does influence the value of its debt. Suppose the corporation has \$80 million of value (in assets or as a going-concern), \$25 million of secured and \$25 million of ordinary debt, both of which trade at par. The corporation also has \$50 million of subordinated notes, which, due to the shortage of assets, have a market capitalization of \$30 million (60% of par). The misrepresentation increases the value of the corporate business by \$10 million. Therefore, the value of the notes may increase from \$30 to \$40 million, depending on the impact of the securities fraud liability to those who buy the notes after the misrepresentation and before the truth is determined.

To determine how the securities fraud liability will influence the incentives of the noteholders, we must examine the seniority of the securities fraud claimants, who in this case are the note buyers. Section 510(b) unambiguously subordinates the claims from the purchase of subordinated notes to make them immediately junior to noteholders' underlying claims.²⁸ Thus, the liability has no effect. Only if the corporation's value increases by \$10 million more would the defrauded buyers see any distribution in liquidation. Effectively, the subordination of the defrauded note-buyers' claims makes the fraud that the noteholders commit not come at their expense. Since the corporate directors owe their fiduciary duties to the noteholders during insolvency, the distorted incentives create an incentive on their part to defraud.

B. The Incentive to Defraud Buyers of Subsidiaries' Stock

The last subordination that this Article tackles is the subordination of fraud claims held by a subsidiary's shareholders, which § 510(b) treats identically to the fraud claims of shareholders

²⁸ 11 U.S.C. § 510(b) (1994).

of the parent. Thus, the claims held by shareholders of a subsidiary are given a seniority equal to that of common stockholders, although in practice that means they are placed immediately senior to those of common stockholders. If the parent is insolvent, this subordination replicates the above effect and produces an incentive to defraud the shareholders of the subsidiary. However, some erosion of the deterrent effect of securities fraud is achieved in this instance even before insolvency. Before turning to their subordination, let us start by studying the seniority of claims against subsidiaries.

Ordinary claims against the subsidiary have the seniority of unsecured debt. Thus, if the subsidiary were to fail, the first to be satisfied would be its secured creditors, followed by its unsecured creditors and any deficiency claims that the secured creditors may have. In liquidation, assets would be sold to satisfy their claims. Any residual value would be distributed next to any creditors who may have agreed to be subordinated, then to any preferred shareholders, and, finally, the remainder will be released to the shareholders, who include the parent corporation. If the parent were to fail as well, what it received by virtue of its ownership of common stock of the subsidiary would be distributed using the same principles. First, if the parent pledged its stock in the subsidiary as collateral securing a debt, assets would be distributed to those secured creditors, then to unsecured creditors, subordinated creditors, preferred shareholders, and, finally, to common shareholders of the parent.

Naturally, the treatment of a fraud claim is not different. Consider a fraud or rescission claim arising from a transaction in the subsidiary's ordinary course of business. Ignoring the complex question of conflicts with secured claims,²⁹ the fraud claim against the subsidiary would rank ahead of preferred and common stock claims of shareholders of the subsidiary, ahead of secured and general creditors of the parent, and ahead of preferred and common shareholders of the parent.

²⁹ Consider, for example, a fraudulent sale of an item from the subsidiary's inventory. The fraud claim of the buyer might be subordinate to a secured creditor with a perfected security interest in the item or in the revolving collateral, here the inventory, and its proceeds. But a rescission claim may also be protected by a constructive trust, in which case the proceeds that the subsidiary received would not become part of its estate and the buyer's claim may be superior to the secured creditor's, provided the res of the constructive trust can be traced. See *supra* note 6.

The priority of fraud claims in the case of a sale of substantially all the assets of the subsidiary is no different from the above analysis of a claim based on a transaction in the ordinary course of the subsidiary's business. The buyer's claim will have the same high seniority. The only difference lies in the fact that often the subsidiary will no longer serve a business purpose and, therefore, the parent may proceed to liquidate it. The issue then becomes the priority of the fraud claim in a setting where the subsidiary is being liquidated. Will the liquidation reduce the priority of the fraud claim?

In principle, the liquidation will not reduce the priority of claims against the subsidiary. If the subsidiary has notice of the possible fraud claim, the subsidiary must account for the claim before making any distribution. If the subsidiary makes the distribution without accounting for the claim, fraudulent transfer law will invalidate the transfer. Fraudulent transfer law has two sources, the Uniform Fraudulent Transfer Act and, in bankruptcy, § 548 of the Code. In both cases, transfers without consideration (including every dividend) that render the debtor insolvent are fraudulent and can be reversed. Corporate law imposes liability on directors that distribute excessive dividends.³⁰ Even if the debtor subsidiary is unaware of the potential liability at the time of the liquidating dividend, the fraud claimant can, with two other creditors, file an involuntary bankruptcy petition up to a year later and recover the transfer under § 548; the reach-back period extends one year because the liquidating dividend payment to the parent is a transfer for the benefit of an insider. Only after satisfying the fraud claimant will the parent be able to distribute the assets of the subsidiary. Only from this distribution will the parent's creditors be satisfied, from secured creditors, through unsecured and subordinated creditors and preferred shareholders, all the way to equityholders.

