2016

Section 510 (b) of the Bankruptcy Code is to be Interpreted Broadly

James M. Kerins

ST. JOHN'S UNIVERSITY
SCHOOL OF LAW

Section 510 (b) of the Bankruptcy Code is to be Interpreted Broadly

2016 Volume VIII No. 10

Section 510 (b) of the Bankruptcy Code is to be Interpreted Broadly

James M. Kerins, J.D. Candidate 2017

Cite as: *Section 510 (b) of the Bankruptcy Code is to be Interpreted Broadly*, 8 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 10 (2016)

I. INTRODUCTION

One of the cornerstone principles of Chapter 11 under title 11 of the United States Code ("the Bankruptcy Code") is section 510 (b).[1] Under section 510 (b), a fraud claim by a purchaser of stock in a corporation that subsequently files a petition for relief under the Bankruptcy Code must be subordinated to general unsecured creditors.[2] Although the application of section 510 (b) may seem straightforward, courts have struggled interpreting the ambiguous language of section 510 (b).

Prior to Congress enacting section 510 (b), there was significant confusion throughout the bankruptcy community regarding what claims must be subordinated. Many courts struggled in determining whether such claims should be treated *pari passu* with claims of general unsecured creditors or whether such claims should be subordinated.[3] Congress sought to clarify these issues when it enacted section 510 (b).

---

[1] 11 U.S.C. § 510 (b)(2016).
[2] *Id.*
[3] *See Allen v. Geneva Steel Co.* (*In re* Geneva Steel Co.), 281 F.3d 1173 (10th Cir. 2002) (explains the history and policy behind section 510(b)); H.R. Rep. No. 595, 95th Cong., 1st Sess. 194 (1977).

When creating section 510 (b), Congress relied heavily[4] on the law review article written by two prestigious law school professors, John J. Slain ("Slain") and Homer Kripke ("Kripke").[5] According to Slain and Kripke, section 510 (b) was created to reflect "the different degree to which each party assumes a risk of enterprise insolvency."[6] Factoring in the general creditor's need for protection, Congress' rationale for section 510 (b) was that general creditors rely on a cushion of securities when they decide to extend credit.[7] Furthermore, since creditors rely heavily on the protections from mandatory subordination in the event of bankruptcy,[8] whereas security holders freely bargained for an equity interest rather than a debt interest when they decided to invest in the corporation's stock,[9] Congress sought to fairly balance these risks. Because security holders voluntarily forgo the risk of insolvency with the hopes of making a profit, Congress designed section 510 (b) with the intent to provide creditors with more protection.

In 1978, Congress enacted section 510 (b) of the Bankruptcy code, which states,

> [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 [11 U.S.C § 502] on account of such a claim, shall be subordinated to all claims or

---

[4] *See Am. Broad. Sys. v. Nugent* (*In* re Betacom of Phoenix, Inc.), 240 F.3d 823, 829 (9th Cir. 2001) ("Congress relied heavily on the analysis of two law professors in crafting the statute."); *In re* Granite Partners, L.P., 208 B.R. 332, 336 (Bankr. S.D.N.Y. 1997) ("Any discussion of section 510 (b) must begin with the 1973 law review article authored by Professors John J. Slain and Homer Kripke...").

[5] John J. Slain and Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy — Allocating the Risk of Illegal Securities Issuance Between Security holders and the Issuer's* Creditors, 48 N.Y.U. L. REV. 261 (1973).

[6] Slain & Kripke, *supra* note 5, at 287.

[7] *See In re* Tristar Esperanza Properties, LLC, 69 C.B.C.2d 1022, 488 B.R. 394 (B.A.P. 9th Cir. 2013); *In re* Betacom of Phoenix, Inc., 240 F.3d at 830; *Jezarian v. Raichle* (*In re* Stirling Homex Corp.), 579 F.2d 206 (2d Cir. 1978); *In re* Orange Cnty. Nursery Inc., 523 B.R. 692 (C.D. Cal. 2014); *In re* KIT Digital, Inc., 497 B.R. 170 (Bankr. S.D.N.Y. 2013); *In re* Commercial Fin. Servs., Inc., 268 B.R. 579 (Bankr. N.D. Okla. 2001); *In re* Lernout & Hauspie Speech Products, N.V., 264 B.R. 336 (Bankr. D. Del. 2001); Slain & Kripke, *supra* note 5.

