NOTES

A CONGRESSIONAL MONTAGE OF TWO SYSTEMS OF LAW—MANDATORY SUBORDINATION UNDER THE CODE

INTRODUCTION: PRELUDE[1]

The most fundamental principle of the American bankruptcy system is equality of distribution among those with a stake in the bankruptcy estate.[2] Yet, in the modern era of bankruptcy, the concept of equality is not so simple to apply. The "Absolute Priority Rule"[3] governs the distribution of the estate such that shareholders are precluded from recovering any property on account of their shareholder stake until all creditor claims have been satisfied in full.[4] The problem of determining what is equality becomes much more complicated when the

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[1] The section headings for this note were inspired by the use of theatrical language in the famous Slain and Kripke article that is discussed herein. *See* 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, 263 (1973). Much like a theatrical work, a legal controversy unfolds in a similar manner. *See generally* Louis Giannetti, UNDERSTANDING MOVIES (8th ed., Prentice Hall 1999).

[2] *See, e.g.*, Young v. Higbee, Co., 324 U.S. 204, 210 (1945) (Black, J.) ("[H]istorically one of the prime purposes of the bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets."); Thomas C. Given & Linda J. Phillips, *Equality in the Eye of the Beholder—Classification of Claims and Interests in Chapter 11 Reorganizations*, 43 OHIO ST. L.J. 735, 735 (1982) (referring to equality as foundation upon which American bankruptcy law rests); *see also* G. Eric Brunstad, Jr. & Mike Sigal, *Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations Under the Bankruptcy Code*, 55 BUS. LAW. 1, 17 (1999) (noting instrumentality of equality in multiple aspects of bankruptcy law, including classification and treatment of claims and interests in administration of reorganization cases).

[3] *See* 11 U.S.C. § 1129(b)(2)(B)(ii) (2000) (requiring senior claims to be satisfied in full before junior claims can receive or retain property from distribution under reorganization plan); *see, e.g.*, Bank of Am. Nat'l Trust & Sav. Ass'n v. N. LaSalle St. P'ship, 526 U.S. 434 (1999) (reaffirming validity of absolute priority rule); *see also* Andrew D. Shaffer, *Corporate Fiduciary—Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*, 8 AM. BANKR. INST. L. REV. 479, 524 (2000) (describing operation of rule, pursuant to which "all senior creditors will be paid in full before any payment to junior creditor claims, and all junior creditor claims will be paid in full before any payment to shareholders."). *See generally* Charles D. Booth, *The Cramdown on Secured Creditors: An Impetus Toward Settlement*, 60 AM. BANKR. L.J. 69, 73 (1986) (highlighting importance of absolute priority rule, whereby lack of compliance can lead to plan rejection).

[4] *See supra* note 3; *see also* H.R. REP. NO. 95-595, at 194 (1977) (citing *In re* Racine Auto Tire Co., 290 F. 939 (7th Cir. 1923) (holding securityholder precluded from asserting rescission claim on parity with general creditors)); Slain & Kripke, *supra* note 1, at 261 (reviewing priority of satisfying provable creditor claims before shareholders can recover investments).

securities laws are taken into consideration. Under those laws, a dissatisfied investor may rescind the purchase of stock if based on a securities law violation, and would be entitled to a damages claim.[5] If treated like the other creditor claims, the securities law claims might allow the shareholder to avoid the absolute priority rule and to share *pari passu* with the claims of general unsecured creditors.[6] While the securities laws claims are essentially for non-bankruptcy purposes,[7] their existence might allow disappointed shareholders to, in effect, convert their equity claims into debt claims.[8] In this way, investors might be able to bootstrap their way into parity with ordinary unsecured creditors by using the securities laws.[9] This was an unexpected development,[10] and it squarely presents the question of whether the bankruptcy equality principle requires that such claims be treated equally with all other valid claims or whether it requires that they be subordinated to other claims.[11]

Congress resolved this conflict by enacting section 510(b) of the 1978 Bankruptcy Code,[12] which provides for the subordination of claims "arising from a rescission of a purchase or sale of a security of the debtor or . . . for damages arising from the purchase or sale of such a security."[13] Section 510(b) reflects a congressional judgment that shareholders, rather than general unsecured creditors, should bear both the risk of insolvency and the risk that the corporation might act

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[5] *See, e.g.*, 15 U.S.C. § 77l (2000) (permitting panoply of remedies as result of securities law violation); Slain & Kripke, *supra* note 1, at 266 (reviewing shareholder's right to rescission if transaction is based on securities or state law violation).

[6] *See* Slain & Kripke, *supra* note 1, at 261. This was treated as a *pseudo*-exception to the absolute priority rule, a question that was never addressed by the Supreme Court in chapter X bankruptcy. *Id*.; H.R. REP. NO. 95-595, at 194–95 (citing Oppenheimer v. Hamman Nat'l Bank & Trust Co., 301 U.S. 206 (1937) (allowing rescinding shareholder to share *pari passu* by estate with general creditors)).

[7] In this context, the securities laws are meant to ensure that holders of securities law claims will be compensated for being wronged. *See, e.g*., Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 521 F. Supp. 118, 125 (S.D.N.Y. 1981). "[T]he modern corporation statutes generally require that the debts and liabilities of the corporation to its creditors [a category that includes holders of securities laws claims] must be paid or adequately provided for . . . before the distribution of corporate assets to stockholders." *Id.* (quoting RICHARD P. EICKHOFF, 16A FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8219 (perm. ed. 1979)); *accord* MODEL BUS. CORP. ACT § 14.05(a) (1984).

[8] *See* Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code*, 56 AM. BANKR. L.J. 293, 298 (1982) (elevating status of defrauded shareholders to that of creditor). *But see* Shaffer, *supra* note 3, at 525 (eliminating shareholders from management's consideration during course of normal corporate liquidation). *See generally* Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 652–53 (1974) (commenting on uncertainty surrounding investors rights, and how at any point general formula for investors may be subject to change).

[9] *See, e.g*., *Oppenheimer*, 301 U.S. at 206 (treating rescinding stockholder similar to other unsecured nonpriority debt of bankrupt). *But cf*. Booth, *supra* note 3, at 73 (discussing *Boyd*'s "fixed principle" of unsecured creditors always being paid in full prior to shareholders); *accord supra* notes 3–4, 6 and accompanying text (introducing well-accepted absolute priority rule, to which current case law and section 510(b) adhere).

[10] *See* Slain & Kripke, *supra* note 1, at 268.

[11] These two questions were at the forefront of the debate over the enactment of section 510(b). *See* H.R. REP. NO. 95-595, at 194 (launching into topic Congress was addressing); *see also* Slain & Kripke, *supra* note 1, at 268 (framing scope of claims subordination analysis should be concerned with).

[12] 11 U.S.C. § 510(b) (2000).

[13] *Id*.

illegally in issuing its securities.[14] As to the insolvency risk, the shareholders had bargained for an equity interest rather than a debt interest when they made a decision to invest in the corporation's stock.[15] Unlike a debt interest, where the return is fixed, the shareholders return is dependent on the success of the enterprise.[16] In addition, the creditors rely on the "equity cushion" provided by the capital contribution of the shareholders in deciding to extend credit to that enterprise.[17] In the context of a solvent enterprise, allowing shareholders to pursue security law claims as creditors does not upset the expectations of general unsecured creditors because there are sufficient remaining assets also to pay their claims in full.[18] However, upon insolvency, the effect of the securities law claim would be not only to deprive the creditors of the expected equity cushion by converting the equity stake into debt, but also to add the former equity holders as competing claimants for the limited remaining assets.[19] Section 510(b) is designed to preserve the balance between shareholders and creditors, and to prevent the expectations of creditors from being frustrated.

The other rationale behind section 510(b) is that, between shareholders and creditors, the shareholders should bear the risk that the corporation might act illegally in issuing its securities.[20] This rationale is somewhat harder to justify, since

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[14] *See* H.R. REP. NO. 95-595, at 195; NORTON BANKRUPTCY LAW & PRACTICE 2D § 44:2 (2d ed. 1997). *See generally* Slain & Kripke, *supra* note 1 (proposing reconsideration of subordination question, which was submitted to Congress during its consideration of 1978 Code).

[15] *See* H.R. REP. NO. 95-595, at 195. A shareholder's ability to reap the benefits of future profits that a corporation may earn is the primary aspect that distinguishes him from the holder of a debt interest. *See* Slain & Kripke, *supra* note 1, at 287; *cf.* Robinson v. Wangemann, 75 F.2d 756, 757–8 (5th Cir. 1935) (making similar point by distinguishing shareholders from "former shareholders," instead of referring to latter group as debt holders).

[16] *See, e.g.*, *Robinson*, 75 F.2d at 758 (precluding payment to "former shareholders," as creditor had not yet been paid from failing enterprise); NORTON BANKRUPTCY LAW & PRACTICE 2D, at § 44:2 (distinguishing nature of claims held by shareholders from others, *e.g*. trade creditors); Slain & Kripke, *supra* note 1, at 286 ("[T]he general creditor asserts a fixed dollar claim and leaves the variable profit to the stockholder; the stockholder.").

[17] *See* H.R. REP. NO. 95-595, at 195; Slain & Kripke, *supra* note 1, at 287; *see also* Cohn, *supra* note 8, at 298 ("Lenders and suppliers often extend credit in reliance on the debtor's capital structure, including equity securities or subordinated debentures that may have been fraudulently issued."). *But see* Kenneth B. Davis, Jr., *The Status of Defrauded Securityholders in Corporate Bankruptcy*, 1983 DUKE L.J. 1, 17–18 (1983) (rejecting concept of reliance on equity cushion as contract terms can be restructured as each party desires).

[18] However, this all changes when a corporation becomes insolvent. *Compare* Cohn, *supra* note 8, at 298 (describing how shareholders holding securities fraud claims are treated as judgment creditors outside of bankruptcy), *with* Shaffer, *supra* note 3, at 525 (detailing how typically creditors replace shareholders as owners of corporation when insufficient assets for distribution).