In sum, even claims that were unknown to the subsidiary or the parent receive ample protection from liquidation. The claimant may have up to four years to recover the transfer under the Uniform Fraudulent Transfer Act.³¹ State corporate law also allows creditors

³⁰ See, e.g., DEL. CODE ANN. tit. 8, § 174 (1998); N.Y. BUS. CORP. LAW § 719 (McKinney 1999); REVISED MODEL BUS. CORP. ACT § 8.33. The directors will often have an action for contribution against the shareholders. See DEL. CODE ANN. tit. 8, § 174(c).

³¹ UNIF. FRAUDULENT TRANSFER ACT § 9 (1994).

to recover distributions to the shareholders of more than surplus or profits from the directors with an even longer limitations period.³² This protection is conclusive. A parent cannot cause the subordination of a fraud claim against a subsidiary.

By contrast, consider the straight application of § 510(b) to a sale of a controlling block of the subsidiary's stock. A stock sale is the equivalent transaction to a sale of substantially all the assets because, in essence, the buyer gets the same control over an enterprise, a productive collection of the same assets and relations—the same assets that would be sold in the sale of substantially all assets.

If the buyer has a fraud claim, the fraud claim will be against the parent company, which is the seller of the stock. One may think that this implies a substantive difference in the transactions since the buyer has voluntarily given up some seniority to drop from a potential creditor of the subsidiary (senior to subsidiary preferred and common equity, and to all parent creditors) to a potential creditor of the parent. This is deceptive because the purchase price paid for the stock will reflect the change in seniority. Consider, for example, that the stock of the subsidiary secured some indebtedness of the parent. That obligation will usually be addressed before the transfer so that the buyer receives unencumbered shares. If not, then the buyer will adjust the price for buying encumbered assets, becoming, in effect, a co-debtor. Similarly, the buyer will adjust the price for the debt load of the subsidiary and any preferred stock that is, in this case, senior to the buyer's equity claim. The parties compensate for all changes in seniority. Section 510(b) overrules that arrangement, but only partially, so as to reduce the fraud claim to the priority of the parent's common stock. The rest of the contractual relation remains unchanged, and a claim for nonperformance, for example, will be a regular unsecured claim against the parent.

One may think that the buyer of a controlling block of a subsidiary should be able to argue that this purchase is not a purchase of stock but a purchase of a business. Indeed, in one of the

³² Delaware law, for example, holds directors liable for illegal dividend distributions for six years. *See* DEL. CODE ANN. tit. 8, § 174(a) (“[T]he directors . . . shall be jointly and severally liable, at any time within 6 years of paying such unlawful dividend . . . to the corporation, and to its creditors . . .”). Directors then have an action against the shareholders for contribution. *See, e.g., id.* § 174(c).

two cases to have dealt with this issue the purchaser unsuccessfully made this very argument.³³ Securities regulations define stock as a security.³⁴ Several exceptions have developed when the context of the transaction requires a sale of stock not to be treated as a sale of securities. The archetypal example involves the sale of shares in a co-op, which entitles the buyer to occupy a specific unit in the building with associated rights and obligations.³⁵ A similar exception had been recognized by many circuits (the "sale of business doctrine") to exclude from the definition of a security the sale of control in an enterprise.³⁶ The Supreme Court intervened and eliminated the sale-of-business doctrine.³⁷ As a result, the fraud claimant in *CLC of America, Inc. v. Lake Shore Equip. Distribs., Inc. (In re Wisconsin Barge Line, Inc.)* had no argument.³⁸ The purchase of the subsidiary was the purchase of stock. The superficial reading of § 510(b) had to apply, and the claim was subordinated.

Perhaps it is fortunate that the sale-of-business doctrine was not resurrected for the purpose of § 510(b) because there is no analytical difference between a fraud claim by a buyer of control and the buyer of a single share of a subsidiary. Neither offers a reason to be subordinated to the parent's creditors. The subordination of fraud claims seeks to return the priority of sellers of common stock to buyers of common stock, in part because they accept the risks inherent in common stock. The buyers of the subsidiary's stock, however, do not accept any of the risks associated with holding stock of its parent. Moreover, the subordination below parent creditors eliminates the deterrence on the parent from incurring securities fraud liability when the parent is insolvent.

