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Physician, Heal Thyself

Saint Vincent Catholic Medical Center, A Case Study

By Adam C. Rogoff and Anupama Yerramalli

A multi-debtor operating entity with over $1 billion of liabilities and thousands of employees and retirees is complicated enough; add to the mix: 1) one of New York City's historic hospitals, founded in 1849, which cared for survivors of the Titanic and later was a leader in confronting the AIDs crisis; 2) ongoing care for tens of thousands of patients throughout New York; and 3) preserving the non-profit, charitable mission of the city's last Catholic hospital, and you have the elements of a complex Chapter 11 case with nuances that are not part of the standard fare. This article addresses some of these complexities.

Background

Saint Vincent Catholic Medical Centers of New York and its debtor-affiliates (collectively SVCMC) filed Chapter 11 cases in 2010 in the Southern District of New York (the Chapter 11 Cases). *See In re Saint Vincent Catholic Med. Ctr. of N.Y. et al*, Lead Case No. 10-11963 (CGM) (Bankr. S.D.N.Y.). For a complete history of the events leading to the commencement of the bankruptcy cases, please refer to the *Declaration of Mark E. Toney*, found at Docket No. 18.

SVCMC operated a 727-bed inpatient Level 1 trauma care hospital serving Lower Manhattan. SVCMC's other services included a hospice, home health agencies, three nursing homes, a cancer care clinic, an inpatient behavioral health hospital, and numerous outpatient clinics. SVCMC relied primarily upon Medicare and Medicaid for its reimbursements, and provided substantial charity (uncompensated) care. Battered by the recession in 2009 and suffering dramatic cuts in government-payor reimbursements, SVCMC could not continue to operate on a stand-alone basis. In early 2010, working closely with New York State agencies and the Governor's office, SVCMC pursued (unsuccessfully) the search for a strategic alliance with a new sponsor.

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Second Circuit Revisits Mandatory Subordination Under Section 510(b)

By Adam H. Friedman and Jonathan T. Koevary

For the third time in six years, the Second Circuit visited mandatory subordination of claims under Title 11 of the United States Code (the Bankruptcy Code). In *CIT Grp. Inc. v. Tyco Int'l. Ltd.*, No. 12-1692-bk, the Second Circuit affirmed a bankruptcy court decision holding that claims arising under a tax-sharing agreement entered into as part of stock divestment restructuring was not subject to mandatory subordination under section 510(b) of the Bankruptcy Code. In this article, we discuss the history of mandatory subordination and the current state of the law.

History

Bankruptcy Code section 510(b) provides in pertinent part that: "a claim arising from rescission of a purchase or sale of a security of the debtor … for damages arising from the purchase or sale of such a security … shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security." 11 U.S.C. § 510(b). In short, the provision ensures that those who bargained to be treated as investors do not find themselves elevated to the priority status of

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Unable to locate a new partner, and suffering over $1 billion of legacy obligations (including funded debt, medical malpractice claims and pension liabilities), SVCMC was constrained to close its Manhattan hospital and find new sponsors for its other services. Promptly following its decision to close the main hospital, in April 2010, SVCMC filed for bankruptcy to facilitate that closure and preserve and transfer patient care services. (Note, In 2005, SVCMC had filed for bankruptcy, emerging in August 2007 from its prior Chapter 11 case.)

Throughout the process, SVCMC and its professionals (which included crisis management provided by Mark E. Toney as CEO/CRO, Steven Korf as CFO, and professionals from Grant Thornton) were guided by: 1) preserving patient care and safety; while 2) maximizing asset values for creditors. At times, SVCMC faced the specter of administrative insolvency. Two years later, SVCMC confirmed a Chapter 11 plan that assured administrative solvency, paid priority claims, and recovered over a half billion dollars of proceeds for the benefit of creditors, including repayment of secured debt. This process also unlocked substantial value from the former Manhattan hospital campus while creating the first free-standing emergency department in New York City to provide comprehensive ongoing care for the community.

Adam C. Rogoff is a partner in the Corporate Restructuring and Bankruptcy Department of Kramer Levin Naftalis & Frankel LLP in New York. A member of this newsletter's Board of Editors, Rogoff has exensive experience representing companies in Chapter 11 and out-of-court restructurings. He served as debtor's counsel for Bayonne Medical Center and Saint Vincents Catholic Medical Centers of New York and its affiliates in their Chapter 11 cases. **Anupama Yerramalli** is an associate in the same department, and also represented SVCMC.