[19] *See* Cohn, *supra* note 8, at 298 (recounting how creditors deprived of expectations if forced to share with defrauded shareholders without being given similar opportunity for "speculative gain" in enterprise); *see also* 7 COLLIER ON BANKRUPTCY ¶ 510.04[2] (Lawrence P. King. et al. eds., 15th ed. 1997) (supporting concept of creditor reliance in having priority over stockholders in event of bankruptcy). *But cf.* Robert J. Stark, 72 AM. BANKR. L.J. 497, 497 (1988) (illustrating ineffectiveness of "vast panoply of statutory, regulatory, and common law remedies" in bankruptcy, thus precluding any alternative for either party).

[20] *See* H.R. REP. NO. 95-595, at 195 (citing Slain & Kripke); Slain & Kripke, *supra* note 1, at 288 (reiterating lack of reason for shifting risk of illegality to creditors); *see also* 7 COLLIER ON BANKRUPTCY at ¶ 510.04[2] (stating same).

section 510(b) subordination is visited upon the victims of the corporation's fraud, who presumably would not have become shareholders had they not been defrauded.[21] Nevertheless, the justification offered for this outcome is based on the allocation of the risk of illegality in the issuance of securities. If a shareholder is permitted to rescind a purchase of stock, in effect, the risk is shifted to the general unsecured creditors of the corporation. Even though the securities laws allow a shareholder to rescind his purchase,[22] there is no corresponding reason to allow the risk of illegality to be borne by the creditors.[23] The risk must remain with the shareholder, as it is to him, and not to the unsecured creditor, that the stock is offered.[24] Section 510(b) is written to assign the risk of illegality to the shareholder, and to protect the unsecured creditor from bearing a risk for which he did not contract.

The early section 510(b) cases generally limited subordination to claims that directly "arose from" a purchase or sale of a security.[25] This meant that claims predicated on post-issuance conduct did not fit within the scope of the statute.[26] Recently, however, in *Baroda Hill Investments, Ltd. v. Telegroup, Inc.* (*In re*

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[21] *See* Cohn, *supra* note 8, at 299. "Th[is] argument . . . is that the fraud victims never really had an opportunity for speculative gain; such opportunity was an illusion induced by misrepresentations. Certainly it seems unfair for the victim of securities fraud to be victimized again by receiving lower priority than other creditors." *Id*. *But cf*. Davis, *supra* note 17, at 19–21 (criticizing argument based on parties' expectations).

[22] *See supra* note 5 and accompanying text.

[23] *See* Slain & Kripke, *supra* note 1, at 288.

[24] *Id*. This rationale builds upon the basic tenets of contract law, that of offer and acceptance. However, in order to illustrate these basic points, it is necessary to look to a more complex scenario. For example, Slain and Kripke illustrate this point with the relationship between a surety and the obligee of a principal debtor. *Id*:

> Occasionally, it occurs that the surety's undertaking is obtained in a transaction which is avoidable by the surety because of wrongdoing (typically fraud) of the principal debtor. The contract law result in such cases is clear and uniform. While the surety may withdraw from his undertaking as against the principal debtor, he remains liable to an innocent obligee who has detrimentally relied upon his undertaking.

Id. Although the analogy may be somewhat strained, it indicates a problem similar to that posed by subordination. Specifically, if the shareholder is victimized by fraud, he may still be forced to contribute to the winding down of the corporation in order that creditors, who rely on that shareholder's equity investment, be paid.

[25] *See, e.g.*, Montgomery Ward Holding Corp. v. Shoeberl (*In re* Montgomery Ward Holding Corp.), 272 B.R. 836, 842 (Bankr. D. Del 2001) ("[T]he 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.").

[26] *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.

Id. (citations omitted). *But see* 7 COLLIER ON BANKRUPTCY ¶ 510.04[3] (Lawrence P. King. et al. eds., 15th ed. 1997) (noting how some courts have adopted broader reading based on "causal link" leading to injury).

Telegroup, Inc.),[27] ("*Telegroup*"), the Third Circuit Court of Appeals read section 510(b) more expansively, allowing the subordination of claims even though the claims arose from a post-petition breach of the debtor's obligations under a stock purchase agreement.[28] The court based its conclusion on the anti-bootstrapping equality rationale of section 510(b), even though the claim in question was a basic contract claim, and not one for fraud or other illegality in the issuance of the security.[29] The Third Circuit read "arising from" expansively to require merely some nexus between the securities sale and the claim, and not that the claim be based on the sale transaction itself. Thus, according to the Third Circuit, there was a sufficient causal connection between the purchase agreement and the resulting claim to support subordination.[30]

Two post-*Telegroup* cases have called the Third Circuit's holding into question. Although the *Telegroup* decision is the controlling authority in Delaware, the recent decisions of *Raven Media Investments L.L.C. v. DirecTV Latin America, L.L.C.* (*In re DirecTV Latin America, L.L.C.*),[31] ("*DirecTV*"), and *Official Committee of Unsecured Creditors v. American Capital Financial Services, Inc.* (*In re Mobile Tool International, Inc.*),[32] ("*Mobile Tool*"), indicate a rejection *sub silencio* of the Third Circuit's application of the statute.[33] The case of *DirecTV* dealt with the subordination of contract claims on facts that were very similar to those in *Telegroup*.[34] Nonetheless, the court distinguished its facts from those in *Telegroup* and refused to subordinate contract claims on the basis of either the equality or the risk of illegality rationales.[35] The second case, *Mobile Tool* adhered to the well-established proposition that claims held by noteholders are not subject to subordination.[36] This case was significant because it reaffirmed this principle and

[27] 281 F.3d 133 (3d Cir. 2002).

[28] *See id*. at 135–36, 144; *see also In re* NAL Fin. Group, Inc., 237 B.R. 225, 232 (Bankr. S.D. Fla. 1999) ("[T]here is no good reason to distinguish between allocating the risks of fraud in the purchase of a security and post-investment fraud . . . ."); *In re* Granite Partners, L.P., 208 B.R. 332, 339 (Bankr. S.D.N.Y. 1997) ("Neither Congress, in enacting section 510(b), nor Slain and Kripke limited themselves to rescission claims.").

[29] *See In re Telegroup, Inc*., 281 F.3d at 140–42. In cases in which the claims are for fraud or other illegality, virtually all courts agree that Congress was clear in its desired application to such facts. *See In re Montgomery Ward Holding Corp*., 272 B.R. at 844 (stating "absent an allegation of fraud in the purchase, sale or issuance . . . section 510(b) does not apply to a claim seeking simple recovery . . . ."); *In re Amarex, Inc*., 78 B.R. at 609–10 ("Section 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.").

[30] *See In re Telegroup, Inc*., 281 F.3d at 138, 143–44 (finding relationship between claim and sale of the security resulted from reasonable reading of statute).

[31] No. Civ. 03-981, 2004 WL 302303, at *1 (D. Del. Feb. 4, 2004).

[32] 306 B.R. 778 (Bankr. D. Del. 2004).

[33] *See* discussion *infra* Part II.

[34] *See In re DirecTV Latin Am., L.L.C.*, 2004 WL 302303, at *1–*2. Specifically, the claims were for breach of a put agreement executed in connection with a sale of stock. *Id.* at *2.

[35] *Id*. at *4.

[36] *See In re Mobile Tool Int'l, Inc*., 306 B.R. at 782; *see also* Merrimac Paper Co. v. Harrison (*In re* Merrimac Paper Co.), 303 B.R. 718 (Bankr. D. Mass. 2003) ("The few courts that have considered statutory subordination in light of a claim based solely on enforcement of a debt instrument have concluded § 510(b) does not apply."); 7 COLLIER ON BANKRUPTCY ¶ 510.04[6] (Lawrence P. King. et al. eds., 15th ed. 1997)

maintained the status quo with respect to noteholders' claims, a position that was not a foregone conclusion after *Telegroup*. Had the court decided to further expand its reading of section 510(b) to encompass claims held by noteholders, it might have been able to do so based on the Third Circuit's broad interpretation of section 510(b). The fact that it abstained from doing so indicates a rejection of *Telegroup*.[37] These two cases illustrate the proper application of section 510(b), to which future courts should adhere.

The Third Circuit erred in its broad reading of section 510(b) in *Telegroup*. Not the plain language, the legislative history, nor its policy rationales support the court's interpretation. Further, as is clear from *DirecTV* and *Mobile Tool*, *Telegroup* does not provide a workable framework for future cases facing a subordination question. Rather, it adds uncertainty and unpredictability to transactions that may have a securities law component. The flaws in *Telegroup* may be reflected by the recent retreat from its holding in *DirecTV* and *Mobile Tool*. These cases, in essence, reject *Telegroup*, and suggest a more useful approach, wedded more directly to the language and purpose underlying section 510(b). Courts should follow the lead of *DirecTV* and *Mobile Tool*, interpreting section 510(b) as Congress intended, instead of continuing to complicate an already confusing area of the law.

I. THE THIRD CIRCUIT'S EXPANDED READING OF SECTION 510(b): "MISE EN SCENE"[38]

A. *The* Telegroup *Case: Entr'acte*

The first subordination challenge arose in the Third Circuit Court of Appeals in 2002, in the case of *Telegroup*.[39] The questions presented to the court were whether claims for breach of a post-sale contractual obligation contained in a stock purchase agreement "arose from" a purchase or sale of a security, and thus whether said claims should be subordinated.[40] On June 5, 1998, the appellant, LeHeron Corporation, Ltd., sold the assets of particular businesses it owned to Telegroup in exchange for shares of Telegroup stock.[41] As part of this sale, a stock purchase agreement was executed, requiring Telegroup to use its best efforts to register its stock and to ensure that the shares were freely tradeable as of June 25, 1998.[42]

(reiterating noteholders' claims do not fall within "damages arising from." (quoting 11 U.S.C. § 510(b) (2000))).

[37] *See* discussion *infra* Part II.

[38] Slain & Kripke, *supra* note 1, at 263; *see* Giannetti, *supra* note 1, at 515.