Because the subordination of the fraud claims of subsidiary shareholders happens with regard to both subsidiary and parent

³³ See *CLC of America, Inc. v. Lake Shore Equip. Distribs., Inc. (In re Wisconsin Barge Line, Inc.)*, 76 B.R. 142 (Bankr. E.D. Mo. 1987).

³⁴ Section 2(a) of the Securities Act of 1933 defines a security to mean "any note [or] stock." 15 U.S.C. § 77b(a)(1) (1999).

³⁵ See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975).

³⁶ The Seventh, Ninth, Tenth, and Eleventh Circuit Courts of Appeal had sided with the proposition that a sale of a controlling block of stock was not a sale of a security for the purpose of the Securities Acts. The Second, Third, Fourth, Fifth, and Eighth Circuits took the opposite position. See RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION CASES AND MATERIALS* 299 n.2 (7th ed. 1992).

³⁷ See *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).

³⁸ 76 B.R. 142.

creditors, there are two deterrent effects at issue: that of the parent and that of the subsidiary. Since § 510(b) would only subordinate the subsidiary's fraud claims to those of the parent creditors' if the parent is in bankruptcy, but not if the subsidiary alone is in bankruptcy, the obvious object of study must regard the insolvency of the parent. An additional concern may arise, however, if a solvent parent files for bankruptcy to take advantage of § 510(b). The two issues will be discussed in turn.

As with any other tort, the parent who is in a position to commit securities fraud through a misrepresentation weighs the consequences of making a false statement about the subsidiary that would result in an immediate benefit to the parent. If the parent were solvent, any tort liability of the parent would reduce the amount shareholders would receive in liquidation and the full incentive to avoid it would exist. If the parent were insolvent, however, the claimants of its last dollar of value would no longer belong to the shareholders but to some more senior class. With insolvency comes a shift in the fiduciary obligations of the board.³⁹ When the board makes its determination whether to defraud, the board must act for the interest of the current holders of the residual. Since § 510(b) subordinates subsidiary shareholders' fraud claims to all the creditors of the parent, the board realizes that the creditors who are the residual claimants will receive all the benefits of the fraud without suffering the liability that follows. Hence, the board of directors effectively has the incentive to defraud buyers of the subsidiary's stock.

The case of a voluntary filing to take advantage of the change in priorities of § 510(b) can be motivated by any one of several scenarios. A particularly pernicious one may be as follows. The parent and the subsidiary are both solvent but the subsidiary is a larger enterprise than the parent. The person controlling the parent owns a smaller fraction of its stock than of the subsidiary. The controller induces a false statement bestowing a benefit on the subsidiary that would normally have been deterred because of the solvency of both. The two corporations file for bankruptcy and invoke § 510(b). Because of the subordination, the controller will receive in full the larger fraction of the subsidiary's inflated value unimpeded by the fraud liability because it is subordinated. The

³⁹ See *supra* note 26 and accompanying text.

parent will receive its share and will distribute it to its shareholders after paying the fraud claimants. In this setting, the fraud deterrence has been eroded even though both corporations are solvent. An example will clarify.

The controller, J.J. Owner, holds 20% of Parent and 35% of Sub. Parent owns 50% of Sub. The value of Sub's business is \$100 million, which after debts of \$50 million leaves \$50 million for its shareholders. Parent's business is worth \$15 million, which after addition of its position in Sub, worth \$25 million, and debts of \$20 million, leaves \$20 million equity for its shareholders. Owner's personal wealth, including the \$4 million position in Parent and the \$17.5 million in Sub, totals \$21.5 million. The false statement increases the value of Sub by \$10 million and creates \$11 million of securities fraud liability. When the liability appears, Parent and Sub make voluntary bankruptcy filings. A buyer for Sub's business offers its full value of \$110 million, of which the shareholders, after paying its debts, receive \$60 million, \$24.5 million accruing directly to Owner and \$30 million accruing to Parent. Parent distributes its value, \$15 million in its business and \$30 million in the Sub, after paying its preexisting debts of \$20 million and the securities fraud liability of \$11 million, leaving \$14 million for distribution, of which Owner receives \$2.8 million. Owner's position after all this is \$24.5 million from Sub plus \$2.8 million from Parent, or \$27.3 million. The fraud, because of the subordination of the fraud claim, improved Owner's position by about \$7 million. Without subordination of the fraud claim, Owner's 35% of Sub would be 35% of the \$49 million of equity remaining after paying the securities fraud claim, namely \$17.15 million, and Owner's 20% of Parent, which would hold 50% of the \$49 million and the \$15 million business of Parent minus Parent's debts of \$20 million, would end up being \$3.9 million. Owner would be limited to \$21.05 million, so that instead of profiting by the fraud, Owner loses \$450,000. These \$450,000 are exactly Owner's share of the \$1 million net loss-gain of \$10 million minus liability of \$11 million—that the fraud inflicts: 35% of \$1 million (through Sub) plus 20% of 50% of \$1 million (through Parent).

