

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for Today's Busy Insolvency Professional

Enron and the Subordination of Stock Options and Other Claims under §510(b) of the Code

Written by:

James Gadsden¹

Carter Ledyard & Milburn LLP; New York
gadsden@clm.com

Judge Gonzales's recent opinion in *In re Enron Corp.*, 341 B.R. 141 (Bankr. S.D.N.Y. 2006), subordinates the claims asserted by Enron employees who held stock options granted as part of their compensation packages made worthless upon Enron's collapse and bankruptcy. The *Enron* decision continues the trend of the courts to construe §510(b) liberally, expanding and refining its application to various types of claims, including those arising from post-issuance conduct, breach of contract, indemnification of officers and directors, and claims by shareholders of a subsidiary.

Section 510(b) of the Bankruptcy Code provides:

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 §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.

11 U.S.C.A. §510(b) (West 1993).

Enron and other decisions justify liberal construction of the statute based on the legislative history of §510(b) and the rationale underlying its enactment set forth in an influential law review article. Slain, John J. and Kripke, Homer, "The Interface

¹ The assistance of Sandra Bourgasser-Ketterling and Katherine Swearingen-Steadwell, associates at Carter Ledyard & Milburn LLP, and Richard Kistnen, CUNY Law School 2008, is gratefully acknowledged.

About the Author

James Gadsden is a partner in the New York office of Carter Ledyard & Milburn LLP and head of the firm's Bankruptcy Practice Group.



James Gadsden

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, 286 (1973). As expressed in *In re Telegroup Inc.*, 281

F.3d 133, 141 (3d Cir. 2002):

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[T]he Slain and Kripke proposal that inspired §510(b) appears intended to prevent disappointed shareholders from recovering the value of their investment by filing bankruptcy claims predicated on the issuer's unlawful conduct at the time of issuance, when the shareholders assumed the risk of business failure by investing in equity rather than debt instruments.

Courts have used this rationale to justify subordination where the claimants have assumed the risk of loss, and also to justify nonsubordination where the risks of loss to creditors (who anticipate only the return of their investment) contract for a fixed return. This article summarizes the *Enron* decision and surveys other recent decisions construing §510(b).

Stock Option Claims

In *Enron*, two threshold questions needed to be answered to determine whether a claim based on a stock option was subject to subordination under §510(b). First, is a stock option a "security"? Second, was the transaction by which the employee acquired the option a "purchase"? The statutory definition of a security answered the first question. It expressly includes a "warrant or right to subscribe to or purchase or sell a security". 11 U.S.C. §101(49)(A)(xv); *Enron*, 341 B.R. at 149-50. In response to the second question, the court determined that options granted in exchange for labor were encompassed by the term "purchase," even where the employees had no choice in receiving options in lieu of cash compensation. *Enron*, 341 B.R. at 151 ("[i]f

these claimants were required to receive a portion of their compensation as options, that was a condition of employment the claimants willingly accepted in return for their labor.").

The same conclusion had previously been reached in *International Wireless Communications Holdings Inc.*, 279 B.R. 463, 467 (D. Del. 2002) (holding that stock acquired by employees as compensation under a stock repurchase agreement could be characterized as a purchase or sale under §510(b)). Judge Gonzales then identified three categories of claims asserted by the employees (proceeding *pro se*) and ruled that each type of claim was subject to subordination.

Fraudulent Inducement

The first category of claim raised by the employees alleged that the company, through its financial statements, fraudulently induced employees to receive

stock options as part of their compensation packages. Following the language of §510(b), the court determined that fraudulent inducement claims should be subordinated since they directly involve claims for damages “arising from” the purchase of a security. Judge Gonzales wrote that subordination of this type of claim followed as “a clear example of a typical claim by the defrauded purchaser of a security to which §510(b) unambiguously applies.” *Enron*, 341 B.R. at 150.

Fraudulent Retention Claims

The second theory of recovery was categorized as “fraudulent retention.” These claims were based on assertions that fraudulent information provided by Enron after issuance of the options induced the employees to hold their options instead of exercising them. *Id.* at 152. Acknowledging the “temporal and conceptual discontinuity” between the acquisition and the alleged fraud, Judge Gonzales followed the majority of the cases concluding that fraudulent retention claims fall within the scope of §510(b). *Id.* at 159. Citing *In re WorldCom*, 329 B.R. 10, 15-16 (Bankr. S.D.N.Y. 2005), the court held that “the stockholder’s loss represented by diminution in or destruction of the value of his stock ultimately constitutes a claim for damages derived from his ownership of stock and therefore ‘arising’ from his purchase of the stock, whether the stockholder retained his stock or sold it.” *Enron*, 341 B.R. at 157.