[39] 281 F.3d 133 (3d Cir. 2002). This is noteworthy, considering the bulk of litigation the lower courts in Delaware had dealt with over the previous decade. *See, e.g.*, *In re* Kaiser Group Int'l, Inc., 260 B.R. 684 (Bankr. D. Del. 2001); *In re* Int'l Wireless Communications Holdings, Inc., 257 B.R. 739 (Bankr. D. Del. 2001); *In re* Motels of Am., Inc., 146 B.R. 542 (Bankr. D. Del. 1992).

[40] *See In re Telegroup, Inc.*, 281 F.3d at 135.

[41] *Id*. at 136.

[42] *Id*.

Telegroup failed to register the stock by that date, and allegedly, failed to use its best efforts to do so. Approximately eight months after the stock was supposed to have been registered, Telegroup filed a voluntary chapter 11 petition.[43] In response, the appellants filed proofs of claim against the bankruptcy estate for breach of the purchase agreement.[44] Appellants sought damages based on the theory that Telegroup had not performed its obligation under the contract, thereby preventing them from avoiding the loss in value by selling the Telegroup stock. Telegroup then objected, asking that the claims be subordinated under section 510(b).[45] The claimants, or shareholders, argued for a narrow construction of 510(b), such that only claims for fraud or other illegality that occurred at the time of the purchase or sale should be subordinated.[46] Telegroup, the debtor corporation, in contrast, urged the court's adoption of a broader reading of the statute, making it irrelevant that the claims were based on conduct that occurred after the purchase was completed because they would not have arisen but for the purchase transaction.[47] Telegroup also maintained that the underlying policies of section 510(b) would support a finding of subordination.[48] Specifically, that subordination would further the statute's purpose in "preventing disappointed equity investors from recovering a portion of their investment in parity with bona fide creditors in a bankruptcy proceeding."[49] Ultimately, the court agreed with Telegroup, and the claims were subordinated.[50]

The Third Circuit Court of Appeals framed the issue in terms of section 510(b)'s scope. In order to answer the crucial question of whether the shareholders' breach of contract claims fit within the purview of section 510(b), the court looked to the text of the statute as the starting point for its analysis.[51] Generally, if a statute's plain meaning is clear and unambiguous, any inquiry into its interpretation ends;[52] however, if its language is susceptible to more than one meaning, then the

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[43] *Id*.
[44] *Id*.
[45] *Id*. Previously, the Bankruptcy Court for the District of Delaware ordered the claims subordinated, ruling that such claims would not have existed "but for" the purchase of Telegroup's stock. *Id*. Subsequently, the District Court affirmed, and this appeal was brought to the Third Circuit. *Id*.
[46] *Id*.
[47] *Id*.
[48] *Id*.
[49] *Id*.
[50] *Id*. at 136, 144.
[51] *Id*. at 137.
[52] *See, e.g.*, Robinson v. Shell Oil Co., 519 U.S. 337, 340 (1997) ("Our first step in interpreting a statute is to determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case. Our inquiry must cease if the statutory language is unambiguous and 'the statutory scheme is coherent and consistent'.") (citations omitted); Conn. Nat'l Bank v. Germain, 503 U.S. 249, 253–54 (1992) ("[C]anons of construction are no more than rules of thumb that help courts determine the meaning of legislation, and in interpreting a statute a court should always turn first to one, cardinal canon before all others. We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then, this first canon is also the last: 'judicial inquiry is complete.'") (citations omitted); United States v. Ron Pair

inquiry must be extended.[53] Here, the phrase deemed determinative of the subordination question was "arising from."[54] The shareholders contended that claims can only "arise from" a purchase or sale of a security if that transaction was itself illegal,[55] and that illegality gave rise to the claim. The concept behind the claimant's argument is that the obligation to register the security was not created as part of the transaction of purchasing securities. In contrast to the shareholders, Telegroup asserted that claims originating from post-issuance conduct should also be viewed as "arising from,"[56] rather than limiting the timeframe. Finding both of those interpretations to be reasonable, the *Telegroup* court concluded that section 510(b) was ambiguous.[57] As a result, the court turned to the legislative history and underlying policies of section 510(b) in order to reach a result.[58]

After looking to both the House Report on the 1978 Bankruptcy Revisions[59] and the Report of the Commission on Bankruptcy Laws[60] for guidance as to what kind of claims should be included in section 510(b), the court noted Congress' focus on claims alleging fraud or other violations of the securities laws in the issuance of the debtor's securities.[61] The court found Congress' consideration of those types of

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Enters., Inc., 489 U.S. 235, 240–41 (1989) ("[T]here generally is no need for a court to inquire beyond the plain language of the statute.").

[53] At this point, "[t]he Court no doubt must listen to the voice of Congress." *See* Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 535 (1947); *see, e.g.*, Allen v. Geneva Steel Co. (*In re* Geneva Steel Co.), 281 F.3d 1173, 1179 (10th Cir. 2002) (looking to section 510(b)'s legislative history because statute itself is "indeterminate and susceptible to opposing interpretations."). *But cf.* Antonin Scalia, *Common Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws*, *in* A MATTER OF INTERPRETATION FEDERAL COURTS AND THE LAW 29–30 (Amy Gutmann ed., 1997) ("My View that the objective indication of the words, rather than the intent of the legislature, is what constitutes the law leads me, of course, to the conclusion that legislative history should not be used as an authoritative indication of a statute's meaning.").

[54] *See In re Telegroup, Inc*., 281 F.3d at 136. The majority of subordination cases look only at the meaning of "arising from," and not any other portion of section 510(b). *See, e.g.*, *In re Geneva Steel Co*., 281 F.3d at 1178; Am. Broad. Sys., Inc. v. Nugent (*In re* Betacom of Phoenix, Inc.), 240 F.3d 823, 827–28 (9th Cir. 2001); Weissman v. Pre-Press Graphics Co. (*In re* Pre-Press Graphics Co.), 307 B.R. 65, 73–74 (N.D. Ill. 2004).

[55] *See In re Telegroup, Inc*., 281 F.3d at 137.

[56] *Id*. at 137–38.

[57] *Id*. at 138. With specific regard to section 510(b), all Circuit Courts of Appeal agree that the plain meaning of the phrase "arising from" is ambiguous, thereby necessitating a further inquiry into the statute's legislative history. *See, e.g.*, Merrimac Paper Co. v. Harrison (*In re* Merrimac Paper Co.), 317 B.R. 215, 223 (D. Mass. 2004) (calling "arising from" an "ambiguous phrase" in section 510(b)); Weissman v. Pre-Press Graphics Co. (*In re* Pre-Press Graphics Co.), 307 B.R. 65, 74 (N.D. Ill. 2004) (stating section 510(b) ambiguous as "is reasonably susceptible to more than one interpretation."); *In re* Granite Partners, L.P., 208 B.R. 332, 339 (Bankr. S.D.N.Y. 1997) ("Initially, the phrase 'arising from the purchase or sale' is ambiguous, at least with respect to fraudulent maintenance claims."). The examination of the legislative history is the point at which courts deviate from one another. *See generally* Scalia, *supra* note 53, at 27 (critiquing methodologies used by courts with respect to statutory ambiguities).

[58] *See In re Telegroup, Inc*., 281 F.3d at 138.

[59] H.R. REP. NO. 95-595, at 194–96 (1977).

[60] H.R. DOC. NO. 93-137, pt. IV, at 115 (1973).

[61] *See In re Telegroup, Inc*., 281 F.3d at 138–39; H.R. REP. NO. 95-595, at 195; *see also* Richard G. Smolev, *Claim Subordination Under Sec.510[b]*, 231 N.Y. L.J. 9, at *1 (2004) ("As a rule . . . damages under th[e] construction of § 510(b) were limited to fraud in the inducement.").

claims to be supported by the Slain and Kripke article, in that they are "at the core of claims that 'arise from the purchase or sale of . . . a security.'"[62] However, the court stressed that neither the legislative history, nor the Slain and Kripke article, limited the reach of section 510(b) to only such claims, thereby leading it to conclude that those examples were "illustrative, not exhaustive" of claims that must be subordinated.[63] In addition, the court discussed Slain and Kripke's thesis that the theory behind subordination can best be explained by reference to the allocation of the risks of business insolvency and of illegality in the issuance of securities.[64] The court reiterated Slain and Kripke's position that both creditors and shareholders assume the risk that a corporation will become insolvent when deciding to engage in any transaction with a corporation.[65] Yet, the risk of illegality in the issuance of securities should not be treated similarly.[66] Specifically, the article takes the view that this risk of illegality should be born by only shareholders, as there is no rationale for shifting the risk from shareholders to creditors.[67] This background led the court to decide that the legislative history lacked explicit guidance with respect to the reach of section 510(b).[68] In doing so, the court decided that Congress' ultimate intent was to prevent a disappointed shareholder from filing a claim in a bankruptcy case that was based on unlawful conduct at the time of the stock's issuance, in order to share equally with the creditors of the corporation.[69] Allowing such a shareholder to file solely for that motive would be improper. A shareholder who had assumed the risk of business failure should not recover the value of his investment *pari passu* with general unsecured creditors.[70] Following Congress' lead, the court also made a judgment that "as between shareholders and general

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[62] *See In re Telegroup, Inc*., 281 F.3d at 140 (citing Slain & Kripke, *supra* note 1, at 267).

[63] *See In re Telegroup, Inc*., 281 F.3d at 140; *accord* Am. Broad. Sys., Inc. v. Nugent (*In re* Betacom of Phoenix, Inc.), 240 F.3d 823, 828 (9th Cir. 2001) ("Recently . . . more courts have interpreted § 510(b), and have decided that the statute requires subordination or more than securities fraud claims." (citing *In re* NAL Fin. Group, Inc., 237 B.R. 225, 234 (Bankr. S.D. Fla. 1999) and *In re* Granite Partners, L.P., 208 B.R. 332, 337 (Bankr. S.D.N.Y. 1997))). *But cf. In re* Amarex, Inc., 78 B.R. 605, 609–10 (Bankr. W.D. Okla. 1987) (limiting subordination to claims based only upon wrongful issuance, not those also based on conduct of issuer occurring after sale).

[64] *See In re Telegroup, Inc*., 281 F.3d at 139–40.