Other distortions that the subordination of securities fraud claims may produce involve the decisions that subsidiary directors make regarding fraudulent statements when they know part of the statement's impact may lead to a bankruptcy filing by the parent,

which will trigger the subordination of liability for their statement and relieve their shareholders from its burden.

A further example may have the subsidiary making business decisions that potentially give the opportunity for the subsidiary to take advantage of the subordination of its fraud debts to the ordinary debts of its parent. Thus, when comparing two projects, a subsidiary might choose the slightly inferior one if the confidence of the parent's lenders in the parent's solvency could be undermined by a fraudulent statement. If this state materialized, the subsidiary would be able to commit securities fraud at no cost to its shareholders. A further complication would have the subsidiary commit securities fraud against its own shareholders, while the parent would still be solvent. The fraud is attractive, not because the subsidiary can avoid the liability every time, but because it may be avoided with sufficient likelihood (in case the parent files for bankruptcy) that the fraud is worthwhile from the perspective of subsidiary shareholders. Further distortions may regard the appeal of bankruptcy itself. Securities fraud claims against an insolvent subsidiary produce a disincentive disfavoring a bankruptcy by the parent. If the claims are settled in a bankruptcy of the subsidiary alone, they will not be paid in full, but if the parent files for bankruptcy before that, its shareholders will feel the full impact of the subordinated liability.

V. SUPERIOR SUBORDINATION: TOWARD A REPAIRED § 510(b)

Doubtless, the details of the subordination that § 510(b) commands are wrong, but what is the optimal shape that subordination should take? The premise of § 510(b) that fraud and rescission claims be subordinated should be accepted.⁴⁰ The

⁴⁰ One need not believe that securities fraud liability is excessive or random (i.e., that security fraud rules over-deter or provide ineffective deterrence) in order to accept the idea that shareholders' fraud and rescission claims should be subordinated. Subordination is also acceptable if firms are appropriately deterred both at the time of issuance as well as after issuance, or if junior creditors cannot effectively police misrepresentations by their debtors. Effective policing is highly unlikely from unsecured creditors who are trade creditors with simple contracts or even involuntary creditors. If fraud and rescission claims were not subordinated, they would take the priority of ordinary credit and reduce only fractionally the distribution to unsecured creditors. Thus, even if unsecured creditors were in a position to monitor securities fraud by their debtors, their incentive to do so is diluted by the fact that they suffer only a fraction of the fraud's cost. Therefore, it is unlikely that changing the basic structure of § 510(b) can be justified.

reparation of the four errors can then be implemented either by means of amending the statute, or by means of judicial interpretation. Compared with other errors of the Code that have been corrected by the judiciary, this interpretive correction may be so straightforward that it might not even justify the usual Scalia dissent.⁴¹

A. *Fixing the Errors of Priority Equal to Common Stock and Subordination of Claims from Resales*

A statutory remedy of the first two problems, the excessive subordination of shareholders' rescission claims and the subordination of fraud claims of former shareholders who resold their shares to the corporation, would be straightforward. The language stating that shareholders' fraud claims receive priority "equal to common stock" would be changed so they receive priority "immediately senior to common stock" and instead of subordinating claims from "purchases or sales," § 510(b) should command the subordination of claims from purchases only.⁴²

Courts, however, have already remedied these lesser errors of § 510(b). They clearly do not apply the excessive subordination language, and although no dismissal of such an argument appears, it is unlikely that courts would accept the argument that fraud claims from resales by shareholders to the corporation should be subordinated. Even if the express language of § 510(b) is considered to impede the latter of these two interpretive corrections, a different one is still available. The only possible

⁴¹ See *Dewsnup v. Timm*, 502 U.S. 410 (1992). In *Dewsnup*, the Supreme Court interpreted § 506(d), in contrast to a literal reading of the statute, which, when read in context states that "to the extent that a lien secures a[n un]secured claim, such lien is void." 11 U.S.C. § 506(d) (1999). The statutory language led some courts, in contrast to legislative intent, to strip liens down to the value of the collateral at the time of the bankruptcy filing. The Supreme Court's opinion in *Dewsnup* drew the ire of Justice Scalia, a well known literalist interpreter. *Id.* at 429 (Scalia, J., dissenting).