Creative Transactional Structures to Maximize Value for Creditors

While the closure of the Manhattan hospital received media, political and community attention, the other healthcare services rendered by SVCMC were relatively unknown to those outside of the immediate catchment areas. Upon filing the petitions, SVCMC sought to complete the safe transfer of all patients from the Manhattan hospital and implement the closure plan while simultaneously stabilizing the numerous other patient care services to ensure that they remained as going concerns. This process — which realized over $500 million of sales proceeds — was done through several independent sales transactions accomplished over an 18-month period. These transactions, because of the healthcare component, were subject to state regulatory approvals as well as the bankruptcy court. In Chapter 11, parties are accustomed to sales being approved quickly (30-60 days) and closing shortly thereafter. However, absent bankruptcy, the sale of a nonprofit's healthcare assets is subject to extensive regulatory approvals and could take a year or longer to obtain. SVCMC's crisis management team worked very closely with numerous state regulatory agencies to obtain — sometimes on an emergency basis — required nonbankruptcy approvals.

One key decision that was made early on was to undertake separate transactions and not pursue a global sale. This ensured that: 1) the best sponsor was located for each ongoing service; while 2) creating maximum marketing potential for the assets. For example, SVCMC operated its home health agency as a single unit. But, because there were separate operating licenses, in Chapter 11, this service was divided into the long-term home health care program (LTHHCP) and the certified home health agency (CHHA). A single stalking horse was selected for each service (using identical sales agreements) and separate auctions were conducted. The auctions themselves were done without having all of the bidders in the same room and, ultimately after multiple

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Third-Party Litigation Funding In Bankruptcy Cases

By Patrick M. Jones

Third-party litigation financing is a booming form of finance that seems like a natural fit for bankruptcy-related litigation initiated by Chapter 7 trustees, and official committees of unsecured creditors and debtors. Although the disclosure requirements of the bankruptcy code may give the most secretive funds pause, these issues can be managed and should not be a barrier to most participants. Ultimately, third-party litigation finance will assist in the efficient, comprehensive liquidation of bankruptcy estates and provide the maximum benefit for creditors.

This type of litigation finance is an alternative asset class that has experienced rapid growth in the U.S. in the past decade. Explained in its its simplest form, a third party provides capital to a claimant to cover or supplement the cost of litigating a claim or to hedge against an adverse outcome. The third party purchases a portion of a claimant's recovery, less attorneys' fees and costs. The financing is almost always provided on a non-recourse basis, *i.e.*, the claimant is not liable to the third party if the underlying lawsuit is unsuccessful.

Significant Expansion

According to a recent survey of U.S. commercial litigators conducted by the Burford Group, a London-based investment firm that provides third-party financing, in-house general counsels and chief financial officers forecast significant expansion of litigation finance. Fifty percent of AmLaw 200 litigators have had cases that could have used litigation funding, and 18% have a current case that could use funding. Additionally, 59% of general counsels and 71% of chief financial officers say that litigation finance levels the playing field between parties with unequal resources.

The primary concern most often expressed by critics of third-party litigation funding is that it will increase the filing of frivolous lawsuits, but that concern misses the fundamental principle of finance — to make money. Third-party litigation financiers only invest in cases where the plaintiff's claims are strong and the damages are demonstrable and recoverable. Investing in frivolous cases is bad business. "We are investing in the best claim sets we can find with a fact pattern that we can deconstruct," noted David Desser, Managing Director of Juris Capital, LLC, a third-party financing firm located in Chicago. "We're not interested in the long odds of venture capital, where a 'home run' counterbalances many 'strike outs.' We target a positive return for more than 70% of our portfolio, with an IRR in excess of 20%."

Background

Third-party litigation finance in the United States initially took the form of modest investments in personal injury claims intended to provide a financial bridge for claimants while their underlying litigation moved toward settlement or trial. More recently, however, more sophisticated funds have formed to provide capital for complex commercial disputes featuring well-financed corporate claimants seeking damages in the range of tens or hundreds of millions of dollars. And, more substantial players enter the field each year. Today, third-party commercial litigation financiers include hedge funds, banks and even two funds traded on the London stock exchange, in addition to several privately held funds. There are dozens of smaller firms and individuals investing small amounts in personal injury (or similar) claims.