[65] *Id*.; *see also* Slain & Kripke, *supra* note 1, at 286–87.

[66] *See In re Telegroup, Inc*., 281 F.3d at 140; *see also* NORTON BANKRUPTCY LAW & PRACTICE 2D § 44:2 (2d ed. 1997) (recognizing different treatment dependent on who held each claim, *i.e*. holders of equity interests did not merit same treatment as trade creditors who dealt with debtor at arm's length); Slain & Kripke, *supra* note 1, at 288.

[67] *See* Slain & Kripke, *supra* note 1, at 288 (rationalizing "it is to the stockholder, and not to the creditor, that the stock is offered."); *supra* note 23 and accompanying text.

[68] *See In re Telegroup, Inc*., 281 F.3d at 140.

[69] *See In re Telegroup, Inc*., 281 F.3d at 141–42; *see also* H.R. REP. NO. 95-595, at 196 (1977) ("[A] rescission claim . . . would share in the proceeds of the estate before equity security holders but after general unsecured creditors.").

[70] *See In re Telegroup, Inc*., 281 F.3d at 141; *see also* Slain & Kripke, *supra* note 1, at 286–87 (stating said risk assumed by both shareholders and creditors, yet "[t]he absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency; no obvious reason exists for reallocating that risk."). *But cf*. Davis, *supra* note 17, at 68 (finding shareholder's ability to share with general creditor as "fairest and soundest allocation of the total fraud loss.").

unsecured creditors, it is the shareholders who should bear the risk of illegality in the issuance of stock in the event the issuer enters bankruptcy."[71]

Based on the facts in *Telegroup*, the Third Circuit Court of Appeals held that mandatory subordination was required. The court viewed the breach of contract claims as clearly "arising from" the purchase or sale of a security.[72] Even though the court recognized the shareholders' argument for excluding the claims from section 510(b) as plausible, it found Telegroup's policy-based argument for subordination was more compelling.[73] The court found the distinction drawn by shareholders between conduct that occurred at issuance and conduct that occurred afterwards to be meaningless.[74] In general, the possibility that a shareholder would be able to recover his equity investment on parity with creditors was something the court considered to be antithetical to the statute's rationale.[75] For example, that a shareholder would be able to reap the reward of profits if the enterprise succeeded, and, at the same time, be protected from losing its investment if the enterprise failed, was viewed by the court to be outside the contemplation of the statute.[76] In this case, the court found the risk of Telegroup's stock not being publicly tradeable to be allocated by contract.[77] If the shareholders elected to invest in equity rather than debt instruments, thereby assuming the risk of business failure, the court could not find any reason to shift that risk to a party who did not contract for it. The creditors should not be forced to share *pari passu* with such claimants.[78] Furthermore, after the court compared the claims here to those for fraud or other illegality in the issuance of securities,[79] it found there to be no apparent differences in the policy considerations underlying the statute with respect to the type of claim,[80] thereby warranting a finding of subordination.[81]

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[71] *See In re Telegroup, Inc*., 281 F.3d at 141.
[72] *Id*. at 144.
[73] *Id*. at 141–42.
[74] *Id*.
[75] *Id*.
[76] *Id*. at 142–43. The court has a hard time believing the argument that the equity holders would have sold their stock, regardless of the financial status of the corporation. *Id.*
[77] *Id*. at 143.
[78] *Id*. at 143–44; *supra* notes 6, 23 and accompanying text.
[79] *See In re Telegroup, Inc*., 281 F.3d at 143:

> In both cases, the claim would not exist but for claimants' purchase of debtor's stock. In both cases, the claim seeks compensation for a decline in the stock's value caused by actionable conduct on the debtor's part. And in both cases, because the stockholder, as an equity investor, assumed the risk of business failure, the stockholder must bear the risk, in the event of bankruptcy, of any unlawful conduct on the debtor's part that causes the stock's value to drop.

Id. (referring to comparison of appellants' claims with those for fraud or other illegality in issuance of securities).
[80] The court utilized what has later been termed a "Hypothetical Securities Fraud Test." *See* Raven Media Invs. L.L.C. v. DirecTV Latin Am., L.L.C. (*In re* DirecTV Latin Am., L.L.C.), No. Civ. 03-981, 2004 WL 302303, at *1, *3 (D. Del. Feb. 4, 2004).
[81] *See In re Telegroup, Inc*., 281 F.3d at 144; *supra* note 79 and accompanying quotation (emphasizing lack of distinction between breach of contract and fraud claims).

B. *Congressional Intent: Flashback*[82]

In order to understand how the *Telegroup* court erred in reaching its conclusion, it is first necessary to take a closer look at the legislative history of section 510(b). An understanding of the Slain and Kripke article is instrumental to any dispute over subordination because of Congress' reliance on it. In highlighting the importance of the article, the Judiciary Committee made it an important indicator of congressional intent. Essentially, Slain and Kripke distill the basic principles and policies of the statute, thereby providing a roadmap for courts applying section 510(b).

The title best exemplified the problem to be dealt with: *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*.[83] Although the securities laws and the Bankruptcy Code were enacted during different eras, and each was designed to foster different objectives,[84] in bankruptcy, they operate in tandem so that they must be reconciled with one another. For instance, traditionally, and pursuant to the "Absolute Priority Rule,"[85] stockholders of a debtor corporation are precluded from recovering any portion of their investment until all provable creditor claims have been satisfied in full.[86] Yet, if a dissatisfied investor was able to prove that the transaction violated federal and/or state securities laws, it would be permitted to rescind its purchase of stock, and to share *pari passu* with the bankrupt corporation's general unsecured creditors.[87] Slain and Kripke declared such "special treatment" in bankruptcy to be unwarranted.[88] At that juncture, the state of the law needed to be reconsidered in light of the concept of risk allocation, as the article's title suggests.[89]

Central to Slain and Kripke's thesis is the idea of reliance. A creditor, in deciding whether to extend credit to a corporate enterprise, relies on the equity cushion provided by its stockholders.[90] Such a creditor has an expectation interest—

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[82] *See* Giannetti, *supra* note 1, at 515.

[83] *See* Slain & Kripke, *supra* note 1, at 261.

[84] *See, e.g.*, Richard E. Mendales, *We Can Work It Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 RUTGERS L. REV. 1213, 1215–16 (1993). "[T]he two bodies of law, having evolved to deal with different kinds of problems, are not always consistent with each other." *Id.* at 1216. "[T]he first[, the Bankruptcy Code,] evolving over the history of the commercial law to deal mostly with relatively small-scale business relationships; the second[, the securities laws,] coming into existence fully developed as party of the apparatus of the modern regulatory state, to police large-scale markets." *Id.* at 1247; *see id*. at 1245 (recounting ancient roots of bankruptcy as historical response to development of commerce and business organizations). *But cf. id.* at 1246–47 (noting enactment of federal securities regulations to deal with problems in national markets). The text uses the example of disclosure to further illustrate the disparity between the two systems of law. *See id*. at 1247–48 (using example of disclosure, albeit limited to court's findings in bankruptcy case, as compared with goal of disseminating information to aid making market decisions in securities context).

[85] *See supra* notes 3, 4 and accompanying text.

[86] *See supra* notes 3, 4 and accompanying text.

[87] *See supra* notes 5–9 and accompanying text.

[88] *See* Slain & Kripke, *supra* note 1, at 261, 268.

[89] *Id*.

[90] *See supra* notes 15–17 and accompanying text.

namely, that the equity investors will bear any initial losses faced by the failing enterprise.[91] Thus, any other result, *i.e.*, preferential treatment afforded rescinding stockholders, would be inequitable. As a recommended solution, Slain and Kripke proffered the following:

> 1. We propose that each creditor of a distressed enterprise be presumed to have relied on each prior investment in equity and junior debt. The corollary is that the rescinding investor should be barred from competition with any subsequent creditor unless, and to the extent that, the investor can prove nonreliance by the subsequent creditor.
>
> 2. As to prior creditors, we would shift the burden of proof, permitting the rescinding investor to share pari passu with each prior creditor unless, and to the extent that, the prior creditor can prove detrimental reliance upon the investor's participation.
>
> 3. We propose that a rescinding shareholder be barred by the doctrine of laches from competing with any creditor, prior or subsequent, if the investor has failed to assert his claim within a reasonable time of learning of its existence.[92]

This approach attempted to incorporate the concepts of risk and reliance into a workable framework. Specifically, Slain and Kripke's proposal allocated the risk of illegality in the issuance of securities to the shareholder, thus preserving the creditor's reliance interest in being paid prior to any investor recouping his investment.[93] Without any change, rescinding shareholders would have been allowed to bootstrap their way into parity with general unsecured creditors.[94] Although this would be consistent with the securities laws, especially if a shareholder had been defrauded by the bankrupt corporation, it would be contrary to the policies underlying bankruptcy distribution.[95] Instead, as proposed, subordination of shareholders' rescission claims in bankruptcy to those of general unsecured creditors strikes an "equitable balance" among all interests.

It must be recognized, however, that Congress did not directly adopt the Slain

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[91] *See supra* notes 15–17 and accompanying text.

[92] *See* Slain & Kripke, *supra* note 1, at 294; *cf. In re* Credit Indus. Corp., 366 F.2d 402 (2d Cir. 1966) (providing foundation on which Slain and Kripke's solution rested on).

[93] *See supra* notes 20–24 and accompanying text.

[94] *See supra* note 9 and accompanying text.

[95] *See* Given & Phillips, *supra* note 2, at 735 (highlighting "twin foundations" of bankruptcy, namely "the discharge for the debtor and the equality of treatment for the debtor's creditors."). *But cf.* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777–78 (1987) (separating bankruptcy policy into competing schools of thought—"How shall the losses be distributed?" versus "Enhanc[ing] the collection efforts of creditors."). Bankruptcy adds a new level of complexity to any transaction, whereby treatment of claims, as with a defrauded shareholder in a subordination context, can differ based on whether the debtor is inside or outside of bankruptcy. *See* Cohn, *supra* note 8, at 298 (discussing treatment of claims in both contexts).

and Kripke article. There are several distinctions between section 510(b), as enacted, and the article's thesis that must be highlighted. First, Congress provided for mandatory subordination under certain circumstances.[96] It did not allow an opportunity for an investor to escape subordination by showing that no creditor relied upon the equity investment.[97] Second, Congress treated all creditors under section 510(b) equally, regardless of whether they were classified as prior or subsequent creditors to the rescission event.[98] Lastly, Congress did not impose a time limit on the ability of a shareholder to compete with a creditor.[99] In comparison, Slain and Kripke recommended that if an investor attempted beyond a reasonable time to assert his claim, he should be barred by the doctrine of *laches*.[100] These differences make section 510(b) only an approximation of Slain and Kripke's scheme; yet the article's analysis remains important nonetheless.