Distinguishing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975), in which the Supreme Court held that claims of shareholders who retained their stock as a result of misrepresentations and claims based on fraudulent insider activity could not be the basis of claims “in connection with the purchase or sale of securities” as that phrase is used in Rule 10b-5 under the Securities Exchange Act of 1934, 17 CFR §240.10b-5, Judge Gonzales followed the majority of recent decisions that have read §510(b)’s “arising from” broadly, covering fraudulent retention claims. *Enron*, 341 B.R. at 153-4. Several of the earliest cases under §510(b) held that for a claim to be subordinated, the conduct had to occur at or before the purchase or sale of the security. See, e.g., *In re Angeles Corp.*, 177 B.R. 920, 926-27 (Bankr. C.D. Calif. 1995) (holding that §510(b) does not encompass claims based on post-issuance conduct by the issuer), *aff’d without op.*, 199 B.R. 220 (B.A.P. 9th Cir. 1996); *In re Amarex Inc.*, 78 B.R. 605, 610 (Bankr.

W.D. Okla. 1987) (holding that claims based on fraud or other conduct occurring subsequent to purchase do not “arise from” the purchase and are therefore not subordinated).

Recent decisions, following *In re Granite Partners*, 108 B.R. 332 (Bankr. S.D.N.Y. 1997), have rejected this narrow reading of §510(b) and have concluded that mandatory subordination applies to claims arising from both pre- and post-issuance conduct. In *Granite Partners*, the court considered whether §510(b) required that the injury “flow from the actual purchase or sale” or whether it was sufficient “that the purchase or sale must be part of the causal link although the injury [flowed] from a subsequent event.” *Id.* at 339. After analyzing the relevant legislative history, Slain and Kripke’s article and other federal statutes, the court concluded that some causal connection between purchase or sale and injury was sufficient. *Id.* at 339-42. Similar results were reached in later cases.² The rationale is expressed in *In re WorldCom Inc.*, 329 B.R. 10, 12 (Bankr. S.D.N.Y. 2005):

From the perspective of §510(b), it makes no difference whether the stockholder’s loss in the value of his stock was caused by a pre-purchase fraud that induced his purchase, or a post-purchase fraud, embezzlement, looting or other corporate misconduct which undermined the value of his stock. In either case, the stockholder’s loss represented by diminution in or destruction of the value of his stock ultimately constitutes a claim for damages derived from his ownership of stock and therefore ‘arising’ from his purchase of the stock, whether the stockholder retained his stock or sold it.

Breach of Contract

The third theory of recovery raised by the employees was breach of contract, characterized as Enron’s failure to perform its promise of delivering the contracted-for value of the options in exchange for the employees’ services. *Enron*, 341 B.R. at 159-60. As noted by Judge Gonzales, “a number of courts have held that breach-of-contract claims may be subordinated under §510(b) where there exists ‘some nexus or

² *In re Geneva Steel Co.*, 281 F.3d 1173, 1174-75 (10th Cir. 2002) (subordination of bondholder’s fraudulent retention claim for damages caused by the post-investment fraud in failing to disclose its financial difficulties); *In re Pre-Press Graphics Co. Inc.*, 307 B.R. 65 (N.D. Ill. 2004) (judgment based on dilution of shareholder’s ownership interest for second issuance of shares of stock to other parties); *In re Audre Inc.*, 210 B.R. 360, 369 (Bankr. S.D. Cal. 1997), (“[e]quityholders do not have a reasonable expectation of becoming the victims of an independent intervening tort merely because they are equityholders.”).

causal relationship between the claims and the purchase of securities...” *Enron*, 341 B.R. at 161 (quoting *Telegroup*, 281 F.3d at 138). Although breach-of-contract claims arguably fall outside of §510(b), many such claims have been subordinated under a variety of fact patterns.³

Breach of Registration Covenant Claims

A number of cases address claims based on the failure of the debtor to perform its promise to register securities sold pursuant to an exemption from the registration requirements of the securities laws in order to provide a broader market for the securities. All hold that the claims are subject to subordination. *In re Telegroup Inc.*, 281 F.3d 133 (3d Cir. 2002) (failure to register stock as required by a stock purchase agreement). See also *In re NAL Financial Group Inc.*, 237 B.R. 225 (Bankr. S.D. Fla. 1999) (failure to register convertible debentures and the stock into which they were convertible); *Int’l Wireless*, 279 B.R. at 470 (failure to register stock).