While third-party litigation finance can solve similar problems addressed by contingency fees arrangements — an allegedly wronged party's inability to pay professionals to remedy the underlying wrong — more and more, attorneys on contingency fee arrangements are reducing their risk of non-payment or under-payment by securing third-party funding directly or on behalf of their clients.

Third-party litigation finance can take numerous forms and is limited only by the imagination of the investors and their counterparties. Capital may be invested in exchange for an interest in the litigation proceeds equal to the amount of the investment, plus a return — in some cases three to five times the invested amount. Commonly, the investor expects ongoing representation on a fixed or contingent fee basis (if not already structured in that way).

An alternative arrangement is for the financing party to loan funds directly to the attorney or law firm representing a litigant. Here, the third party will provide an interest-bearing loan, but with this structure the attorney or law firm is the investor's counterparty. These loans may be recourse or "non-recourse," the later meaning if the underlying lawsuit is not successful, the borrower (law firm) is not obligated to repay the financier. And, most third-party investors disclaim any participatory role in the litigation due to privilege issues and potential attorney-client conflicts.

Third-Party Funding in Bankruptcy Cases

Third-party litigation funding seems like a natural fit for bankruptcy-related litigation. In the typical Chapter 11 bankruptcy case the "hard assets," *e.g.*, equipment, inventory, receivables, etc., are sold and the proceeds are distributed primarily — if not entirely — to the debtor's secured creditor and the estate's professionals. Often, the only assets remaining are causes of action in the form of preference and avoidance actions, breach of contract claims, and breach of fiduciary duty claims which may be difficult and expensive to monetize.

The creditors committee, in the case of an ongoing Chapter 11 bankruptcy case, or the bankruptcy trustee, if the case has been converted to Chapter 7, may have difficulty finding

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Patrick M. Jones is an officer in the Chicago office of Greensfelder, Hemker & Gale, P.C., and a member of the firm's Creditors' Rights and Bankruptcy and Litigation Practice Groups. He represents parties in complex business disputes and corporate bankruptcies, including plaintiffs and defendants, debtors, lenders, creditors' committees and Chapter 7 trustees. Jones can be reached at pmj@greensfelder.com or 312-345-5018.

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qualified counsel willing to pursue such claims on a contingency basis. The likelihood of retaining qualified counsel would increase, however, if the estate and its retained professionals could hedge the risk associated with the litigation at the outset. Obtaining third-party funding, however, could be perceived by the court as reducing the amount recoverable from the estate's assets and, therefore, require bankruptcy court approval. How bankruptcy courts will treat such arrangements has yet to be seen.

"We don't know of any direct investments in bankruptcy, but it would not be surprise us," said Desser. "First, third-party litigation finance simply hasn't been around that long in the United States. Second, the investors typically prefer to keep the existence of a financing confidential. We have looked at several opportunities in the bankruptcy context, although we have yet to find the appropriate fit for our fund."

Although third-party litigation financing seems like a natural fit for bankruptcy-related litigation, the Bankruptcy Code's disclosure requirements may make it less attractive to the ordinarily secretive funds. And, the courts have yet to parse out exactly what amount of disclosure is enough (and what amount is not).

Financing the Bankruptcy Estate 'Directly'

One option would be for the lending party to enter into a funding agreement with the bankruptcy estate via the debtor, the creditors committee or the bankruptcy trustee in exchange for an interest in a specific piece of litigation or all of the existing claims that the estate may own. The estate then has the advantage of a "war chest" to pursue claims for the benefit of its creditors that might otherwise have gone unliquidated and, depending on the terms of the financing, pay other expenses of administering the estate.

"Typically, the claimant directs us to transfer some portion of our investment directly to its attorneys who have committed to a flat fee for litigating the case to closure," said Desser. "In so doing, the attorneys are pre-paid and the investor recovers from the proceeds of the litigation or from other assets."

This type of arrangement benefits the bankruptcy estate because it can control the funds, permitting it to retain counsel on an hourly or fixed-fee basis. This may expand the range and quality of law firms available to the estate, since larger firms typically discourage their attorneys from taking cases pursuant to a contingency fee arrangement (and effectively funding the litigation themselves).

