



Insights

The Subordination of Equity-Related Claims in Bankruptcy

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Lenders and investors in companies often have assumed, based upon Section 510(b) of the Bankruptcy Code and decades of court decisions, that claims related to the purchase and sale of securities, such as breach of contract, fraud, misrepresentation or other securities law violations, are subordinated to the level of the underlying security in question and therefore subordinated to all unsecured and secured claims against the bankrupt company. The logic for this is that one should not be able to elevate an underlying equity interest by “bootstrapping” such interest to a breach of contract, fraud or misrepresentation claim with respect to such security.

However, a recent decision of the United States Court of Appeals for the Ninth Circuit, *Khan v. Barton (In re Khan)*,¹ has raised a serious question as to when claims for damages should be deemed “arising from” the purchase or sale of a security such that they should be subordinated under Section 510(b) of the Bankruptcy Code. This issue is of particular importance to lenders and investors who attempt to analyze a company’s pending legal matters to determine whether any could impact their investment or the value of the company.

Section 510(b) provides that:

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

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interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock. (Emphasis added).

The Ninth Circuit, in *In re Khan*, held that a creditor's claims, based upon a monetary court judgment of conversion against the debtors of securities once owned by the claimant, would not be subordinated under Section 510(b) on the grounds that the claims did not "arise from" the claimant's prior acquisition of the securities.

The claimant, Kenneth Barton, in 2013 had obtained a judgment for \$3,840,060 in California Superior Court against Zafar David Khan and Terrance Alexander Tomkow (the "debtors") and RPost International Ltd. (RIL) for, among other things, conversion and fraud, based upon allegations that the debtors had fraudulently converted his 6,016,500 shares of common stock in RIL, a company Barton had formed with the debtors. The Superior Court had found that the debtors unlawfully canceled Barton's shares and returned them to RIL's treasury, had forged corporate resolutions in an effort to support their fraud and had either "misplaced or destroyed" the corporate shareholder registry. The Superior Court awarded Barton damages based upon the value of the converted stock.

Before the Superior Court determined the value of the RIL stock for the award of damages, each of the debtors filed for bankruptcy protection under Chapter 13 of the Bankruptcy Code. Barton thereafter filed a proof of claim in the bankruptcy cases and the debtors objected to the claims on the grounds that they should be mandatorily subordinated under Section 510(b). The bankruptcy court held that Barton's claims were not subject to subordination because they were not "for damages arising from the purchase or sale of ... a security."² Instead, the bankruptcy court found that Barton's claims were based upon the Superior Court's money judgment for fraud and conversion.

Upon appeal, the Ninth Circuit, by majority decision, affirmed the bankruptcy court's decision that Barton's claims should not be subordinated under Section 510(b) because they did not arise from the purchase or sale of a security. Rather, the majority concluded that Barton's claims were "based upon the judgment entered against the Debtors by the Superior Court on account of their actions many years later (2009) when they fraudulently converted Barton's stock."³ The court noted that the often-quoted rationales for Section 510(b) thus did not apply since the wrongdoing of the debtors, i.e., their conversion of Barton's shares, had "no connection to the purchase or sale of Barton's shares of stock in RIL."⁴

The dissent disagreed,⁵ arguing that the conversion of Barton's shares by the debtors "did not erase the fact that Barton's subsequent claims against Debtors arose from his previous purchase of securities."⁶ Specifically, the dissent pointed out that numerous courts, including the Ninth Circuit, have consistently interpreted the phrase "arising from" in Section 510(b) broadly and that the majority, while noting these past cases, did not attempt to distinguish them.

A number of factors may have played a role in the Ninth Circuit's decision, not least of which was that the debtors had appeared to have acted with less than good faith both in their dealings with Barton and in the filing of their Chapter 13 petitions.

Under that scenario, it is clearly possible that a court might look hard to find an exception that would protect the claimant from further damage, regardless whether a closer or finer legal analysis might conclude that the facts fell within prior precedent justifying a broad interpretation of the language of Section 510(b). At the very least, the Ninth Circuit's decision raises a question as to how broadly the phrase "arising from" will be interpreted to determine the subordination of claims under Section 510(b).

The Ninth Circuit's decision should be monitored to see if other jurisdictions adopt this analysis. As mentioned, lenders and potential investors in companies will often perform due diligence on all claims and potential litigation to determine whether any of such claims or potential claims could impact the value of the company or impair their investment.

Prior to the Ninth Circuit's decision, the expansive view of the "arising from" language within Section 510(b) has suggested that the subordination of claims under Section 510(b) is virtually automatic. The Ninth Circuit's recent decision puts such notions in question and should compel investors to conduct careful due diligence of any securities related claims or litigation to determine whether such claims are likely to be subordinated to all unsecured and secured claims.

1. Khan v. Barton (In re Khan), No. 15-6002 (9th Cir. January 23, 2017) ("Slip Op.").
2. Slip Op., p. 8.
3. Slip Op., p. 12.
4. Slip Op., p. 14.
5. The dissent concurred with the majority's rulings on other issues in the case not the subject of this article.
6. Slip. Op., p.18.

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