⁴² Thus, if only these two corrections are made, a redlined version of § 510(b) would read as follows:

For the purpose of distribution under this title, a claim arising from rescission of a purchase ~~or sale~~ of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase ~~or sale~~ of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has ~~the same priority as~~ *immediately senior to* common stock.

overreaching use of securities fraud by shareholders involves those situations when they have the firm distribute more of its value than they legitimately can enjoy by means of a securities fraud claim.⁴³ Courts can use this example as a basis to understand that the § 510(b) subordination applies to claims from resales because the claimants are still shareholders of the firm. From this and the fact that fraud claims of purchasers are claims of active shareholders, courts should derive that § 510(b) applies to claims of active shareholders only. If the nexus between shareholder and corporation has been broken by a complete resale to the firm, then § 510(b) would not apply because when it refers to "shareholders" it means "active shareholders." This interpretation would prevent a wholesale transfer of value to shareholders by means of a concession of securities fraud liability because any general scheme to transfer excessive value to shareholders would involve a tender offer for less than all shares in which the vast majority of shareholders would participate.⁴⁴

⁴³ See *infra* note 44.

⁴⁴ The basis of the transaction would be an attempt on the part of shareholders to circumvent the priority of creditors by repurchasing shares instead of declaring dividends. The intended transaction would be a distribution of more than the amount of unencumbered equity. For example, assume that a corporation has assets of \$5 million and liabilities of \$4 million. Additionally, assume that the corporation has one million shares outstanding, each commanding the appropriate price of \$1. The corporation might be tempted to take a secured loan of \$1.5 million and institute a self-tender for 500,000 shares at a price of \$3 per share. At the completion of the self-tender the corporation would have managed to distribute to the shareholders \$500,000 more than it could distribute as dividends. Note that all the shareholders should tender, the offer will be prorated according to the Securities Exchange Act, see 15 U.S.C. § 78n(d)(6) (1998); 17 C.F.R. § 240.14d-8 (1999), and as a result all the shareholders would have the opportunity to participate equally in the distribution.

Since such transactions cannot be implemented because of fraudulent transfer and corporate law, in which would undo the transfers to the shareholders and impose liability on the corporate directors, see *supra* notes 30-32 and accompanying text, an alternative worth exploring is whether the corporation could give its shareholders fraud claims instead of cash. In the absence of § 510(b), these fraud claims would receive the priority of unsecured debt and allow shareholders to receive more than they would otherwise. Consider the following transaction. The same corporation repurchases one-half of its shares at the correct price of \$1. The corporation achieves this end by distributing \$500,000 of its unencumbered equity, leaving it with \$4.5 million of assets and \$4 million of unsecured debt. The corporation subsequently (falsely) concedes that it manipulated the price of its stock, which should be at \$3, giving the selling shareholders a fraud claim of \$2 for each of the 500,000 repurchased shares, or \$1 million. Now the corporation is insolvent with \$5 million of debt and \$4.5 million of assets, liquidates, and pays ninety cents on each unsecured claimant's dollar. The shareholders receive 90% of their \$1 million fraud claim. Added to their \$500,000 tender offer proceeds, the shareholders have managed to extract \$400,000 from the corporation that they could not otherwise. If their claim is subordinated, this paradox disappears.

As the first two (lesser) errors of § 510(b) can be corrected by either a legislative amendment or interpretation by the courts, so can the other two errors, regarding fraud claims of securities other than common stock (hereinafter “debt securities,” although they include preferred stock), and claims of subsidiary common stockholders. Both, however, are complex errors that can be solved in numerous different ways.

B. The Subordination of Fraud Claims of Debt Securities

In the case of claims of debt securities, the remedy must be chosen from among several candidates. Should fraud claims of all debt securities be immediately senior to the claims of the class or should that priority apply only to claims arising from the purchase of only those debt securities which at that time have a claim to the residual? This is a valid question because, unlike the distortion in deterrence and decisionmaking from the error regarding subsidiary stock, the error regarding debt securities does not distort decisions in anticipation of bankruptcy or insolvency. Before insolvency the corporation is operated for the shareholders’ benefit. The error regarding fraud claims of senior securityholders influences only the wealth calculus of senior securityholders. Thus, even if the shareholders anticipate insolvency and have the ability of senior security holders to commit securities fraud with impunity, they cannot take advantage. Thus, the error regarding the subordination of senior securityholders’ fraud claims does not lead to an anticipatory distortion of decisions or of deterrence. Therefore, it need not receive a general correction. The regime that § 510(b) establishes can apply to all fraud claims, as long as it does not apply to those that arise while the error eliminates their deterrence. Thus, both a complete correction that makes fraud claims of all classes’ immediately senior to the claims of each class

