**A LEG UP FOR EQUITY?**
**Part I - Fraudulent Retention Claims** [1]

Equity security holders[2] or investors [3] ("Equity Holders") in debtor entities are usually subordinated to creditors' claims in bankruptcy cases.[4] This need not always be the case.

Two conditions exist where Equity Holders' claims may be equal or superior to general unsecured creditors' claims. The first are claims based on "fraudulent retention" ("Fraudulent Retention Claims"). The second are claims based on debtors' post-petition interfering with Equity Holder's rights to sell their investment, to benefit the debtors' reorganization effort ("Freeze Claims").

Allowed[5] Fraudulent Retention Claims are treated equally to general unsecured creditors'

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[2] See 11 U.S.C. § 101 (16) and (17)

(16) The term "equity security" means—
- A) share in a corporation, whether or not transferable or denominated "stock", or similar security;
- B) interest of a limited partner in a limited partnership; or
- C) warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind specified in subparagraph (A) or (B) of this paragraph.

(17) The term "equity security holder" means holder of an equity security of the debtor.

[3] See, *In re Montgomery Ward Holding Corp.*, 272 B.R. 836, 842 (Bkrtcy.D.Del.,2001).

[4] See, 11 U.S.C. § 510(b)(Subordination) and 11 U.S.C. § 1129(b)(2)(B)'s "absolute priority rule" which "generally requires that all unsecured creditors be paid in full before equity security holders are allowed to retain any ownership interest in the debtor." *In re Brotby*, 303 B.R. 177, 195 (9th Cir.BAP 2003).

[5] Allowed claims give the creditor holding that claim a right to payment of a specified sum of money pursuant to 11 U.S.C. § 502(b), usually enforceable against the debtor's bankruptcy estate. See, *In re Ayers Bath (U.S.A.), Co., Ltd.*, 2021 WL 4317321, at *41 (Bkrtcy.C.D.Cal., 2021). A "claim becomes allowed in one of three ways: first, a proof of claim is filed or deemed filed and no party objects; second, a claim is allowed by the court after an objection is filed; and third, a claim is estimated by the Court under the provisions of section 502( c ). *In re Rowe*, 342 B.R. 341, 348 (Bkrtcy.D.Kan.,2006).

claims. Allowed[6] Freeze Claims may receive an administration priority[7] over general unsecured claims. Allowed Fraudulent Retention Claims get available "bankruptcy dollars[8]." Allowed Freeze Claims are entitled to full payment, subject to the bankruptcy estate's resources.[9]

This blogtical is the first of two. It addresses the subordination or not of Fraudulent Retention Claims. The next blogtical of this series concerns allowing Freeze Claims.

**Fraudulent Retention Claims**

A Fraudulent Retention Claim is a pre-petition claim of a debtor's Equity Holder who is injured by retaining that debtor's Equity Interests relying on fraudulent information provided by that debtor or its management.[10]

*Subordination*

Some courts subordinate "Fraudulent Retention Claims" applying Bankruptcy Code § 510(b) ("§ 510(b)"). As discussed *In re Granite Partners, L.P.*[11] Fraudulent Retention Claims:

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[6] See, *Id.*

[7] 11 U.S.C. § 503(b).

[8] " Bankruptcy Dollars " are the percentage recoveries by creditors holding unsecured claims. Paying 10¢ on the $ 1.00 is probably above average in most chapter 7 cases. *In re Rappaport*, 517 B.R. 518, 538 (Bkrtcy.D.N.J., 2014)

[9] See 11 U.S.C. § 507. Priorities. Regulating the priorities in distributing the bankruptcy estate's assets.

[10] See, R.J, Stark, *"Reexamining the Subordination of Investor Fraud Claims in Bankruptcy: a Critical Study of in re Granite Partners*, L.P." 72 Am. Bankr. L.J. at 497

[11] 208 B.R. 332, 342 (Bkrtcy.S.D.N.Y.,1997)("*Granite Partners*"), See also, *In re Enron Corp*., 341 B.R. 141, 152 (Bkrtcy.S.D.N.Y.,2006)("*Enron*")("The key issue is the temporal and conceptual discontinuity between the purchase of the security and the fraudulently induced

> " . . . involve a risk that only the investors should shoulder. In essence, the claim involves the wrongful manipulation of the information needed to make an investment decision . . . Just as the opportunity to sell or hold belongs exclusively to the investors, the risk of illegal deprivation of that opportunity should too. In this regard, there is no good reason to distinguish between allocating the risks of fraud in the purchase of a security and post-investment fraud that adversely affects the ability to sell (or hold) the investment; both are investment risks that the investors have assumed.

However, § 510(b)'s terms address claims:

> . . . 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.

By its terms, § 510(b) applies to fraud resulting in "damages arising from the purchase or sale of such" securities. It does not say damages resulting from their "ownership." *Granite Partners* and it progeny effectively interpreted the statute[12] to include ownership. However, the statute's terms do not reach that far. Purchase and sale may result in ownership. However, they may not be the only vehicle.

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retention. These are two separate, if not necessarily distinct, acts, and the alleged injury is necessarily the direct result of the retention, not the purchase. Nonetheless, the use of the phrase "arising from" suggests that the injury need not directly result from the purchase. . ."), *In re WorldCom, Inc.*, 329 B.R. 10, 16 (Bkrtcy.S.D.N.Y.,2005)("*WorldCom*"), *In re Geneva Steel Co.*, 260 B.R. 517, 523 (10th Cir.BAP, 2001)("*Geneva Steel* ").

[12] See, *Granite Partners* at 339, *Enron* at 152, *Geneva Steel* at 522–23, *WorldCom* at 329 B.R. 10, 16 (Bkrtcy.S.D.N.Y.,2005).