[8] *See In re* Stirling Homex Corp., 579 F.2d at 206.

[9] *See* H.R. REP. NO. 95-595, at 195. One of the main differences between a shareholder and a creditor is the shareholders ability to reap the benefit of future profits that a corporation may earn. *See* Slain & Kripke, *supra* note 5, at 287

> 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.[10]

However, shortly after its enactment, courts were confused when interpreting section 510 (b). Was it intended for mandatory or discretionary subordination? Due to the ambiguous scope of section 510 (b),[11] courts were forced to resort to the canons of construction, such as legislative history and Congress' intent when interpreting section 510 (b).[12] After reviewing the canons of construction, courts have consistently interpreted the language of section 510 (b) broadly, requiring the subordination of claims regardless of whether fraud, breach of contract, or other actions are involved.[13]

Currently, section 510 (b) is the primary tool used by courts in determining whether a claim is treated equally with all other valid claims or is subordinated. Grounded in Congress' policy that unsecured creditors should not bear all of the risk, courts have been authorizing mandatory subordination whenever there is a "causal relationship between the claim and the purchase" or sale of securities.[14]

II. GENERAL IMPLICATIONS OF BROADLY INTERPRETATING SECTION 510 (B)

[10] 11 U.S.C. § 510 (b)(2016).
[11] *See id; SeaQuest Diving LP v. S & J Diving Inc.* (*In re* SeaQuest Diving LP), 579 F.3d 411, 418 (5th Cir. 2009).
[12] *James v. City of Costa Mesa*, 700 F.3d 394, 399 n.8 (9th Cir. 2012).
[13] *See Baroda Hill Inv., Inc. v. Telegroup, Inc*. (*In re* Telegroup, Inc.), 281 F.3d 133 (3d Cir. 2001) (breach of contract); *In* re Betacom of Phoenix, Inc., 240 F.3d 823 (9th Cir. 2001) (breach of contract); *In re* Washington Mutual, Inc., 464 B.R. 656 (Bankr. D. Del. 2012) (breach of contract); *In re* Int'l Wireless Communs. Holdings, Inc., 279 B.R. 463 (D. Del. 2002); *In re* Public Serv. Co. of N.H., 129 B.R. 3 (Bankr. D.N.H. 1991); *In re* Lenco, Inc., 116 B.R. 141 (Bankr. E.D. Mo. 1990) (ERISA violation in sale to ESOP). *But see In re* Lehman Bros. Holdings Inc., 513 B.R. 624 (Bankr. S.D.N.Y. 2014) (holding that mortgage backed securities were not securities "of the debtor or of an affiliate of the debtor" under section 510(b)); *In re* CIT Group Inc., 460 B.R. 633 (Bankr. S.D.N.Y. 2011) (holding that payments of consideration for tax benefits are not subordinated under section 510(b)); *In re* Washington Mutual, Inc., 462 B.R. 137 (Bankr. D. Del. 2011) (holding that a fraud claim based upon misrepresentations is not a security of the debtor and is therefore not subordinated under section 510(b)).
[14] *See Pensco Tr. Co. v. Tristar Esperanza Props., LLC (In re* Tristar Esperanza Props., LLC), 782 F.3d 492, 497 (9th Cir. 2015) (quoting *Leroy's Horse & Sports Place v. Am. Wagering, Inc. (In re* Am. Wagering), 493 F.3d 1067, 1072 (9th Cir. 2007)).

Courts have consistently held that section 510 (b) is ambiguous in scope.[15] Initially, courts generally limited subordination to claims that directly "arose from" a purchase or sale of a security.[16] For example, courts would not apply the statute to any claims that occurred after the issuance of the security.[17] However, this is no longer the case.