That § 510(b) subordinates fraud claims from resales motivated by preventing the above transaction is a prime example of an extreme reaction to the excessive fear of securities fraud liability exemplified in *Slain & Kripke*. The corporation abused judicial process in creating nonexistent liability. The transfer to the shareholders in the context of the tender offer is avoidable with a one-year reach-back period in cases of purchasers from directors, officers, and controlling persons and their relatives (insiders as defined by § 101(31) which also includes partnerships of the debtor and their general partners). The admission of fraud itself constitutes an avoidable transfer that few courts would have difficulty identifying. There is little danger of such a transaction succeeding.

and a partial remedy makes the fraud claims that arose while that class claimed the residual immediately senior to a particular class's claims (i.e., the class was the last in-the-money class or, in other words, the last class that would receive any distribution in a liquidation), should be acceptable. At issue is to establish how each can be implemented and what concerns argue in favor of each.

A legislative correction could easily implement the complete correction by amending § 510(b) so that all fraud claims become immediately senior to the claims of their own class.⁴⁵ A partial correction would be more difficult because it would have to leave the existing subordination regime in place except for fraud claims arising at a time when the class of the security that was purchased would be the most junior class that would receive any distribution in a liquidation. A second exception would have to be appended to § 510(b), excluding from subordination under § 510(b) fraud claims arising while the same class of claims would have been the most junior claimant receiving any distribution in a liquidation. Those claims would be subordinated to become immediately senior to the claims of the same class.⁴⁶ An example will illustrate the effect of this kind of subordination.

⁴⁵ Such a legislative arrangement would provide an additional, but simply aesthetic benefit by shortening § 510(b). Since both the fraud claims of holders of common stock as well as the fraud claims of other security holders would be immediately senior to the underlying claims of their own class, § 510(b) could state one subordination rule rather than the current two. The redlined version reads as follows:

For the purpose of distribution under this title, a claim arising from rescission of a purchase ~~or sale~~ of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase ~~or sale~~ of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to ~~or equal~~ the claim or interest represented by such security; ~~except that if such security is common stock, such claim has the same priority as common stock.~~

⁴⁶ Contrary to the previous correction, this one would produce a lengthier provision. The redlined text here also cures the next error by not subordinating claims from purchases of subsidiaries' stock. The redlined text also carries over the deletion of the "or sale" language and the cure of the excessive subordination of fraud claims by holders of common stock. It would be as follows:

For the purpose of distribution under this title, a claim arising from rescission of a purchase ~~or sale~~ of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase ~~or sale~~ of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that (i) if such security is common stock, such claim ~~has the same priority as~~ shall be subordinated only to all claims or interests that are senior to common stock and (ii) if such claim arose while the class of

Manufacturing, Inc. has liabilities in the amount of \$5 million payable to bondholders, \$5 million payable to subordinated noteholders, and \$5 million payable to preferred shareholders. As its prospects fade, the total value of the firm drops below \$15 million on February 1, then below \$10 million on March 1, and when Manufacturing files for bankruptcy on March 15, it is worth \$7 million and is sold for that amount. The board of Manufacturing has made two misrepresentations, one on February 10, and one on March 10. Each misrepresentation influenced the price of the bonds and the notes and caused liability of \$1 million to each set of claimants. Consider when each class of claims had a claim to the residual. Changes in value of the firm accrued to the holders of the common stock before February 1, to the preferred stockholders between February 1 and March 1, and to the unsecured noteholders after that. The February 10th misrepresentation, although made during insolvency, was not made while the noteholders were the residual claimants. The board of Manufacturing at that time owed its fiduciary duties to the preferred stockholders, who had everything to lose from securities fraud liability to the noteholders. Even if that claim would be subordinate to the noteholders' underlying claim, it would still be senior to the claim of preferred shareholders. Therefore, the deterrent effect of securities liability was in effect at the time the fraud was committed. The March 10 misrepresentation, however, is made while noteholders claim the residual. The board of Manufacturing owed its fiduciary duties at that time to noteholders. If § 510(b) is followed and noteholders' fraud claims are subordinated to the ordinary claims of the noteholders, there would be no deterrence. At the time the misrepresentation is made to purchasers of notes, it is known that they will not be able to collect on their fraud claims because § 510(b) makes them junior to noteholders' ordinary claims. For the noteholders and the board that serves their interests to be deterred, fraud claims arising while they claim the residual must be senior to them. By contrast, the seniority of the claim of the defrauded bondholders need not change. Even though it is junior to bondholders' ordinary claims, the decisionmakers on February 10 and March 10 are deterred from incurring that additional liability.

claims or interests represented by such security were the most junior class that would receive any value in a chapter 7 liquidation, then such claim shall be subordinated only to all claims or interests that are senior to the claim or interest represented by such security.