C. A Flawed Approach: The Drama Unfolds

To reiterate, that Congress relied on Slain and Kripke's stated policy rationales is significant, as a court applying section 510(b) must consult the legislative history, including the article, for guidance.[101] Nevertheless, many courts have, and continue to, misconstrue section 510(b) even in light of the stated policy objectives.[102] *Telegroup* is a prime example of such a faulty statutory interpretation. Despite the Third Circuit's thorough discussion of the case law and relevant legislative history, its departure from the statute's purpose is clear. The departure occurred on three fronts—from the plain language, from the legislative history, and from the underlying policy—each of which will be examined in turn. As a result, the court's subordination analysis was incorrect and the opinion provided an unworkable framework for future courts.

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[96] *See* 11 U.S.C. § 510(b) (2000).

> For the purpose of distribution under this title, a claim arising from a rescission of a purchase or sale of a security of the debtor or 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 claim, shall be subordinated to all other claims or interest 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.

Id.; *see also* H.R. REP. NO. 95-595, at 194–96 (1977).

[97] *See* 11 U.S.C. § 510(b); H.R. REP. NO. 95-595, at 194–96. *But see* Slain & Kripke, *supra* note 1, at 294 (including reliance as factor to prevent subordination if shown in certain scenarios).

[98] *See* 11 U.S.C. § 510(b); H.R. REP. NO. 95-595, at 194–96. *But see* Slain & Kripke, *supra* note 1, at 294 (distinguishing prior from subsequent creditors).

[99] *See* 11 U.S.C. § 510(b); H.R. REP. NO. 95-595, at 194–96. *But see* Slain & Kripke, *supra* note 1, at 294 (barring rescinding stockholder from competing with creditors if laches is applicable).

[100] *See* Slain & Kripke, *supra* note 1, at 294.

[101] *See* H.R. REP. NO. 95-595, at 195–96 (citing Slain and Kripke, as well as discussing central aspects of article's thesis).

[102] *See infra* Part I.*C.*; *see, e.g*., Am. Broad. Sys., Inc. v. Nugent (*In re* Betacom of Phoenix, Inc.), 240 F.3d 823 (9th Cir. 2001) (reading section 510(b) expansively so as to subordinate breach of contract claims based on breached merger agreement); *see also* Allen v. Geneva Steel Co. (*In re* Geneva Steel Co.), 281 F.3d 1173 (10th Cir. 2002) (stating same with respect to fraudulent retention claims).

As previously discussed, any question of a statute's construction must begin with its text.[103] In the case of *Telegroup*, the Third Circuit found the phrase "arising from" to be ambiguous.[104] The court conceded, at a minimum, that "arising from" required some nexus or causal connection between the purchase or sale itself and the resulting claim.[105] However, the court reasoned that Telegroup's reading, which did not limit the requisite nexus to claims regarding illegality in the purchase itself, was the more natural of the proposed interpretations.[106] Interestingly, it found both parties' interpretations to be reasonable,[107] even going so far as to say that the shareholders' reading of section 510(b) had "some appeal at an abstract level."[108] The court's analysis is somewhat ironic, as generally the most natural reading of a statute is its plain meaning. Logically, then, the phrase "arising from" should include claims directly connected to the purchase transaction, rather than those only tangentially related to it. Thus, in this case, the *Telegroup* court's statements did nothing more than undermine the courts' ultimate reading of the statute, suggesting that perhaps it was not certain that it had chosen correctly between the two interpretations.

Secondly, both the House Report on the 1978 Bankruptcy Revisions[109] and the Report of the Commission on Bankruptcy Laws[110] made it very clear that subordination is to be applied only to claims for fraud or other illegality in the security's issuance.[111] This is further supported by Slain and Kripke, who also discussed subordination only in that limited context.[112] Although the *Telegroup* court commented that the examples were merely "illustrative, not exhaustive,"[113] nowhere in the statute or relevant legislative history would an extended application be appropriate. Neither of the policy rationales were envisioned to be applied to claims for breach of contract. Had Congress intended such a result, it would have worded the statute differently. Essentially, the court quickly dismissed this point without carefully considering its ramifications.[114]

Finally, as noted, the rationale for subordination is allocation of risk, namely the

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[103] *See supra* note 51–53 and accompanying text.

[104] *See supra* note 51–58 and accompanying text.

[105] *See In re Telegroup, Inc*., 281 F.3d at 138; *supra* note 55–57 and accompanying text.

[106] *See In re Telegroup, Inc*., 281 F.3d at 138; *supra* note 55–57 and accompanying text.

[107] *See In re Telegroup, Inc*., 281 F.3d at 138.

[108] *Id*.

[109] H.R. REP. NO. 95-595, at 194–96 (1977).

[110] H.R. DOC. NO. 93-137, pt. IV, at 115 (1973).

[111] *See* H.R. REP. NO. 95-595, at 194–5 (framing discussion of subordination in terms of tort claims for rescission and illegal stock offerings); H.R. DOC. NO. 93-137, pt. IV, at 116 (stating subordination appropriate "by holders of securities of a debtor corporation that are based on federal and state securities legisltation, rules pursuant thereto, and similar laws."). *But see In re Telegroup, Inc*., 281 F.3d at 140 (reading "arising from" claims referred to in legislative history "as illustrative, not exhaustive, examples of claims that must be subordinated pursuant to § 510(b).").

[112] *See* Slain and Kripke, *supra* note 1, at 267 (considering impact of state- or federal-based claims on distribution of corporation's assets in bankruptcy).

[113] *See In re Telegroup, Inc*., 281 F.3d at 140.

[114] *Id*. at 141–44. It is interesting that the court acknowledged the opposing view as "plausible . . . , but also ha[ving] some appeal at an abstract level," yet summarily dismissed it. *Id*. at 141–42.

question of who assumes the risk of illegality in the issuance of securities.[115] Thus, in the breach of contract scenario presented by the *Telegroup* case, there has been no similar assumption of risk. Instead, all that has occurred is that the Telegroup's shareholders have allocated the risk that the corporation will not use its best efforts to register its stock by a date certain in order that it be freely tradeable, hardly a fraudulent activity. In accepting this crucial proposition, it is not possible for the court to conclude that the shareholders' breach of contract claims should be subordinated. The policy rationale that the court has assigned to the statute precludes such a result. The risk that a corporation will breach a contract is indistinguishable from routine creditor risk, and thus does not merit special treatment in bankruptcy. Similarly, there is also no reason for extending the reach of section 510(b) to claims arising out of post-issuance conduct.[116] Despite the Third Circuit's view that there is no difference between claims based on post-issuance conduct and claims that occurred at the time of the initial transaction, there is no support for such a proposition. Had Congress intended that section 510(b) be interpreted so expansively, it would have so stated, or at the very least, discussed such a possibility in its legislative history.[117]

Even though the *Telegroup* court consulted and properly explored the legislative history of section 510(b), its conclusion was incorrect. The court ignored the intent of Congress, as expressed via the Slain and Kripke article. It twisted the underlying purpose and policy of the statute in order to reach what it believed was the correct outcome. In reality, all that was done was to blur the state of subordination law. In consulting *Telegroup*, future courts will have no clear methodology to apply. Instead, there is a danger that courts will employ policy-based justifications to reach desired outcomes, rather than adhering to the letter of the law.

II. A REJECTION OF THE CONTROLLING AUTHORITY: DENOUEMENT

In order to illustrate the difficulties faced by courts in applying section 510(b), it is necessary to look to the recent decisions of *Directv* and *Mobile Tool* within the Third Circuit. Although each court recognized *Telegroup* as its controlling

[115] *See* H.R. REP. NO. 95-595, at; *see also* 7 COLLIER ON BANKRUPTCY ¶ 510.04[2] (Lawrence P. King. et al. eds., 15th ed. 1997) (noting critical role of risk assumption in section 510(b)'s rationale); Slain & Kripke, *supra* note 1, at 286–88 (reconceptualizing subordination as question of risk allocation).

[116] *See, e.g.*, *supra* note 26; *accord In re* Stern-Slegman-Prins Co., 86 B.R. 994, 998 (Bankr. W.D. Mo. 1988) (restricting application of section 510(b) to claims with allegations of illegal stock issuance). If breach of contract claims are subject to subordination, there becomes no reason for claims held by noteholders to be similarly excluded, for those claims are just as far removed from the purchase or sale as those for breach of contract. For discussion of how well-established the exclusion of noteholder claims from subordination analysis is, see *supra* note 36, focusing on *Mobile Tool*, and accompanying text.

[117] *See In re Telegroup, Inc.*, 281 F.3d at 144 n.2 (recognizing point as part of claimants' argument).

authority,[118] both decisions rejected *sub silencio* the Third Circuit's interpretation of the statute.[119] Perhaps this rejection indicates that the statute will be applied correctly from now on.

