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Problems in the Code

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Shareholder vs. Shareholder: Solvent Debtors and the Ranking of Disclosure-Related Claims

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When a solvent debtor faces disclosure-related claims by past or current stockholders, § 510(b) of the Bankruptcy Code is a stumper. As amended in 1984,[1] it states that such claims have the "same priority" as common stock. If the debtor is solvent, these words are nonsensical. A securities-disclosure claim is allowable, or not, in a liquidated amount. A common-stock interest, after return of usually nominal par value, entitles its holder to a portion of the firm's residual value. A liquidated amount and a residual interest cannot have the "same priority."

The Problem

The legislative history of § 510(b) does not mention "solvent debtors," but it focuses on whether disclosure-related claims should be subordinate to claims by other creditors. There was a hot debate about this in the 1970s. For many years, U.S. law generally permitted plaintiffs with disclosure claims to dilute the recoveries of other creditors.[2] Eventually, following a seminal article on the topic by Profs. John Slain and Homer Kripke in 1973,[3] Congress reversed this by establishing a clear rule that claims "arising from a purchase or sale" of stock are subordinate to creditor claims. Stockholders come last, *even when they have been defrauded*. In the language of law and economics, as between an equity investor and an unrelated creditor, the risk of a company lying to the equity investor in connection with a sale of equity should be borne by the equity investor, not the third-party creditor.

This is now settled law. Indeed, since 1978, case law has expanded the category of subordinated § 510(b) claims substantially beyond the type of rescission claim first analyzed by Profs. Slain and Kripke (*i.e.*, a claim where the plaintiff purchased stock from the debtor in reliance on misleading disclosure). Section 510(b) now captures, for example, claims by plaintiffs who purchased stock from third parties (rather than the debtor), claims by plaintiffs who merely held stock in reliance on questionable disclosure (rather than purchased it), and various contractual claims by stockholders and third parties related to common stock transactions.

The Fifth Circuit summed up the expansive view of § 510(b) nicely in a recent appeal from the *Linn Energy* bankruptcy, concluding that "arising from" as used in § 510(b) is "ambiguous," and therefore the "most important question is this: Does the nature of the [plaintiff's] interest make the [plaintiff] more like an investor or a creditor?"[4] If "investor," says the Fifth Circuit, then the investor's claim is subordinate to claim of real "creditors."[5]

The "creditor-first" policy is easy to apply when equity receives no distribution. Mandating that disclosure-related claims have the same priority as stock simply means that they receive nothing. However, it remains unclear as to what happens in cases where there is residual value after distributions to creditors and what the correct allocation of this residual value is between common stockhold-

1 Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (codified in scattered sections of titles 11 and 28).

2 *See Allen v. Geneva Steel Co.*, 281 F.3d 1173 (10th Cir. 2002) (discussing background of § 510(b)).

3 John J. Slain & Homer Kripke, "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).

4 *French v. Linn Energy LLC (In re Linn Energy LLC)*, 936 F.3d 334, 341 (5th Cir. 2019).

5 *Id.*

ers and disclosure-related claims. Common stock and these claims cannot have the same priority, at least not without some extra-statutory method of converting shares of stock into fixed claim amounts, or vice versa.

In past cases in which the author has been involved, the debtor has considered taking the following approach: picking a conversion ratio to establish an equivalency between the claims and the stock. Notwithstanding the foregoing, this arbitrary choice of a conversion ratio risks an objection by securities claimants, stockholders or both — and the Bankruptcy Code provides no reliable guidance in resolving that objection.[6]

The Argument for a Claims-First Approach

Given a lack of clarity within the statutory language regarding the issue previously discussed, perhaps the simplest solution would be to amend § 510(b) so that claims arising out of common-stock transactions rank behind creditors and preferred stockholders, but ahead of common-stock interests. In other words, once other creditors are paid, § 510(b) would no longer apply. If a debtor faced $100 million of allowed, uninsured disclosure claims and had only $90 million to distribute to common stockholders after the creditors had been satisfied, the disclosure claims would receive 90 cents on the dollar and common stockholders would receive nothing.

We can refer to this mechanism as the "claims-first approach." The proposed language necessary to implement it is straightforward and reads as follows:

> (b) For the purpose of a distribution under this title, a claim arising from recission 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 to the claim or interest represented by such security, except that if such security is common stock, such claim ~~has the same priority as~~ *shall not be subordinated to common stock*.