"We looked at a case on behalf of a Chapter 7 bankruptcy trustee for an estate of a failed hedge fund," said Desser. "The trustee was charged with litigating against dozens of recipients of distributions from the fund in an effort to recover and redistribute those funds to the general creditor body. At the end of the day, I believe the trustee obtained less expensive (and recourse) financing, but that's the type of bankruptcy-related situations that would interest a fund like Juris Capital."

Such "direct" financing is similar to debtor-in-possession (DIP) financing, and presumably would require full disclosure of its terms and prior approval by the presiding bankruptcy court pursuant to Section 364 of the Bankruptcy Code. Additionally, as is the case with traditional DIP financing, the movant would have the burden of proving that the funding is necessary and that less expensive alternatives were unobtainable. This may be difficult — but not impossible — in light of the high cost associated with third-party litigation financing and the availability of professionals willing to be retained pursuant to a contingency fee arrangement.

Financing the Bankruptcy Estate 'Indirectly'

As an alternative to funding the estate directly, the third-party funding firm could fund the bankruptcy estate "indirectly" by entering into an agreement with the attorneys retained by the estate. This is especially likely if the attorneys are retained on a contingency basis, as most funders prefer that the attorneys have "skin in the game." The one obvious downside of this type of arrangement from the bankruptcy-estate perspective is that it eliminates the potential for "surplus" funds which it could other use to pay the expenses of administration.

This form of "indirect" financing also would have to be disclosed to the court pursuant to Rule 2016(b) of the Federal Rules of Bankruptcy Procedure, which requires the disclosure of any agreement by a professional retained by the debtor to share compensation received by the estate with any person not a member of the attorney's law firm. Technically, this provision only applies to professionals retained by the debtor — not necessarily those retained by a creditors committee or a Chapter 7 trustee. And, this disclosure requirement arguably would not apply if the agreement were drafted so that the funds to repay the third-party financing did not come from payments of the debtor. However, failure to disclose such a relationship, even if technically outside the requirements of Rule 2016(a), could result in a denial of any payments received by

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Maintenance and Champerty

For centuries, common law prohibited limited non-parties from participating in lawsuits by the doctrines of maintenance and champerty. Maintenance is where a non-party provides economic support to a party to an existing lawsuit. Champerty, which is technically a form of maintenance, is where a party acquires an interest in the outcome of a lawsuit to which it is not a party based on economic or other support of one of the parties, typically the plaintiff. The majority of decisions issued in England and the United States discarded dated concerns over maintenance long before litigation finance even existed. More recently, courts and many state bar ethics opinions have held in favor of third-party litigation finance providers and their clients on the basis that, in many cases, third-party financing grants access to justice that financially strapped individuals and corporate litigants might otherwise be denied for purely economic reasons.

ON THE MOVE

McDermott Will & Emery LLP has announced that **Jeremy R. Johnson** has joined the firm's New York office as a partner in the Restructuring & Insolvency practice. Previously with **DLA Piper**, Johnson has a wide-ranging restructuring practice with experience advising domestic and international clients in insolvency proceedings, out-of-court restructurings and insolvency issues in non-distressed transactions. He has served as counsel to corporate debtors, committees, creditors, purchasers of distressed assets, the Federal Deposit Insurance Corporation and other stakeholders in numerous bankruptcy cases, with a particular emphasis on corporate debtor and buy-side asset sale representation.

Morrison & Foerster has named **Brett Miller** as managing partner of the firm's New York office. Miller, a partner in the firm's Bankruptcy and Restructuring Group, succeeds **Charles ("Chet") L. Kerr**, a partner in the firm's litigation department, who has led the office since 2008. Miller is currently representing Louis J. Freeh, Chapter 11 Trustee for MF Global, which, with $41 billion in assets at the time of filing, is the largest bankruptcy filing of 2011 and the eighth largest in U. S. history. Miller also recently represented the Official Committee of Unsecured Creditors in the Chapter 11 of the Los Angeles Dodgers.

The firm also announced the promotion of **Larren Nashelsky**, co-chair of the Bankruptcy & Restructuring Group, to firm-wide chair. He succeeds **Keith Wetmore**, who spent 12 years as firm chair and will continue with the firm as chair emeritus.

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the attorney from the debtor. Therefore, as always, disclosure would be highly recommended.