Continuously over the years, courts have been authorizing mandatory subordination whenever there is a "causal relationship between the claim and the purchase" or sale of securities.[18] Currently, a claim neither needs to directly flow from a securities transaction nor contemporaneously arise with the purchase or sale of a security.[19] As long as there is a "causal link" between the transaction and the injury suffered, it will be viewed as "arising from" the transaction.[20] This broad interpretation has led courts to apply section 510 (b) to a wide variety of actions.[21]

---

[15] *See In re* SeaQuest Diving LP, 579 F.3d at 418; *Allen v. Geneva Steel Co. (In re* Geneva Steel Co.), 281 F.3d 1173, 1178-79 (10th Cir. 2002); *In re* Orange Cnty. Nursery Inc., 523 B.R. 692, 697 (C.D. Cal. 2014); *In re* Granite Partners, L.P., 208 B.R. 332, 339 (Bankr. S.D.N.Y. 1997).

[16] *See, e.g., Montgomery Ward Holding Corp. v. Shoeberl* (*In re* Montgomery Ward Holding Corp.), 272 B.R. 836, 842 (Bankr. D. Del 2001) ("The plain language of the statute limits automatic subordination to claims that directly concern the stock transaction itself."); *In re* Amarex, Inc., 78 B.R. 605, 609 (Bankr. W.D. Okla. 1987) ("The legislative history expressly focuses on the initial illegality and thus the automatic subordination should extend no farther.").

[17] *See, e.g., In re* Angeles Corp., 177 B.R. 920, 927 (Bankr. C.D. Cal. 1995):

> If Congress had wanted to subordinate all claims of security holders to an equity position, regardless of the source of the claim, Congress would have worded Section 510(b) to say: 'All claims made by security holders, regardless of the source of the claim, shall be subordinated to an equity class ....' However, Bankruptcy Code Section 510 (b) does not say this. Thus, Section 510(b)'s subordination of claims 'arising from the sale or purchase of a security' must mean subordinating less than every claim of a security holder, regardless of how that claim arises.

[18] *See In re* Tristar Esperanza Props., LLC, 782 F.3d at 497 (quoting *In re* Am. Wagering, 493 F.3d at 1072).

[19] *In re* SeaQuest Diving, LP, 579 F.3d at 421-22; *In re* Pre-Press Graphics Co., Inc., 307 B.R. 65, 78 (N.D. Ill. 2004); *In re* NAL Fin. Group, Inc., 237 B.R. at 232.

[20] *In re* SeaQuest Diving, LP, 579 F.3d at 421-22; *In re* Pre-Press Graphics Co., Inc., 307 B.R. at 78; *In re* Washington Mutual, Inc., 464 B.R. 656, 669 (Bankr. D. Del. 2012); *In re* NAL Fin. Group, Inc., 237 B.R. at 231; *In re* Granite Partners, L.P., 208 B.R. at 339.

[21] *See Am. Broad. Sys. v. Nugent (In* re Betacom of Phoenix, Inc.), 240 F.3d 823, 828 (9th Cir. 2001) ("the statute requires subordination of more than securities fraud claims"); *Leroy's Horse & Sports Place v. Am. Wagering, Inc.* (*In re* Am. Wagering), 493 F.3d 1067 (9th Cir. 2007) (stating that as long as there is a sufficient nexus between the claims and the purchase of securities, section 510 (b) can apply to an ordinary breach of contract); *In re* SeaQuest Diving, LP, 579 F.3d at 421 (acknowledging that the Second, Third, Tenth and Ninth Circuits all adopt a broad interpretation of section 510(b)); *Rombro v. Dufrayne* (*In re* Med Diversified, Inc.), 461 F.3d 251, 255 (2d Cir. 2006) (recognizing that most courts support a broad interpretation of section 510(b)); *Allen v. Geneva Steel Co. (In*

The broad interpretation of section 510 (b) is due in large part to the acknowledgment by courts of Congress' intent for section 510 (b), which was to shift some of the risks associated with securities away from general unsecured creditors and onto the security holders. One example of security holders bearing more risk is the fact that only security holders are faced with the risks associated with an unlawful issuance of securities.[22] In the event the debtor issues unlawful securities, rather than splitting the risk between general creditors and the security holders, the security holder's claims are to be mandatorily subordinated pursuant to section 510 (b).[23]