Some strong arguments support the claims-first approach. First, it is consistent with the limited legislative history of § 510(b), which focuses exclusively on the ranking of disclosure claims *vis-à-vis* claims by creditors. Second, the claims-first approach complies with the important principle that the Bankruptcy Code should not modify nonbankruptcy legal entitlements without an important reason to do so. Outside of chapter 11, the stockholders of a public corporation assume the risk of undisclosed liabilities under the securities laws, including potential liabilities to other stockholders. It appears nonsensical to use the Code to reach a different result.

Lastly, the claims-first approach seems intuitively fair when one considers the archetypical securities transaction described by Profs. Slain and Kripke, and picked up in the legislative history concerning § 510(b). This archetypical transaction is a "primary offering" in which the debtor sells stock to new public investors for cash. In a primary offering, the corporation receives the proceeds from the sale of the stock, and these proceeds increase the value of the corporation for other stockholders. Accordingly, the rescission claim must rank prior to stockholder distributions to put everyone in the position they would be in had the fraud never occurred. At least in the case of disclosure claims relating to a primary offering for cash, the claims-first approach avoids unjust enrichment of the stockholders who were not defrauded, requiring the corporation (after payment of creditors) to return to the defrauded stockholder the value received.

The Modified Stockholder-First Approach

However, the question is not so simple, because not all § 510(b) claims arise out of a primary offering. Let us return to the expansion of § 510(b) by courts since 1978 to cover securities claims not considered by Profs. Slain and Kripke, or the legislative history.

The most common type of securities-disclosure claims today arise from secondary trading, and typically allege a fraud-on-the-market theory of transaction causation.[7] These claims are inherently different from a claim arising from a direct offering. The fraud-on-the-market plaintiff did not transact with the debtor or pay value to the debtor's estate. Instead, the plaintiffs purchased shares from third parties in presumed reliance on misleading disclosure and then, after corrective disclosure, sold the shares to other third parties at a loss. Alternatively, the plaintiffs did not sell shares at all, but merely *retained* shares in the corporation in reliance on misleading disclosure.

The net economic result of a successful fraud-on-the-market claim is not a return by the corporation of ill-gotten gains that would otherwise be kept for the benefit of stockholders. Generally, if the plaintiff bought high and sold low, the "winner" in the transaction with the plaintiff is the third party who sold the shares to the plaintiff at the inflated price — not the corporation or its stockholders. Nevertheless, if a fraud-on-the-market claim succeeds, the corporation and not the third party must compensate the plaintiffs at the expense of its current stockholders, even when most of these current stockholders did not participate in or benefit from the transaction.

The securities laws impose this liability outside of chapter 11 as a penalty to encourage accurate disclosure of information. The same deterrence policies may continue to be relevant in chapter 11. However, in chapter 11, there are other considerations at play, including a general dislike of noncompensatory damages and policies that encourage finality, new investment and the fair compromise of complex claims.

As we consider the merits of a strict claims-first approach, it might be interesting to keep in mind what

6 Some solvent-debtor cases, such as *PG&E*, have incorporated a class-action settlement into the reorganization plan, avoiding the need to rely on § 510(b)'s ranking language other than as background for the reasonableness of the settlement. *See* Debtors' and Shareholder Proponents' Joint Chapter 11 Plan of Reorganization, dated June 19, 2020, *In re PG&E Corp. and Pac. Gas and Elec. Co.*, Case No. 19-30088 (N.D. Cal.). In *Garrett Motion*, where my firm represented the debtor and we did not have a certified class with whom we could settle, the plan paid allowed uninsured § 510(b) stock claims in full in cash or, at the debtor's election, in stock at plan value. *See* Debtors' Amended Joint Chapter 11 Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, dated April 20, 2021, *In re Garrett Motion Inc., et. al.*, Case No. 20-12212 (S.D.N.Y.).

7 *See Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

happens under § 510(b) to disclosure-based claims by *bondholders* when a plan does not pay the applicable series of bonds in full. In a chapter 11 case, any bond represents in the first instance a claim for the amount due under the bond itself.

However, the bond also can give rise to incremental disclosure claims, for the same reason that common stock can give rise to both an historical disclosure claim and an entitlement to a current distribution. For example, if a corporate debtor issued $1 billion of bonds and files for bankruptcy when the bonds are trading at $200 million, the debtor could owe *more than $1 billion* with respect to the $1 billion of bonds. It obviously owes $1 billion to the current holders (putting aside interest, original issue discount,[8] etc.). In addition, if prior bondholders establish that the debtor misled them in a manner that entitles them to damages under the securities laws, the debtor also may owe prior bondholders for trading losses.