CONCLUSION

The emergence of third-party litigation funding in bankruptcy cases seems inevitable and may already be more prevalent than public filings would indicate. The ethical "red flags" associated with third-party financing do not appear to be any more disconcerting than contingency fee arrangements, which bankruptcy courts not only tolerate but in certain instances, might favor. Participation in the bankruptcy case by third parties that results in a more efficient and complete liquidation of the debtor's assets for the benefit of its creditors fits soundly within the framework of the bankruptcy code and should be a welcome development.

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meetings with the bidders to improve their bids, each bidder submitted a final and highest bid. This bifurcated process, coupled with the final and highest bid approach, increased the aggregate purchase prices from $32.1 million to $47 million — a substantial increase.

No single sales approach was used in the case. One notable private sale concerned the inpatient behavioral health hospital, which served approximately 2,800 inpatients and had over 620,000 outpatient visits in clinics and residences throughout the New York City region. This service heavily relied upon Medicaid and, in order to retain the benefit of suitable reimbursement rates, optimal buyers needed an "Article 28" hospital license. Time was of the essence, too, due to rate changes that could adversely affect rates after October 2010.

Without preserving favorable reimbursement rates, the viability of the behavioral health hospital was uncertain. As if a limited pool of potential operators and looming deadlines wasn't enough, SVCMC also confronted claims by certain creditors with mortgages on 67 acres of developed and undeveloped real estate located in an affluent New York suburb that the facility should be closed to sell the land to a developer. SVCMC relied upon certain case law holding that when a debtor is a non-profit with a charitable healthcare mission (as here), the debtor and court were permitted to weigh the continuation of that mission as a sales factor. *See In re United Healthcare Sys., Inc.*, Civ. No. 97-1159, 1997 U.S. Dist. LEXIS 5090, *17-18 (D.N.J. Mar. 26, 1997).

Simply, price alone would not dictate the result. Working closely with New York State agencies, SVCMC showed that closure of the facility was untenable, as there was inadequate absorption for displaced patients. The bankruptcy court concurred; closure was not an option, allowing SVCMC to focus on what process would best preserve operations and value. SVCMC's crisis managers and professionals developed a two-prong sale: 1) the healthcare business was sold outright to St. Joseph's Hospital, which provided uninterrupted care at all of the inpatient and outpatient locations; and 2) SVCMC received an option to seek to repurchase and sell 37 acres of undeveloped real estate adjacent to the facility over the next year to a developer. Despite subsequent marketing, no developer emerged. However, the preservation of this optionality created the opportunity for an upside for mortgagees without disrupting the essential transfer of patient care. In total, SVCMC's marketing strategies resulted in approximately $255 million in sale proceeds from the non-hospital services.

Once patient care services were stabilized, SVCMC pursued unlocking value from its substantial Manhattan real estate. This transaction required balancing numerous concerns — 1) obtain highest price; with 2) few to no contingencies; and 3) provide for

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a portion of the property dedicated to future healthcare to address the needs of the community. The sale of the real estate, which was subject to landmark and zoning restrictions, required a close collaboration among SVCMC, creditors and a potential purchaser, working closely with the regulatory agencies. The parties determined that the best path to address the three criteria was a revised sale with the Rudin family (which had entered into a sale contract with SVCMC as part of the prior Chapter 11 case, but which sale had not been consummated as of the later case). The original sale contract was amended to remove numerous closing contingencies, provide for payment in full upon closing — a $260 million purchase price — and provide for the development of a comprehensive care center owned and operated by North Shore-Long Island Jewish Health System to provide ambulatory and emergency health services, a treat and release facility, and diagnostic care in one of the buildings being sold.

A Single Forum: Using the Automatic Stay

Given the importance of SVCMC as a healthcare provider, the closure of the Manhattan hospital was understandably distressing for many. This distress led to attacks on the decision to close, including lawsuits filed in New York State courts. A key part of the Chapter 11 case was the concentration of these actions into the bankruptcy court. However, since various actions were lodged against the regulatory agencies directly — and not SVCMC — this required finding that non-debtor actions were disguised attacks against SVCMC or its property. This was aided by an early strategic decision to seek interim and final bankruptcy court approval to implement the hospital closure plan at the outset of the case.