The basis for this stems from Congress' overall rationale for the creation of section 510 (b), which is that creditors need to be protected against risks, especially ones they have no control over. When a security holder purchases a security, they are assuming the risk of illegality. Contrary to the rights of unsecured creditors, at any time, security holders are allowed to rescind a purchase of stock. Therefore, since the risk of illegality and the ability to get out rests solely in the hands of the security holder, there is no reason to shift the risk of illegality to the general unsecured creditors.[24]

---

re Geneva Steel Co.), 281 F.3d 1173, 1182 (10th Cir. 2002); *In re* Enron Corp., 341 B.R. 141 (S.D.N.Y. 2006) ("In this Court's opinion, the broad applicability of section 510(b) is now quite settled"); *In re* Touch Am. Holdings, Inc., 381 B.R. 95, 103 (Bankr. D. Del. 2008) (stating that the language in section 510(b) is "broad enough to include indemnification claims for both liabilities and expenses incurred on account of a claim for 'damages arising from the purchase or sale' of the debtor's or its affiliate's securities").

[22] *See In re* Med Diversified, Inc., 461 F.3d at 256; *In re* Geneva Steel Co., 281 F.3d at 1180; *Baroda Hill Inv., Inc. v. Telegroup, Inc*. (*In re* Telegroup, Inc.), 281 F.3d 133, 139-40 (3d Cir. 2001); *In re* Betacom of Phoenix, Inc., 240 F.3d at 830; *Kelce v. United States Fin. Inc.* (*In re* United States Fin. Inc.), 648 F.2d 515, 520 (9th Cir. 1980); *Jezarian v. Raichle* (*In re* Stirling Homex Corp.), 579 F.2d 206, 214 (2d Cir. 1978); *In re* Commercial Fin. Servs., Inc., 268 B.R. 579, 592-93 (Bankr. N.D. Okla. 2001); *In re* NAL Fin. Group, Inc., 237 B.R. 225, 232-33 (Bankr. S.D. Fla. 1999); *In re* Walnut Equip. Leasing Co., Inc., 1999 Bankr. LEXIS 1626, at *34-35 (Bankr. E.D. Pa. Dec. 28, 1999); Slain & Kripke, *supra* note 9.

[23] 11 U.S.C. § 510 (b)(2016).

[24] *See* Slain & Kripke, *supra* note 9, at 288.

However, although courts have broadly interpreted section 510 (b)'s language, courts have still acknowledged that section 510 (b) is not limited strictly to security holder claims.[25] There are cases where a creditor's claim can be subordinated. [26]

III. CLARITY AND LIMITS ON SECTION 510 (B)'S USE OF "ARISES FROM"

An ambiguous term set forth in section 510 (b) which courts have struggled to define is the term "arises from." The U.S. Court of Appeals for the Ninth Circuit, in *Pensco Trust Co. v. Tristar Esperanza Props., LLC* (*In re* Tristar Esperanza Props., LLC),[27] interpreted and defined limits on the term "arises from." The Ninth Circuit held that a creditor's claim, based upon a debtor's failure to pay an arbitration award, must be subordinated pursuant to section 510 (b) of the Bankruptcy Code.[28] In *Tristar*, Jane O'Donnell purchased a minority membership interest in Tristar, a limited liability company. Three years after the purchase, she exercised her right to withdraw her membership interest.[29] When O'Donnell and Tristar could not agree on a price, O'Donnell brought an arbitration action and won an award of approximately $400,000, which was later converted into a state court judgment.[30] Subsequently, Tristar filed a chapter 11 bankruptcy petition and commenced an adversary proceeding against O'Donnell seeking to subordinate her claims pursuant to section 510 (b) of the Bankruptcy Code.[31]

O'Donnell insisted that section 510 (b) of the Bankruptcy Code did not apply because the claim was "not for damages, but for a fixed, admitted debt."[32] Additionally, O'Donnell claimed