The case of *DirecTV* presented the question of whether claims "arising from" a stock purchase agreement were within the scope of section 510(b).[120] The network of business organizations involved in that case provided satellite television services throughout Latin and South Americas, and in particular, in Argentina.[121] As a result of a floundering joint venture between Directv Latin America, L.L.C., ("DTVLA"), and Raven Media Investments L.L.C., ("Raven"), both entities began to look for an alternative business arrangement.[122] On November 10, 2000, they executed a stock purchase agreement, by which DTVLA purchased Raven's interest in the joint venture in exchange for a 4% membership interest in DTVLA.[123] Pursuant to this transaction, DTVLA and Raven agreed that Raven would be exempt from certain corporate obligations, such as the need to make capital contributions and to attend meetings, among others.[124] In addition, a put agreement was executed, under which DTVLA's obligation to Raven was fixed at a price of $169 million, plus five percent interest per annum, totaling $194.8 million.[125] However, DTVLA's obligation to pay could be triggered by designated accelerating events, one of which occurred here two months prior to the petition date.[126] Thus, when DTVLA voluntarily filed a petition under chapter 11, Raven held a contract claim for approximately $169 million against it for failure to honor the put agreement.[127] It was this obligation that DTVLA asked be subordinated.[128] In deciding the subordination question, the District Court reiterated what the Third Circuit had done in *Telegroup* before turning to the facts at hand.[129] It noted that the plain language of section 510(b) was ambiguous, and looked to the legislative history for guidance.[130] The court acknowledged Congress' intention to prevent shareholders from bootstrapping their

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[118] *See* Official Comm. of Unsecured Creditors v. Am. Capital Fin. Servs., Inc. (*In re* Mobile Tool Int'l, Inc.), 306 B.R. 778, 780–82 (Bankr. D. Del. 2004); Raven Media Invs. L.L.C. v. DirecTV Latin Am., L.L.C. (*In re* DirecTV Latin Am., L.L.C.), No. Civ. 03-981, 2004 WL 302303, at *3–*4 (D. Del. Feb. 4, 2004).

[119] *See* discussion *infra* Part II.

[120] *See In re DirecTV Latin Am., L.L.C.*, 2004 WL 302303, at *1 (recapping controversy presented).

[121] *Id*. Satellite television in the area was distributed through Galaxy, a local operating company. *Id*.

[122] *Id*. DTVLA, a privately held company primarily owned by Hughes Electronics Corp., Inc., and Raven, a wholly owned subsidiary of Grupo Clarin, Inc., an Argentine communications company, both owned interests in Galaxy. DTVLA and DTVLA Holdings, Inc. owned 49%, while Plataforma Digital, S.A., another wholly owned subsidiary of Grupo Clarin, owned the remaining 51%. A corporate restructuring resulted in the transfer of Plataforma's interests to Raven, who was then working with DTVLA; however, not for very long. *Id*.

[123] *Id*. at *2. The entire transaction ending the joint venture, was comprised of three agreements: the stock purchase agreement, the put agreement, and the L.L.C. agreement. *Id*. at *1–*2.

[124] *Id*. at *2.

[125] *Id*.

[126] *Id*. For the purposes of this case, DTVLA stipulated that such an "accelerating event" had occurred. *Id*.

[127] *Id*.

[128] *Id*.

[129] *Id*. at *3.

[130] *Id*. at *3.

way into parity with creditors in order to avoid the statutory priority scheme.[131] In addition, it characterized the Third Circuit's approach as a "hypothetical securities fraud test," under which the breach of contract claims present in *Telegroup* could have been brought as securities fraud claims at the time of the stock's issuance, had the debtor corporation misrepresented its intention to register the securities.[132] The *Telegroup* "test" should have made Raven's contract claims indistinguishable from those for fraud or other illegality in the issuance of the stock.[133] However, the *DirecTV* court found section 510(b)'s application to these facts was inapposite.[134] The court distinguished *Telegroup* in several respects in order to avoid an incorrect result. First, the structure of the agreement entered into by DTVLA and Raven was such that Raven did not bear any risk. Specifically, Raven was allocated a specific contract price in the event of a breach, unlike the shareholders whose interest depended on the success of the enterprise.[135] This fact is critical in light of the heavy reliance on the anti-bootstrapping intent of the statute, since a justification for subordination based on an allocation of the risk of illegality is inappropriate here.[136] Second, the court admitted that Raven's contract claim was not predicated on misleading statements or misconduct of any kind, a fact the Third Circuit chose to ignore with respect to the *Telegroup* case.[137] And lastly, the court correctly acknowledged that the application of section 510(b) should not have been reduced to a subjective, bright-line test.[138] In contrast to the Third Circuit Court of Appeals, the *DirecTV* court's application of section 510(b) was proper. The claims there should not have been subordinated since they did not "arise from" the purchase or sale of a security in the sense Congress had intended.[139] Similarly, the underlying policy of section 510(b) supports the conclusion that the *DirecTV* court

[131] *Id*. at *3.("As residual claimants, the Bankruptcy Code requires that shareholders bear the risk of unlawful conduct which results in a loss of share value.").

[132] *Id*. at *3. The court's impulse that the claims had to be securities fraud in order to fall within section 510(b) was correct. *See supra* notes 29, 61, 111 and accompanying text. However, it goes too far in its stretch to include those claims based on breach of contract.

[133] *See In re DirecTV Latin Am., L.L.C.*, 2004 WL 302303, at *3 (citing *In re Telegroup, Inc*., 281 F.3d at 143).

[134] *Id*. at *4 ("Applying the Third Circuit's hypothetical securities fraud claim test, this court concludes that the present case is distinguishable from *Telegroup* and from the scope of claims covered . . . .").

[135] *See* H.R. REP. NO. 95-595, at 195 (justifying subordination because of shareholders' ability to participate in enterprise's profits, as compared with creditor); *see, e.g*., Robinson v. Wangemann, 75 F.2d 756, 757–8 (5th Cir. 1935) (segregating shareholders from what court calls noteholders, or previous shareholders, because latter possess fixed claim amounts). *See generally* Slain & Kripke, *supra* note 1, at 287 (reiterating lack of creditor dependence on corporate payout based on enterprise success).

[136] Specifically, such justification rests on the notion that the ability to share in the profits and losses of the corporation merits lower status with respect to the order of payment in bankruptcy. Therefore, because the contract allocated a fixed price to Raven pursuant to the agreement, there was neither opportunity nor reason for the shareholders to alter that framework. *See also supra* notes 20–24 and accompanying text.

[137] *See In re DirecTV Latin Am., L.L.C.*, 2004 WL 302303, at *4. "Raven's right to payment arose without respect to actionable conduct by DTVLA, and without relation to the present value of its interest in DTVLA." *Id*. *But see In re Telegroup, Inc*., 281 F.3d at 136 (describing claims in question as those for breach of contract).

[138] *See In re DirecTV Latin Am., L.L.C.*, 2004 WL 302303, at *4 (finding such a test inconsistent here).

[139] *Id*. at *1, *5.

acted correctly. Thus, despite the court's statement that it was applying the *Telegroup* "test,"[140] a closer look at its analysis reveals that in effect it diverged from it.[141] Had this case been decided by the *Telegroup* court, the expansive reading of the statute would have been applied and the outcome would most certainly have been different.[142] Instead, the *DirecTV* court saved the statute here, by adhering to its language and purpose.

The case of *Mobile Tool* further supports the proposition that even courts within the Third Circuit are rejecting the *Telegroup* analysis. It presented the question of whether claims held by noteholders "arose from" the purchase or sale of a security.[143] Specifically, the court looked at whether there was a sufficient nexus or causal connection between the promissory notes issued and the actual transaction to support mandatory subordination under the Code.[144] The debtor corporations, Mobile Tool International, Inc., and Mobile Tool International Insulated Products, Inc., both of whom conducted business in the telecommunications industry, entered into a stockholder agreement with their corporate officers.[145] The agreement effectuated a repurchase of the class B common stock from those officers. In addition, a put purchase note agreement was executed that authorized the issuance of notes to the individual officers as consideration for the sale.[146] Approximately one year later, the debtors filed voluntary petitions for relief under chapter 11.[147] The controversy arose when the officers, then noteholders, filed claims on their outstanding notes.[148] The debtor corporations moved to subordinate those claims under section 510(b).[149] The court began its discussion with the text of the statute.[150] However, instead of turning to the legislative history, this court engaged in an overview of the relevant case law.[151] This was not particularly surprising as it was

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[140] *Id*. at *3.

[141] *See* discussion *supra* notes 129–39 and accompanying text.

[142] *See generally In re Telegroup, Inc*., 281 F.3d at 136, 144 (reading section 510(b) broadly); *cf. In re DirecTV Latin Am., L.L.C.*, 2004 WL 302303, at *3 (distinguishing *Telegroup*).

[143] *See* Official Comm. of Unsecured Creditors v. Am. Capital Fin. Servs., Inc. (*In re* Mobile Tool Int'l, Inc.), 306 B.R. 778, 779–80 (Bankr. D. Del. 2004).

[144] *Id*. at 780; *see also In re Telegroup, Inc*., 281 F.3d at 138 (conducting same inquiry to determine whether subordination was proper).

[145] *See In re Mobile Tool Int'l, Inc*., 306 B.R. at 779.

[146] *Id*.

[147] *Id*.

[148] *Id*.

[149] *Id*.

[150] *Id*. at 780; *accord In re Telegroup, Inc*., 281 F.3d at 137. This is in line with all other courts interpreting a statute. *See supra* notes 51–53 and accompanying text.

[151] *See In re Mobile Tool Int'l, Inc*., 306 B.R. at 780–81 (discussing *Telegroup*, before dismissing plaintiffs arguments with respect to various Third Circuit cases such as *Kaiser*, *International Wireless* and *Alta+Cast*):

> The fundamental concept in these cases cited by Plaintiffs is that the nexus or causal connection required to employ section 510(b) exists where stock is retained by the claimant. When stock is exchanged and a separate debt instrument is issued by the debtor, however, the claimant is converted from an owner of stock to a creditor . . . [which] is the case here.