Shortly after interim approval was obtained, a community group commenced a state court action to enjoin the New York State Department of Health (DOH) approval of the closure plan. Relying upon the interim closure order, SVCMC brought this action into the bankruptcy court asserting that the relief — while directed against DOH — interfered with SVCMC's property (the hospital). Simply, no hospital could continue without use of SVCMC's assets. The plaintiff group also objected to entry of the final order approving the closure process. The bankruptcy court entered the final closure order and enjoined the state court action, finding that: 1) the public health and safety exception to the automatic stay did not apply to private plaintiffs; 2) the plaintiffs (a community interest group only) lacked standing; and 3) although the plaintiffs did not specifically institute the action against SVCMC, the action affected estate property. *See In re SVCMC*, 429 B.R. 139 (Bankr. S.D.N.Y. 2010). Moreover, forced continued operations at the Manhattan hospital — without financial resources to operate effectively — would have threatened patient well-being and interfered with the orderly patient transfer process underway. *See Id.*

Several months later, another local constituent group commenced an action under New York's Freedom of Information Law (FOIL) against DOH, seeking documents related to the Manhattan Hospital closure. *See Erica Kagan v. New York State Department of Health*, Case No. 10110869 (N.Y. Sup. Ct.). That action was based upon a host of allegations against SVCMC. The bankruptcy court found that the FOIL action violated the stay by seeking improper discovery relating to allegations best investigated by the estate and, specifically, the Creditors' Committee. *In re SVCMC, Hr'g Tr.* at 46:9-19 (Sep. 2, 2010) (Docket No. 1131). The Committee ultimately determined that there was no misconduct. *In re SVCMC, Hr'g Tr.* 46:21-47:1 (Dec. 14, 2011) (Docket 2259). Again, the Chapter 11 case provided a centralized forum to address collateral attacks on the closure process directed against third parties (*e.g.*, DOH) but, in reality, targeting SVCMC's conduct.

Conclusion

The SVCMC Chapter 11 Cases were successful, despite the risk of administrative insolvency, based upon a process aimed at: 1) preserving patient care and respecting SVCMC's healthcare mission; 2) marketing and transferring healthcare services at a deliberate pace through a variety of private sales or auctions processes; and 3) achieving consensus to avoid significant litigation. When efforts arose to derail this process through collateral litigation, the automatic stay and the core jurisdiction of the bankruptcy court provided a single forum to monitor and resolve these issues. While SVCMC's historic provision of healthcare services came to an end, its rich legacy of patient care and integrity was preserved due to its ability to properly utilize the Chapter 11 process.

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creditors should a claim arise on account of their investments. The provision is about expectations: If a party expected to be treated as a shareholder, the provision ensures that the party will be treated as a shareholder, even though it has a claim of a creditor.

The most straightforward application of section 510(b) is in the case of a shareholder fraud claim. Suppose a group of claimants are defrauded into purchasing stock of a company. The fraud is later uncovered and the company files for bankruptcy protection. Unsecured creditors are projected to receive less than full recoveries and shareholders, nothing. The defrauded shareholders have obtained judgments against the bankruptcy estate for rescission on account of the fraud. Under the Bankruptcy Code, these judgments are "claims." Absent section 510(b), these defrauded shareholders would have general unsecured claims on the same priority level as other creditors such as trade creditors and ordinary unsecured noteholders.

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Section 510(b), however, subordinates these claims to the other claims. It may, at first glance, not seem fair. Why should these defrauded shareholders be treated worse than ordinary claimants? The answer is that these shareholders bargained to be treated as investors. When they purchased the stock, they were investing in the company, with the expectation of a return on their investment consummate with the performance of the company. Ordinary creditors make no such bargain. They, generally, bargain only for repayment of principal and interest. The drafters of the Bankruptcy Code included section 510(b) in recognition that it would have been unfair to dilute the claims of ordinary creditors with creditors who bargained for the benefits and risks of shareholders. *In re Granite Partners, L.P.*, 208 B.R. 332 (Bankr. S.D.N.Y. 1997) and *In re Geneva Steel Co.*, 281 F.3d 1173 (2002) each provide examples of section 510(b) subordination in the fraud claim context. These two cases also make clear that the statute also applies to a fraudulent maintenance claim for post-investment fraud and not merely to fraudulent inducement claims.