This brings up the question: What is the priority of the competing bond and bond-related disclosure claims? Section 510(b) *displaces state law priorities* and provides a new bankruptcy answer to the question. This Code section subordinates all securities-litigation claims by the former bondholders to the actual bond held by the current bondholders, even though the securities claim and the bond would rank equally under nonbankruptcy law.

The subordination makes sense. Granting a priority to the current bondholders increases the bond's value. The bond should trade at a higher price in the market because recoveries are not subject to dilution by unknown disclosure claims, and distributions to holders can occur immediately without waiting for the resolution of disclosure litigation. Since the value and price of the bond are higher, any seller of a bond after corrective disclosure — *including the party injured by nondisclosure* — can mitigate its losses. Effectively, the market moots the claim.

Given this workable solution for bonds, it stands to reason that the same approach could work with common stock. In a typical solvent-debtor case, the graph of stock price over time is concave: The stock price first declines from a pre-petition "high" to a "low" around the date of filing, then, if the debtor does its job well, it climbs again during the chapter 11 case. Why should stockholders who sold at the low point be entitled to recover from the estate at the expense of stockholders who did not sell? Why should a new investor who purchases stock in a distressed corporation both (1) pay the selling stockholder for the stock and (2) suffer the reorganized corporation "paying" the selling stockholder again on a disclosure theory?

Extending the bond rule to stock claims would provide a different general rule, which we can call a modified stockholder-first approach. For most claims — such as fraud-on-the-market claims arising from second trading activity — distributions on disclosure claims would rank junior to distributions on common stock and be extinguished by the chapter 11 plan.

However, the approach would be "modified" because § 510(b) claims related to a primary offering by the debtor (the type of claims contemplated by Profs. Sloan and Kripke and the legislative history of the 1978 Act) would rank senior to common stock and be paid in full before common stock recoveries. As previously discussed, this approach prevents unjust enrichment of the corporation and its other stockholders from the proceeds of misleading disclosure. It also seems appropriate to pay contractual indemnity claims ahead of common stockholders in most circumstances,[9] and to allow the court, for cause, to grant senior status to stock-related claims where appropriate to avoid unjust enrichment of insiders or to preserve a deterrence function (*i.e.*, in the unlikely chapter 11 case filed for the purpose of avoiding fraud-on-the-market disclosure liabilities). Putting all of this together, § 510(b) could be amended to implement a modified stockholder-first approach as follows:

> (b) For the purpose of a distribution under this title, a claim arising from recission 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 to 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~~ *shall be (1) senior to common stock to the extent (A) arising from a purchase of common stock from the debtor, (B) arising under a contract with the debtor, (C) arising under indemnification or contribution undertakings included in the debtor's constitutive documents or (D) as ordered by the court for cause, and (2) otherwise extinguished.*

Who wins or loses with this approach? A clear winner is the plan-formation process, which is simplified. Many § 510(b) claims relating to secondary-market transactions eventually prove meritless or fully covered by directors and officers insurance, and the modified stockholder-first approach eliminates the need for the reorganization plan to address purely theoretical claims or to deal with nuisance litigation prior to making stockholder distributions. Other clear winners are new investors in the reorganized capital structure: The modified stockholder-first approach reduces contingent claims that could survive chapter 11 and should improve the availability and pricing of forward equity commitments.

The most interesting argument in favor of the modified stockholder-first approach is that it also may be the fairest way to compensate the victims of pre-petition disclosure violations based on secondary market trading. As we saw with bondholder disclosure claims in cases where bonds were the fulcrum security, the modified stockholder-first approach should *maximize the market price at which pre-petition stockholders (those harmed by the alleged disclosure violation) may sell their common stock prior to*

8 "Original issue discount" can alter the allowed amount of a bond and occurs when the face amount of the bond significantly departs from its market price at the time of issuance.

9 For example, corporate indemnification obligations in favor of directors, officers, underwriters and other nondebtors — typically assumed in a solvent debtor case — seem properly senior to common equity interests as claims entitled to the benefit of the absolute-priority rule. The modified stockholder-first approach is useful as a way to allocate value among stockholders, although not necessarily among stockholders and others.

and during the chapter 11 proceeding. The injured stockholder may forfeit a fraud-on-the-market securities disclosure claim, but the absence of all similar securities claims increases the trading value of the common stock during chapter 11 and at emergence. Higher trading value means a better immediate opportunity for all stockholders to mitigate their losses (whether or not related to disclosure) in a market sale.

Conclusion

These are complicated issues. There also may be better alternatives than either the claims-first approach or modified stockholder-first approach, each of which in any case would require analysis beyond the scope of this article. What is clear is that, for a solvent debtor at the end of its waterfall, § 510(b) as drafted is unworkable. abi

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