Thus the incomplete remedy of not subordinating only those fraud claims that were not deterred cures the problem with a minimal interference in the existing mechanics of § 510(b).

This partial correction, which would only change the treatment by § 510(b) of those fraud claims that arise while their class claims the residual, will have the additional advantage of appeasing those who distrust the system of securities fraud liability. Because the typical securities fraud claim would still be subordinate to the underlying claims of the same class, it would not have been rendered more appealing to the contingent-fee lawyers who usually prosecute securities fraud class actions and are vilified by those who believe that most securities fraud suits are brought for their nuisance value rather than their merits.⁴⁷ Finally, the reduction of securities fraud suits against failed companies that § 510(b) induces by its excessive subordination can be considered desirable even if securities fraud litigation is generally meritorious. The premise for this argument is that once the corporation is in bankruptcy, the amount that the equityholders will receive does not depend on the amount of unsatisfied unsecured claims. The equity may get nothing or it may get the constant amount that its bargaining advantage in chapter 11 allows it to extract. Regardless, contingent upon bankruptcy having occurred, additional unsecured claims have no effect on the welfare of equityholders. Consequently, the possibility of securities fraud liability does not deter the equityholders from fraud and since the liability serves no social function, the litigation to determine it is a waste that is better avoided. An example will explain.

The example that illustrates the ineffectiveness of securities fraud liability to deter because of its irrelevance in bankruptcy would start by positing that equity claimants receive the same amount regardless of the size of unsatisfied unsecured claims. In the case of the chapter 11 filing of our paradigmatic Manufacturing, Inc., suppose that the equity receives nothing due to its bargaining power. Consider the deterrence created by the fear of securities

⁴⁷ While this concern likely was behind the Slain and Kripke drive toward subordination, see *supra* note 6, as well as its success, see *supra* notes 15-18 and accompanying text, it is still the subject of concern, see, e.g., Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Acts: The Commission's Authority*, 107 HARV. L. REV. 963 (1994); Joseph A. Grundfest, *We Must Never Forget That It Is an Inkblot We Are Expounding: Section 10(b) as a Rorschach Test*, 29 LOY. L.A. L. REV. 61 (1995).

fraud liability when Manufacturing is still solvent with equity of \$10 million, but faces a 25% probability of insolvency in six months. The management of Manufacturing considers the ramifications of a misrepresentation that would produce \$3 million of gain, but \$4 million of liability, and will reduce the probability of insolvency to 15%. The calculus of deterrence will be as follows.

Without making the misrepresentation, equity will get \$10 million the 75% of the time that Manufacturing remains solvent and nothing the 25% on the time that Manufacturing is in chapter 11, for an expected value of \$7.5 million ($.75 \times 10 + .25 \times 0$). With the misrepresentation, equity receives \$9 million 85% of the time but again nothing in the 15% of the time they are in chapter 11, for a greater expected value of \$7.65 million ($.85 \times 9 + .15 \times 0$). The paradox is not that the calculus of deterrence favors fraud; it may not. The fact that the amount the equity receives in insolvency does not depend on the fraud takes insolvency out of the equity's deterrence decision. This becomes apparent if we examine the opposite case, when equity's welfare in bankruptcy does depend on the absence of the securities fraud claim. Imagine that the \$4 million of securities fraud liability prevents the equity from receiving \$1 million it otherwise would have been able to extract because of its bargaining advantage in chapter 11. Now the calculus of deterrence changes. Without the fraud, equity receives \$10 million the 75% of the time Manufacturing is solvent and \$1 million the 25% of the time it is in chapter 11, for a value of 7.8 ($.75 \times 10 + .25 \times 1$). With the misrepresentation, equityholders receive the same \$9 million the 85% of the time the corporation is solvent, and again nothing in bankruptcy, for the same value of \$7.65 million ($.85 \times 9 + .15 \times 0$). Now that the equity's welfare in bankruptcy depends on fraud liability, the existence of the fraud liability in bankruptcy becomes relevant for deterrence before the bankruptcy.

Those who believe equity's welfare in bankruptcy does not depend on the amount of unsatisfied unsecured claims should favor reducing the disputes about unsecured claims, and to the extent subordination does that by reducing the incentive to prosecute securities fraud class actions, they would be in favor of maintaining the subordination of fraud claims to below the claims of the same class that § 510(b) mandates and that the partial repair maintains. Those who believe equity's welfare in bankruptcy does depend on the amount on unsecured claims would believe that determining

fraud liability in bankruptcy plays a role in deterrence outside bankruptcy. Therefore, they would consider the prosecution of fraud claims useful and measures that reduce the likelihood of securities fraud class actions, such as the subordination of fraud claims to the claims of the same class, undesirable. They would favor the complete correction. Without more study of this matter, this dispute cannot be resolved here. What is clear is that the partial correction is definitely justified, while the complete correction may not be.