Over time, a series of circuit-level court decisions applied section 510(b) subordination to breach of contract claims as well. In *In re Betacom of Phoenix, Inc.*, 240 F.3d 823 (9th Cir. 2001), the debtor failed to close a merger agreement that provided that, as acquirer, the debtor would transfer certain of its shares to the target's shareholders. The claimants/target shareholders filed claims for the breach and the debtor sought subordination. The claimants argued that the statute applied only to fraud claims, that section 510(b) was inapplicable because they never enjoyed the rights of stock ownership and because, since the merger agreement never closed, there was no actual sale or purchase of securities triggering the statute. *Id.* at 828.

The Ninth Circuit disagreed. Citing prior lower court decisions including *Granite*, the Ninth Circuit cautioned against an overly restrictive interpretation of section 510(b). Citing *Granite*, the court looked to the legislative history of the statute, which makes clear that Congress "relied heavily" on a 1973 article by two law professors in crafting Section 510(b). *Id.* at 829, citing H. Rep. 95-595 at 195 (1977), Slain & Kripke, The Interface Between Securities Regulation and Bankruptcy-Allocating Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors, 48 *N.Y.U. L. Rev.* 261 (1973). The Slain & Kripke article asserted that "the dissimilar expectations of investors and creditors should be taken into account in setting a standard for mandatory subordination. Shareholders expect to take more risk than creditors in return for the right to participate in firm profits. The creditor only expects repayment of a fixed debt. It is unfair to shift all of the risk to the creditor class since the creditors extend credit in reliance on the cushion of investment provided by the shareholders." *Id.* In *Betacom*, because the claimants had the expectation of shareholders, section 510(b) applied.

The Third Circuit applied the same rationale as *Betacom*, but went a little further in *In re Telegroup, Inc.*, 281 F.3d 133 (3d Cir. 2002). The stock was delivered, but the debtor breached the underlying stock purchase agreement's requirement that, as issuer, it use its best efforts to register its stock and ensure that it's freely tradable. The Third Circuit found "arising from" ambiguous. Looking at the statute's legislative history, it held that the post-transfer breach of its registration obligations fell within the meaning of the statute and its legislative history. As in *Betacom*, the claimant bargained to be treated as a shareholder, holding that subordination under section 510(b) is appropriate where there is "some nexus or causal relationship between the claim and the purchase of securities."

The Second Circuit followed *Betacom* in *In re Med Diversified, Inc.*, 461 F.3d 251 (2d Cir. 2006). The court held that breach of an employee termination agreement that provided for the transfer of stock as severance was subject to subordination. The Second Circuit found "arising from" ambiguous in statutory text and examined the legislative history, focusing on the Slain & Kripke article. The Second Circuit reduced the interpretation to require subordination if the claimant "(1) took on the risk and return expectations of a shareholder, rather than a creditor, or (2) seeks to recover a contribution to the equity pool presumably relied upon by creditors in deciding whether to extend credit to the debtor." Because the claimant took on the risk and expectations of a shareholder, its claim was subject to subordination. *Med Diversified* also cited the *Enron* opinion decided months earlier by the bankruptcy court for the Southern District of New York. In *Enron*, the debtor's employees brought fraudulent inducement claims for damages related to the acceptance of stock options over cash and fraudulent maintenance claims for their decision not to exercise when vested. The bankruptcy court subordinated these claims under section 510(b). *See In re Enron Corp.*, 341 B.R. 141 (Bankr. S.D.N.Y. 2006). The Second Circuit opined again in *In re Marketxt Holdings Corp.*, 346 Fed. Appx. 744 (2d Cir. 2009), where it held that "a finding that subordination furthers either the risk-expectations or equity pool rationale is sufficient for a court to require" subordination." *Id.* at 746 (state court judgment for damages arising from purchase or sale of security requires mandatory subordination).

In contrast, in 2007, the Ninth Circuit declined to apply section 510(b) in *In re American Wagering, Inc.*, 493 F.3d 1067. In *American Wagering*, the debtor had breached a consulting contract to provide 4% of the monetary value of an IPO, but not stock itself. Years prior to the bankruptcy, the claim was reduced to a money

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Adam H. Friedman is a member of this newsletter's Board of Editors and a partner in the Business Restructuring and Bankruptcy Department of Olshan Frome Wolosky LLP in New York. **Jonathan T. Koevary** is an associate of the firm, in the same department. They may be reached at AFriedman@olshanlaw.com and jkoevary@olshanlaw.com, respectively.