Id. at 781. *But cf. In re Telegroup, Inc.*, 281 F.3d at 138 (turning to legislative history after finding section 510(b) to be ambiguous).

well-established that noteholders' claims were not subject to subordination under section 510(b).[152] Yet, in light of *Telegroup*, such a generalization was not certain. The Bankruptcy Court cited *Montgomery Ward Holding Corp. v. Schoeberl* (*In re Montgomery Ward Holding Corp.*),[153] ("*Montgomery Ward*"), for the proposition that a claim based on a promissory note should not be subordinated under the Code, as such a claim is nothing more than an attempt to recover an unpaid debt.[154] Thus, the fundamental distinction between a share of stock and a debt instrument, the latter of which can be issued in exchange for stock, remained intact.[155] Nevertheless, the debtors attempted to argue that the noteholders' claims were no different from those in *Telegroup*, and that the imposition of the Third Circuit's expansive reading of section 510(b) to claims "rooted in contract" was warranted.[156] The court did not accept this argument, stating that the noteholders had "divested themselves of all forms of ownership when they sold the securities back to the Debtors and accepted notes in exchange. As such, they no longer enjoyed the primary benefit of ownership: the potential for unlimited profits."[157]

In finding subordination to be inappropriate here, the court adhered to the long-standing precedent on which nearly all Circuit Courts of Appeal that have spoken on the issue agree.[158] This outcome further undermines the *Telegroup* decision because it openly criticized the broad reading of section 510(b).[159] The asserted rationale that "[t]he Debtors' liability to the Defendants became fixed when the Debtors issued promissory notes" could also be said of claims for breach of contract.[160] The fact that a contract can be structured to allocate certain risks and responsibilities that become certain upon its execution bolsters the argument that holders of contract claims, in addition to noteholders, are analogous to general creditors rather than to shareholders. Thus, the court's finding that subordination under section 510(b) was not, and should not, be interpreted to include such claims, was correct.

In contrast to *DirecTV* and *Mobile Tool*, a few other Third Circuit cases appear

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[152] *See supra* note 36 and accompanying text.

[153] 272 B.R. 836 (Bankr. Del. 2001).

[154] *See In re Mobile Tool Int'l, Inc.*, 306 B.R. at 780 ("The Montgomery Ward Holding Corp. v. Schoberl case is on all fours with this case."). *But cf. In re* Kaiser Group Int'l, Inc., 260 B.R. 684, 688 (Bankr. D. Del. 2001) (holding subordination inappropriate when no divestiture of ownership); *In re* Int'l Wireless Communications Holdings, Inc., 257 B.R. 739, 745–46 (Bankr. D. Del. 2001) (subordinating claim that "involved neither separate promissory note nor a debt instrument.").

[155] *See In re Mobile Tool Int'l, Inc.*, 306 B.R. at 782 (reaffirming long-standing principle of not subordinating noteholders' claims after *Telegroup*).

[156] *Id*. at 781(citing *In re Telegroup, Inc.*, 281 F.3d at 138).

[157] *Id*. at 782.

[158] *See supra* notes 36, 116, 152 and accompanying text.

[159] *See In re Mobile Tool Int'l, Inc.*, 306 B.R. at 782 ("In holding that even claims 'rooted in contract' come under section 510(b), the Court only removed the distinction other courts had drawn between actions occurring at the tine of stock sale and post-transaction activities. The Court's expanded definition, however, still only applies to claims held by shareholder and not to claims held by noteholders.").

[160] *Id*.

to follow *Telegroup*.[161] For example, in *In re International Wireless Communications Holdings, Inc.*,[162] ("*International Wireless*"), and *In re Alta+Cast, L.L.C.*,[163] ("*Alta+Cast*"), each court held subordination to be proper for claims "arising from" breach of stock purchase agreements.[164] However, such cases are limited to factual situations that are virtually identical to that of the *Telegroup* case, and thus more difficult for a lower court to distinguish.[165] To date, there are no cases within the Third Circuit that require subordination of claims based on promissory notes regardless of *Telegroup*'s apparent contravention of *Montgomery Ward*'s view that section 510(b) is inapplicable in such cases.[166] Nevertheless, as the legislative history of section 510(b) indicates, Congress never contemplated such an expansive application of the statute.[167] The *Telegroup* court erred in its broad interpretation, from which the lower courts in Delaware are attempting to retreat.[168] Otherwise, there can be no explanation for the recent decisions discussed above. Each interpretation comports with a narrow reading of the statute, rather than that of the *Telegroup* court.[169] The *DirecTV* and *Mobile Tool* decisions illustrate a precise application of section 510(b) as Congress intended it.[170]

III. THE STATE OF THE LAW IN OTHER CIRCUITS: A WIDE-ANGLE LENS[171]

Outside of the Third Circuit, the treatment of section 510(b) is no less uncertain. While the Courts of Appeal generally follow the same methodology in approaching a question of subordination,[172] the resulting decisions vary significantly.[173]

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[161] *See, e.g.*, *In re* Int'l Wireless Communications Holdings, Inc., 68 Fed. Appx. 275 (3d Cir. 2003) (subordinating claims pursuant to section 510(b), following *Telegroup*); *In re* Peregrine Sys., Inc., No. 02-12740, 2004 Bankr. LEXIS 346, at *1 (stating same); *In re* Alta+Cast, L.L.C., 301 B.R. 150 (Bankr. D. Del. 2003) (stating same).

[162] 68 Fed. Appx. at 275.

[163] 301 B.R. at 150.

[164] *See In re Int'l Wireless Communications Holdings Inc.*, 68 Fed. Appx. at 278; *accord In re* Alta+Cast, L.L.C., 301 B.R. at 155.

[165] The cases adhering directly to *Telegroup* all involve breach of contract claims. *See, e.g.*, *In re Int'l Wireless Communications Holdings Inc.*, 68 Fed. Appx. at 278 (subordinating claims for nondelivery of equity security as required by agreement); *In re Peregrine Sys., Inc.*, 2004 Bankr. LEXIS 346, at *5 (holding same with respect to claims arising from noncompetition agreement executed as part of merger). *But see* Raven Media Invs. L.L.C. v. DirecTV Latin Am., L.L.C. (*In re* DirecTV Latin Am., L.L.C.), No. Civ. 03-981, 2004 WL 302303, at *3 (D. Del. Feb. 4, 2004) (distinguishing *Telegroup* despite claims contract claims based on stock ownership).

[166] *But cf.* Burtch v. Gannon (*In re* Cybersight L.L.C. d/b/a), No. 04-112, 2004 U.S. Dist. LEXIS 24426, at *1 (D. Del. 2004); *accord* Official Comm. of Unsecured Creditors v. Am. Capital Fin. Servs., Inc. (*In re* Mobile Tool Int'l, Inc.), 306 B.R. 778 (Bankr. D. Del. 2004) (adhering to pre-*Telegroup* view of not subordinating noteholder claims).

[167] *See* discussion *supra* Part I.*B*.

[168] *See* discussion *supra* Part II.

[169] *See In re Mobile Tool Int'l, Inc.*, 306 B.R. at 781–82 (distancing itself from *Telegroup*); *In re DirecTV Latin Am., L.L.C.*, 2004 WL 302303, at *4 (doing same).

[170] In other words, each decision narrowly adhered to the words of the statute and the rationales put forth in the legislative history. *See* discussion *supra* Part I.*B*.

[171] *See* Giannetti, *supra* note 1, at 519.

[172] *See supra* notes 51–53 and accompanying text.

Typically, courts restricted the application of section 510(b) to claims that directly "arose from" the purchase or sale of a security.[174] Construction of the phrase "arising from" becomes controversial only when the underlying claim does not flow directly from a tort committed at the time of the purchase or sale itself. Thus, claims either not flowing from the initial transaction or claims occurring later in time, were not within the purview of the statute.[175] The issue was not challenged following the enactment of the 1978 Code until recently, when several circuits began to adopt a broader reading of section 510(b).[176] This has created a split among the circuits that has yet to be resolved. The split is defined by how the statute is read—traditionally or broadly—each of which will be examined in turn.

The traditional approach entails a narrow application of section 510(b). Courts that adhere to this reading of the statute apply it only to claims that directly arose out of the initial purchase or sale.[177] Essentially, this limits the application of section 510(b) to claims for fraud in the purchase or sale of securities.[178] For example, *In re Amarex, Inc.*,[179] ("*Amarex*"), and *Montgomery Ward*, are prime examples of this literal reading of the statute. In the case of *Amarex*, the limited partners of the Amarex enterprise filed proofs of claim alleging damages resulting from securities laws violations, breach of contract, breach of fiduciary duty, negligence, and common law fraud.[180] The court emphasized the "Congressional desire to shift to the shareholders the risk of fraud in the *issuance* and *sale* of a security—no more."[181] Because of the court's finding that the legislative history did not extend section 510(b)'s automatic subordination beyond the initial illegality, the court declined to subordinate claims arising after the stock transaction was concluded.[182] Thus, none of the claims were subordinated, as they all arose from the mismanagement of the limited partnerships after the initial issuance and sale of securities.[183] Similar reasoning was employed by the court in *Montgomery Ward* to

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[173] *See, e.g.*, Merrimac Paper Co. v. Harrison (*In re* Merrimac Paper Co.), 303 B.R. 710 (Bankr. D. Mass. 2003) (finding subordination proper under (c), after rejecting similar claim under (b)); *cf.* Weissman v. Pre-Press Graphics Co. (*In re* Pre-Press Graphics Co.), 307 B.R. 65, 78 (N.D. Ill. 2004) (subordinating claims for shareholder oppression under (b)). *But cf. In re* Stern-Slegman-Prins Co., 86 B.R. 994, 998 (Bankr. W.D. Mo. 1988) (denying subordination under section 510(b) for claims based on illegal stock issuance).

[174] *See supra* notes 25–26.

[175] *See supra* notes 25–26. *See generally* Smolev, *supra* note 61, at *1–*2 (recapping what he calls "traditional approach" to subordination).

[176] *See, e.g.*, Allen v. Geneva Steel Co. (*In re* Geneva Steel Co.), 281 F.3d 1173, 1179 (10th Cir. 2002); Baroda Hill Invs., Ltd. v. Telegroup, Inc. (*In re* Telegroup, Inc.), 281 F.3d 133 (3d Cir. 2002); Am. Broad. Sys., Inc. v. Nugent (*In re* Betacom of Phoenix, Inc.), 240 F.3d 823 (9th Cir. 2001).

[177] *See supra* notes 25–26, 174–75.

[178] *See supra* notes 25–26, 174–75.

[179] 78 B.R. 605 (Bankr. W.D. Okla. 1987).

[180] *Id.* at 606.

[181] *Id.* at 609–10.