---

[25] *In re* Touch Am. Holdings, Inc., 381 B.R. at 103 ("Section 510(b) is not limited to shareholder claims.").
[26] *See e.g., In re* Jacom Computer Servs., Inc., 280 B.R. 570 (Bankr. S.D.N.Y. 2002); *In re* Mid-America Waste Sys., Inc. 228 B.R. 816 (Bankr. D. Del. 1999); *In re* Walnut Equip. Leasing Co., Inc., 1999 Bankr. LEXIS 1626 (Bankr. E.D. Pa. Dec. 28, 1999).
[27] *Pensco Tr. Co. v. Tristar Esperanza Props., LLC (In re* Tristar Esperanza Props., LLC), 782 F.3d 492, 497 (9th Cir. 2015).
[28] *See id.* at 497-98.
[29] *See id.* at 494.
[30] *Id.*
[31] *See id.*
[32] *See id.* at 495.

that section 510 (b) should not apply because the claim "does not arise from the purchase or sale of securities" because she converted her equity interest to a debt claim before debtor filed its bankruptcy petition.[33] The bankruptcy court rejected O'Donnell's arguments and held that the subordination clause of section 510 (b) "sweeps broadly."[34] Consequently, the bankruptcy court "broadly interpreted"[35] the phrase "arises from"[36] to mandate subordination whenever there is a "causal relationship between the claim and the purchase" or sale of securities.[37] Furthermore, although O'Donnell did not "enjoy the benefits of equity ownership on the date of the petition,"[38] according to the bankruptcy court, since O'Donnell bargained for an equity position she therefore, "embraced the risks that position entails."[39] On appeal, the Bankruptcy Appellate Panel for the Ninth Circuit and the United States Court of Appeals for the Ninth Circuit both affirmed.[40]

The *Tristar* holding affirmed what many other courts had previously held, that section 510 (b) is to be broadly interpreted. While reaffirming Congress' intent, *Tristar* also clarified some additional issues. When performing a section 510 (b) analysis, the critical question is whether or not the claim arises from the purchase or sale of a security.[41] According to the Ninth Circuit, the status of the claim on the petition date does not matter.[42] Although the court did leave open the possibility of a limitation if a substantial period of time following a transaction has passed,[43] they did not address that issue.

---

[33] *See id*.
[34] *See id.*
[35] *See id* at 497.
[36] *See id.*
[37] *See id.* (quoting *In re* Am. Wagering, 493 F.3d at 1072).
[38] *See In re* Tristar Esperanza Props., LLC, 782 F.3d at 497.
[39] *See id.* at 498.
[40] *Id*.
[41] *See id.* at 497.
[42] *Id*.
[43] *See id.* at 498.

The major takeaway from *Tristar* was the reasoning the Ninth Circuit used in reaching its decision. Faced with a new issue, whether section 510 (b) applies when a security holder converts their equity interest into a debt claim before debtor filed its bankruptcy petition,[44] the Ninth Circuit stuck to its guns, stating that the language of section 510 (b) "sweeps broadly."[45] This gives the legal community great clarity and a sense of direction. As long as there is a "causal relationship between the claim and the purchase,"[46] the court will apply section 510 (b). By maintaining Congress' intent, as well as abiding by previous courts interpretations, the Ninth Circuit has provided guidance to the legal community on how section 510 (b) issues may play out.

IV. Conclusion

When interpreting section 510 (b), courts have continuously abided by the intent and reasoning set forth by Congress, which was to shift some of the risks associated with securities away from general unsecured creditors and onto the security holders. As a result, courts have been routinely interpreting and applying section 510 (b) broadly. This has provided the legal community with some stability.

Currently, a section 510 (b) analysis has two steps. *First*, when determining if a claim is to be treated equally with all other valid claims or whether it requires to be subordinated, courts must decide whether the claim arises from the purchase or sale of a security. *Second*, if the claim arises from the purchase or sale of a security, the court will mandate subordination if there is a "causal relationship between the claim and the purchase" or sale of securities. When in doubt, it is important to keep in mind that the language of section 510 (b) "sweeps broadly." Lastly, if the court is presented with a new issue when interpreting section 510 (b), it would be wise to

[44] *See id.* at 495.
[45] *Id.*
[46] *See id.* at 497 (quoting *In re* Am. Wagering, 493 F.3d at 1072).

remember that courts continuously look to the intent and reasoning set forth by Congress when it enacted this section of the Bankruptcy Code.