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judgment. The court distinguished *Betacom* because in this case, compensation "was to be *valued* on the basis of the debtors' share price upon completion of the IPO, the contract did not provide for that compensation in the form of shares. His potential to earn greater profits as a shareholder did not exist." *Id*. at 1072-73 (emphasis in original). The court also found it of note that from the outset of the dispute, the claimant sought to reduce its claim to a money judgment and never attempted to recover stock. Similarly, in *In re Nations Rent, Inc.*, 381 B.R. 83 (Bankr. D. Del. 2008) claimants received notes and tangential make-whole claims in exchange for their interests in entities that the debtor acquired. The make whole payments due were tied to the value of the debtors' common stock on a date certain. The bankruptcy court was persuaded that the make-whole amounts were not damages arising from fraud or the issuance of stock, but rather "claims to recover payment due under agreements of sale of businesses." *Id*. at 92. Instead, these amounts "exist to provide the [claimants] with their bargained for sales price. [These amounts] are deferred compensation with a formula which serves as a damage buffer." *See also In re Motels of America, Inc.*, 146 B.R. 542 (Bankr. D. Del. 1992) (contractual claim of former employee to put stock to debtor not subject to section 510(b) subordination as former employee contracted away shareholder rights).

CIT Group Inc. v. Tyco Int'l. Ltd.

The facts of *CIT* result from a complex divestment. Tyco International Ltd. (Tyco) sought to divest itself of its equity in CIT Nevada, held indirectly through a holding company, TCH. Prior to divestment, TCH had incurred net operating losses totaling approximately $794 million. This divesture was done in three steps: 1) a merger of CIT Nevada and TCH; 2) a merger of the newly combined entity with a Delaware corporation, which created "new CIT"; and 3) an initial public offering of new CIT stock. Post-IPO, Tyco ceased to be a shareholder of CIT (as new). The parties entered into a series of agreements to effectuate the merger, including a Tax Agreement. Among other things, pursuant to the Tax Agreement, CIT agreed to make a formula-based payment to Tyco tied to the tax benefit received by CIT, plus interest. Tyco claimed approximately $190 million of benefits due and various breaches of the Tax Agreement.

CIT sought to subordinate Tyco's claim. It argued that, following Telegroup, there was a causal connection between the claim under the tax agreement and the underlying securities agreement to require subordination. It argued that section 510(b) subordination was appropriate because "the Tyco Claim arises directly from the sale of CIT's shares through the IPO because it asserts damages for the purported breach of one of the principal contracts executed in connection with the sale of shares." *Id* at 9. While the bankruptcy court agreed there was a nexus between the Tax Agreement and the IPO, it declined to find such a "mere connection" supports that a claim "arises from" the purchase or sale of a security. The Court also rejected that the Tax Agreement was "so integral a part of the IPO as to be a part of the securities offering itself … ."

The court held that the Tax Agreement, while arguably integral, was not a mere supplement. It distinguished *In re Int'l Wireless Comm. Holdings, Inc.*, 257 B.R. 739 (Bankr. D. Del. 2001) (subordinating claim for breach of a supplement to a share purchase agreement which required the issuer to conduct an IPO by a date certain). Rather, the bankruptcy court was persuaded that Tyco's expectations were that of a creditor. Following *NationsRent*, it held that merely because the value was variable, didn't mean that the creditor bargained to become a shareholder. It did "not include an interest in the firm's future equity value or management." The court also found ample authority that a former shareholder can divest itself of a debtor's shares in exchange for a contractual payment obligation without being subject to section 510(b).

By summary order dated Sept. 6, 2012, the Second Circuit affirmed "substantially for the reasons stated in its thoughtful and comprehensive December 21,2011 Memorandum of Opinion," determining CIT's arguments "meritless."

Conclusion

CIT further clarifies that just because a claim arises from or in connection with a transaction containing an equity component does not mean that the specific claim is subject to subordination. Before bringing potentially costly subordination litigation, bankruptcy practitioners should understand that even where a claim is rooted in an equity transaction or contains an equity component, if the specific claim at issue carries traditional debt expectations and not the "risk and return expectations" of equity, a court may decline to subordinate.

Bankruptcy practitioners should also advise their corporate colleagues of the potential subordination risks in equity transactions containing debt components and vice versa. Where possible in complex transactions, drafters should clearly delineate what pieces constitute debt and how that debt is to be repaid (in cash or equity), especially where the debt is linked to the stock price or is issued in connection with a restructuring, as in *CIT*.

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