Expanding § 510(b) beyond its clear terms is inappropriate. As is often stated[13]:

> Congress knows how to draft statutes without making them more complicated than they need to be. Congress "does not, one might say, hide elephants in mouseholes." *Whitman v. Am. Trucking Ass'ns, Inc*., 531 U.S. 457, 468 (2001). Moreover, courts must forego any invitation to import words into statutes that are simply not there. See, *e.g., Lamie v. U.S. Tr.*, 540 U.S. 526, 538 (2004) (declining to enlarge a statute where a plain, non-absurd meaning is "in view"). "[W]hen the statute's language is plain, the sole function of the courts – at least where the disposition required by the text is not absurd – is to enforce it according to its terms." *Id.*, at 534.

*Not Subordinating Retention Claims*

It's been said that 'one's first response is often the correct one." Its corollary is Occam's Razor[14], "the simplest solution is almost always the best." Those maxims may apply to § 510(b) and Retention Clams.

*In re Amarex, Inc*.,[15] ("*Amarex"*) addressed Fraudulent Retention Claims in 1987. It held that § 510(b) does not impact Fraudulent Retention Claims. *Amarex'*s analysis of § 510(b) was stated simply:

> 510(b) reveals a Congressional desire to shift to the shareholders the risk of fraud in the issuance and sale of a security—no more. The legislative history expressly

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[13] Restated recently in *In re Ibbott*, 2022 WL 697287, at *9 (Bkrtcy.D.Md., 2022).

[14] Attributed to philosopher William of Ockham (1285–1347/49),

[15] 78 B.R. 605, 609–10 (W.D.Okl.,1987) .

> focuses on the initial illegality and thus the automatic subordination required by section 510(b) should extend no farther. The Bankruptcy Court's expansive interpretation of section 510(b) ignores the clear language of section 510(b), its underlying policies and the purposes for which it was enacted. Section 510(b) pertains only to claims based upon the alleged wrongful issuance and sale of the security and does not encompass claims based upon conduct by the issuer of the security which occurred after this event. Such construction gives expression to the legislative comment that it is the nature of the claim, and not the status of the claimant, that is significant.[16]

A decade later, *In re Angeles Corp.*,[17] agreed with *Amarex*'s application of § 510(b): The

> . . . fraud or other wrongful conduct occurring subsequent to the purchase of the security is not a claim "arising from" the purchase of the security. The District Court reversed the Bankruptcy Court for holding to the contrary. The District Court noted the bankruptcy court erred by using a "but for" test as the definition of "arising from."[18]

More recently, *Stucki v. Orwig*,[19] followed *Amarex* and *Angeles* stating:

> . . . the statute does not state that any claim arising from "ownership" of a security is subject to mandatory subordination; rather, it states, in relevant part, claims arising from damages relating to the purchase or sale of a security are subject to

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[16] *Id.*

[17] 177 B.R. 920, 926–27 (Bkrtcy.C.D.Cal.,1995)("*Angeles*").

[18] *Id.*

[19] 2013 WL 1499377, at *5 (N.D.Tex.,2013)("*Stucki"*).

mandatory subordination.[20]

Rejecting "an elephant in a mouse hole" *Stucki* cited *Angeles*[21]

> If Congress had Angeles 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 all security holders, regardless of the source of 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."[22]

Similarly, *In re Montgomery Ward Holding Corp*.,[23] determined that § 510(b)'s "plain language" meant it, "applies only to a claim that directly concerns the stock transaction itself, i.e., the actual purchase and sale of the debtor's security must give rise to the contested claim."[24] That court recognized *Granite Partners,* but did not follow it. [25]

Scholarship has concluded that the most supportable interpretation § 510(b) rejects

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[20] *Id.*

[21] At 177 B.R. 927

[22] *Id.*

[23] 272 B.R. at 842

[24] *Id.*

[25] *Id.,* at 843.

subordinating Fraudulent Retention Claims.[26]

This conclusion is consistent with the rule that forfeitures,[27] like subordination, should be construed narrowly.[28]

It appears whether a Fraudulent Retention Claim is subordinated depends on where the issue is litigated. This is frequently the case. Nevertheless, strong and recent arguments exist to prevent subordination of Fraudulent Retention Claims.

The blogticle on Freeze Claims will follow shortly.

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[26] *"Reexamining the Subordination of Investor Fraud Claims in Bankruptcy: a Critical Study of in re Granite Partners* 72 Am. Bankr. L.J. at 524

[27] Forfeit or forfeiture means losing a right, privilege, or property without compensation as a consequence of violating the law, breaching a legal obligation, failing to perform a contractual obligation or condition, or neglecting a legal duty. https://www.law.cornell.edu/wex/forfeit

[28] See. *In re Miller*, 511 B.R. 621, 630 (Bkrtcy.W.D.Mo.,2014), *U.S. v. One Lear Jet Aircraft, Serial No. 35A-280,Registration No. YN-BVO*., 808 F.2d 765, 770 (11th Cir. 1987), *Lemmon v. Cedar Point, Inc*., 406 F.2d 94, 97 (6th Cir.1969) (narrow construction given to any provision which authorizes forfeiture of important rights almost earned by rendering of substantial service), *Dahly Tool Co. v. Vermont Tap and Die Co.,* 561 F.Supp. 600, 600–01 (D.C.Ill.,1982), *Willis v. People*, 71 V.I. 789, 813, 2019 WL 3291616, at *10, fn.5 (V.I., 2019) fn 5, citing, *Western Union Tel. Co. v. Kansas*, 216 U.S.1, 44 (1910).