The complete correction is not forthcoming from interpretation alone. Courts can, however, follow a line of interpretation that allows them to approach the partial correction of the error of eliminating deterrence against defrauding buyers of debt securities during insolvency. The last two errors of § 510(b) show that it was not drafted so as to apply to frauds that occur during insolvency. Once the corporation is insolvent, following the letter of § 510(b) would create incentives to defraud buyers of debt securities and buyers of common stock of subsidiaries. Since Congress cannot have intended this result, it is apparent that § 510(b) was intended only to apply in the instances in which it does not eliminate deterrence. Therefore, it does not apply in the cases of fraud claims of nonequity security buyers that arose at the time that particular class was the most junior in-the-money class.⁴⁸ In those cases, pre-Code law will apply. If the res of a constructive trust can be traced, the fraud claimant would receive priority, otherwise the fraud claimant would be treated as an ordinary creditor, unless the creditor gives grounds for subordination, in which case it will be subordinated as the equities of the particular case dictate per § 510(c).

C. The Subordination of Fraud Claims of Subsidiary Shareholders

Unlike the subordination of fraud claims of debt securities, the subordination of the fraud claims of subsidiary shareholders does distort decisions in anticipation of insolvency. Fraud committed before insolvency upon subsidiary shareholders will appear more

⁴⁸ Indeed, the against-the-text-of § 510(b) practice of not subordinating fraud claims of equity buyers should be seen as part of this interpretation. Fraud claims of buyers of any security do not fall under § 510(b) if they arise when that class claims the residual because this would eliminate deterrence of fraud.

attractive if insolvency of the parent is likely in the future, whereupon the fraud claims would be subordinated to extinction. Because of this anticipatory distortion in deterrence, the correction here must be complete.

The error about the subordination of subsidiary shareholders' fraud claims can be corrected in a manner that has the same consequences, regardless of whether the correction is implemented legislatively or through interpretation. A legislative correction would simply strike the text "or of an affiliate of the debtor" from § 510(b).⁴⁹ An interpretive correction would be founded on the notion that the subordination § 510(b) imposes generally is subordination to a level immediately junior to the security's underlying claims. When this general principle is applied to fraud claims arising from the purchase of common stock of subsidiaries, the reference that these claims must be subordinated to the level of common stock means not common stock of the parent, but common stock of the subsidiary. Since common stock claims of the subsidiary are senior to all claims of parent creditors, this level of subordination will remedy the error.

VI. CONCLUSION: PROBLEMS LATENT AND ACUTE; REPAIRS INTERPRETIVE AND LEGISLATIVE, PARTIAL AND COMPLETE

The variety of errors that § 510(b) presents for correction allow a look at a broad spectrum of types of problems that the Bankruptcy Code may give rise to, as well as a broad spectrum of remedies. The problems encountered ranged from the latent to the acute. Two different types of latent errors were represented by the first two errors discussed. The excessive subordination of common stock's fraud claims is latent because courts ignore the text of the provision. The false subordination of fraud claims from the resale of securities to the corporation is latent because transactions giving rise to such claims are unlikely to occur before bankruptcy when the corporate prospects and the liquidity of the corporate coffers are fading.

The correction of latent errors may seem pointless but its function exceeds the correction of a rule that is not applied. The against-the-text interpretation that courts apply to correct the error of excessive subordination shows that the courts have the capacity to adopt the interpretations necessary to correct the other errors as

⁴⁹ As in the redlined text *supra* at note 46.

well. The correction of the false subordination of the fraud claims from resales to the corporation removes a pointless impediment that makes transactions involving stock buybacks by corporations costlier and less attractive. The need to correct the acute errors, of course, needs no justification.

That both legislative and interpretive corrections can achieve largely the same purposes may be an idiosyncrasy of bankruptcy law and of the interpretive latitude that has always been necessary to reign in wily debtors and to produce equitable results with limited rules. When evaluating the plausibility and the necessity of the interpretive corrections, it must be kept in mind that legislative attempts to fix § 510(b) have repeatedly failed and that recent proposals about updating the Bankruptcy Code have been divisive rather than consensus-building. Despite that legislative corrections would lead with greater predictability to the intended result, they are not particularly likely to be implemented. The unusual political economy of amending the Code argues in favor of interpretive corrections. The difficulty of producing the consensus necessary for amending the Code also argues in favor of the partial corrections compared to complete corrections when a choice exists and the partial correction will suffice.