[182] *Id.* at 610; *see also supra* notes 25–26, 174–75. *But cf.* Smolev, *supra* note 61, at *4 ("[B]ankruptcy and appellate courts seem to have no problem.").

[183] *In re Amarex, Inc.*, 78 B.R. at 610 ("The Proofs of Claim filed on behalf of all limited partners . . . very clearly demonstrate that there are common law claims which arise from conduct which occurred subsequent to, and which do not arise from, the issuance and sale of the securities.").

preclude subordination of claims based on promissory notes.[184] Therein, the court confined subordination to claims "directly concern[ing] the stock transaction itself."[185] This idea, that subordination of noteholders' claims should be denied, has never been altered.[186] Although somewhat restrictive in its treatment of claims, this method has the strongest justification, in light of the plain meaning and legislative history of section 510(b).[187]

In contrast to the traditional approach, there has been a recent trend toward a broader application of section 510(b).[188] In addition to the Third Circuit's decision in *Telegroup*, the Ninth and Tenth Circuits have also adopted a more expansive reading.[189] The case of *American Broadcasting Systems, Inc. v. Nugent* (*In re Betacom of Phoenix, Inc.*),[190] ("*Betacom*"), was the first circuit-level opinion to adopt the broader view.[191] The Ninth Circuit applied section 510(b) to breach of contract claims arising from the execution of a merger agreement pursuant to which stock was exchanged.[192] The court relied on *Granite* and *NAL* in finding subordination appropriate, as their "recent interpretations of the statute [we]re more persuasive . . . . Section 510(b)'s legislative history does not reveal an intent to tie mandatory subordination exclusively to securities fraud claims."[193] Thus, the policy-based justification for subordination was born. Shortly thereafter, *Telegroup* was decided, and as previously discussed,[194] a similar outcome was reached with respect to claims for breach of contract.[195] Finally, the trilogy of cases applying an expansive reading of section 510(b) was rounded out by the Tenth Circuit's 2002 decision in *Allen v. Geneva Steel Co.*, (*In re Geneva Steel Co.*),[196] ("*Geneva*"). The

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[184] *See* Montgomery Ward Holding Corp. v. Shoeberl (*In re* Montgomery Ward Holding Corp.), 272 B.R. 836, 842 (Bankr. D. Del 2001):

> The legislative history of § 510(b) supports a conclusion that the plain language of the statute limits automatic subordination to claims that directly concern the stock transaction itself. Existing case law uniformly agrees that Congress enacted § 510(b) to prevent equity investors from converting their interests into higher priority general unsecured claims by asserting fraud or rescission claims.

Id.

[185] *Id*. at 842.

[186] *Id*.

[187] *See* discussion *supra* Parts I.*B*.–*C*., II.

[188] *See infra* notes 188–200 and accompanying text.

[189] *See, e.g*., Am. Broad. Sys., Inc. v. Nugent (*In re* Betacom of Phoenix, Inc.), 240 F.3d 823 (9th Cir. 2001) (rejecting literal application of section 510(b)); *accord* Allen v. Geneva Steel Co. (*In re* Geneva Steel Co.), 281 F.3d 1173 (10th Cir. 2002) (stating same).

[190] 240 F.3d at 823.

[191] *See* Smolev, *supra* note 61, at *1–*5 (discussing recent trends in subordination law); *cf*. Baroda Hill Invs., Ltd. v. Telegroup, Inc. (*In re* Telegroup, Inc.), 281 F.3d 133 (3d Cir. 2002) (occurring subsequent to *Betacom*) and *In re Geneva Steel Co*., 281 F.3d at 1173 (taking place after both *Betacom* and *Telegroup*).

[192] *See In re Betacom of Phoenix, Inc*., 240 F.3d at 826–28.

[193] *Id*. at 829 (determining section 510(b) has been interpreted to subordinate more than merely securities fraud claims (citing *In re* NAL Fin. Group, Inc., 237 B.R. 225, 234 (Bankr. S.D. Fla. 1999) and *In re* Granite Partners, L.P., 208 B.R. 332, 337 (Bankr. S.D.N.Y. 1997)).

[194] *See* discussion *supra* Parts I and II.

[195] *See* discussion *supra* Parts I and II.

[196] 281 F.3d at 1173

Geneva court extended section 510(b)'s scope to encompass fraud claims arising both from the inducement of the purchase or sale of securities and the retention of said securities.[197] The court acknowledged that the claims before it were clearly the kinds of claims intended to be covered by the statute,[198] and found subordination to be appropriate in light of an argument based on risk allocation.[199] The fact that the fraud occurred subsequent to the purchase or sale itself was to no avail.[200]

Still, there are several Courts of Appeal that have not reconsidered the issue since the enactment of the 1978 Code. For example, the Second Circuit has not dealt with the question of subordination since *Jezarian v. Raichle* (*In re Stirling Homex Corp.*),[201] ("*Homex*"), which was decided under the prior Bankruptcy Act while the current Code was still pending in Congress. That case posed the question of whether claims filed by an allegedly defrauded stockholder of the debtor corporation should be subordinated.[202] The claims arose from operations that "included 'land transactions that were not what they were claimed to be, labor relations that were not only inappropriately 'cozy' but undisclosed, contracts . . . based on guile and trickery rather than agreement, and deceptive bookkeeping practices,'"[203] as well as other management-related infractions.[204] The court determined that subordination was appropriate based on the claimants' "bargaining for equity type profits and assumed equity type risks."[205] Thus, this presumption of behavior was reasonable in light of the expectations of the parties. Recently, however, certain lower courts within the Second Circuit have departed from *Homex* and have been cited for their increasingly broad interpretations.[206] Consequently,

[197] *Id*. at 1174 (finding defrauded steel investor claim with respect to retention of securities also within statute's reach); *see also In re Granite Partners, L.P*., 208 B.R. at 334 (including fraudulent retention or maintenance claims).

[198] *See In re Geneva Steel Co*., 281 F.3d at 1179–81 (citing to *Betacom*, *NAL*, and *Granite* throughout for support of its expansive interpretations of section 510(b)).

[199] *Id*. at 1180. For a discussion of the risk allocation argument, see *supra* notes 14–24 and discussion in Part I.*B*.

[200] *Id*. at 1179 (finding "no good reason to distinguish so-called fraudulent inducement claims from fraudulent retention claims." (citing *In re Granite Partners, L.P*., 208 B.R. at 344)).

[201] 579 F.2d 206, 210 (2d Cir. 1978).

[202] *Id*. at 208.

[203] *Id*. (citations omitted).

[204] *Id*. ("Key officials of the corporation 'engaged collectively in a calculated and multifaceted plan to give the investing public the false impression that Homex was in a sound and steadily improving financial position and at the same time without adverse information that was material to an accurate appraisal of the company's prospects'" (citations omitted)).

[205] *Id*. at 210. "We will not allow stockholders whose claims are based solely on the alleged fraud that took place in the issuance of stock to deplete further the already meager pool of assets presently available to the general creditors." *Id*. at 213.

[206] *See, e.g.*, *In re* PT-1 Communications, Inc., 304 B.R. 601, 610 (Bankr. E.D.N.Y. 2004) (subordinating claims alleging breach of contract, breach of fiduciary duty, unjust enrichment, and tortious interference because "[it] is . . . reasonably clear that the present situation is in line with Congressional policy concerns . . . under *section 510(b) of the Bankruptcy Code*."). "While the facts of this case do not fit squarely into the framework of the statute, this Court believes that the Spano Claim should be subordinated to the class of unsecured creditors." *Id*.; *In re* Granite Partners, L.P., 208 B.R. 332, 337, 339 (Bankr. S.D.N.Y. 1997) (including post-investment fraud claims in those subordinated).

the Fifth Circuit decided a subordination challenge in *Robinson v. Wangemann*,[207] another Bankruptcy Act case, and has not revisited the issue since. Therein, the claimant entered into a transaction in which he accepted a note in exchange for his stock.[208] The court subordinated his resulting claim to those of creditors,[209] which is interesting in light of the modern doctrine with respect to noteholders' claims.[210] Nevertheless, the court reasoned that the character of the claim itself had not changed, and although the claimant became a noteholder, he retained certain characteristics vis-à-vis creditors that should not be disturbed.[211] Before the respective Courts of Appeal reconsider section 510(b) subordination, no outcome can be predicted. Thus, the disparate approaches will remain until either Congress finds it necessary to reconsider the issue altogether or the Supreme Court grants certiorari to consider a subordination challenge.

CONCLUSION: FLASH-FORWARD[212]

Currently, the scope of claims that fall within section 510(b) is in dispute. There is no generally accepted framework that courts can use in a subordination analysis of claims that are not based on fraud in the issuance of securities. While the statutory language and legislative history appear to limit the application of section 510(b) to only claims arising from the initial purchase or sale of securities, the *Telegroup* line of cases has extended the provision well beyond that sphere. These decisions have served only to complicate matters. The policy-based justifications that are employed are far-fetched and unclear, thus providing no guidance for future courts to utilize. However, the recent cases of *DirecTV* and *Mobile Tool* indicate a rejection *sub silencio* of the Third Circuit's decision in *Telegroup*, to which courts should turn in attempting a proper reading of section 510(b).

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[207] 75 F.2d 756 (5th Cir. 1935).

[208] *Id*. at 757.

[209] *Id*. at 758.

[210] The modern doctrine has, for a long time, held that such claims are not subject to subordination. *See supra* notes 36, 116, 152 and accompanying text.

[211] *See Robinson v. Wangemann*, 75 F.2d at 757–58.

[212] *See* Giannetti, *supra* note 1, at 512.

The broad view of subordination that has been espoused by some courts has been extremely destructive to the bankruptcy law, as it thwarts the fundamental principle of equality of distribution. The restrictive application of section 510(b) is more desirable, and consistent with the justifications based on the allocation of the risk of insolvency and the risk of illegality in the issuance of securities. Thus, at least until new legislation is enacted or the Supreme Court simplifies the current statute, courts should adhere to a literal reading of the statute's text. In this way, courts can ensure that the section 510(b) that Congress formulated as law has not been lost forever.

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