Stock Redemption Claims

There are several cases addressing the treatment of notes issued in connection with the repurchase or redemption of the debtor’s stock. These cases generally hold that subordination is not appropriate due to the distinction between the expectations of shareholders and noteholders. The court in *In re Mobile Tool International Inc.*, 306 B.R. 778, 781 (Bankr. D. Del. 2004), held that §510(b) is not applicable where stock is exchanged for separate debt instruments. Subordination was also held inappropriate in *In re Montgomery Ward Holding Corp.*, 272 B.R. 836 (Bankr. D. Del. 2001), where stockholders filed claims for nonpayment of a promissory note issued by the debtor to repurchase its own stock. The same result was reached in *In re Response U.S.A. Inc.*, 288 B.R. 88 (D. N.J. 2003) (claim for

³ *In re Betacom of Phoenix Inc.*, 240 F.3d 823 (9th Cir. 2001) (breach of a merger agreement where the debtor failed to issue shares as provided in the agreement); *In re American Wagering Inc.*, 465 F.3d 1048 (B.A.P. 9th Cir. 2006) (judgment for damages arising from breach of an employment contract under which the employee was to receive a portion of his compensation in the form of corporate stock); *In re Peregrine Systems Inc.*, 42 Bankr. Ct. Dec. 229 (Bankr. D. Del. 2004) (exchange of shares in one company with those of the debtor pursuant to an employment agreement); *In re Vista Eyecare Inc.*, 283 B.R. 613, 628 (Bankr. N.D. Ga. 2002) (failure to repurchase shares pursuant to a put option agreement); *In re PT-1 Communications Inc.*, 304 B.R. 601, 610 (Bankr. E.D.N.Y. 2004) (failure to issue stock to the other co-owners of the company to compensate them for dilution from the issuance of shares to other parties); *In re Kaiser Group International Inc.*, 260 B.R. 684, 689 (Bankr. D. Del.), *aff’d*, 2001 WL 34368405 (D. Del. 2001) (breach of a merger agreement requiring the company to issue additional shares or pay the difference in cash if the shares did not reach a minimum value); *In re Alta+Cast LLC*, 301 B.R. 150, 155 (Bankr. D. Del. 2003) (breach of an employment agreement that required the repurchase of shares after an employee was terminated for cause); *In re Med Diversified Inc.*, 461 F.3d 251 (2d. Cir. 2006) (failure to issue stock to an employee in exchange for his stock in another company pursuant to a termination agreement).

breach of a stock purchase agreement that included a risk-limiting provision pursuant to which the debtor would pay the difference between the purchase price and the sale price if within five years the price declined and the shareholders sold the stock at a loss).

Indemnification Claims

Courts have applied §510(b) to indemnification claims in a number of fact patterns. In relevant part, §510(b) states, “For the purpose of distribution under this title, a claim...for reimbursement or contribution allowed under §502 on account of such a claim, shall be subordinated...” 11 U.S.C.A. §510(b) (West 1993). In *In re Public Service Co. of New Hampshire*, 129 B.R. 3 (Bankr. D. N.H. 1991), an insurance company that paid the settlement of officers and directors of a company in a securities lawsuit filed a claim for indemnification under the insurance policy agreement. In the bankruptcy proceedings, the court held that the defense costs incurred under the policy were included within §510(b)’s “reimbursement” language. *Id.* at 4. See also *In re Mid-American Waste Systems Inc.*, 228 B.R. 816 (Bankr. D. Del. 1999) (claim by former officers and directors and underwriters of the company for fees and expenses incurred in the defense of a securities case); *In re Jacom Computer Servs. Inc.*, 280 B.R. 570 (Bankr. S.D.N.Y. 2002) (claim by the underwriters for indemnification of costs incurred in the defense of a class action suit filed in connection with the company’s initial public offering).

Claims Against Debtor-Parent Relating to the Purchase of Subsidiary’s Stock

One final category of claims that may be subordinated under §510(b) involves claims against a parent company relating to the stock of a subsidiary. In *In re VF Brands Inc.*, 275 B.R. 725 (Bankr. D. Del. 2002), a parent company purchased all of the stock of another company, holding it as a subsidiary. When the parent’s shareholders filed claims against the seller for breach of the stock purchase agreement, the court held that the claims against the parent by a purchaser of stock of the subsidiary “arise from” the purchase or sale of securities, and therefore, must be subordinated to claims of the parent’s creditors. *Id.* at 727. The same result was reached in *In re Lernout & Hauspie Speech Products N.V.*, 264 B.R. 336 (Bankr. D. Del. 2001) (Section 510(b)

mandated subordination of subsidiary shareholders’ claims to the claims of parent’s creditors).

Conclusion

Enron follows the trend among courts to construe §510(b) liberally and expand its application to various categories of claims. In most of those decisions, the courts have looked to the policy underlying §510(b) to construe the statutory language broadly and apply it to a variety of facts and circumstances beyond claims beyond rescission and fraudulent inducement claims. ■

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