Once a Shareholder – Always a Shareholder?

In a perhaps overlooked decision in the Caprock Oil Tools Chapter 11 proceeding,[1] the Bankruptcy Court for the Southern District of Texas ruled that a claim held by a former shareholder for money the debtor owed him as a result of the redemption of his shares must be subordinated to general unsecured claims under Section 510(b) of the Bankruptcy Code – and treated as common stock – because it "arose from" the purchase or sale of common stock.

Caprock Oil Tools' vice president, Wayne Hall, owned 177 shares of common stock in Caprock. Pre-bankruptcy, Caprock and Hall entered into a shareholder agreement pursuant to which the company had the right to repurchase Hall's shares upon his termination of employment. The agreement provided that the consideration for Hall's shares would be paid by the company in five equal annual installments. Caprock subsequently terminated Hall and notified him that it was repurchasing his shares pursuant to the shareholder agreement. The company sent Hall the first annual payment for the stock and notified him that his shares were "redeemed and are no longer outstanding."

Caprock filed for Chapter 11 bankruptcy before making any of the four additional payments to Hall. Hall filed a proof of claim, asserting a general unsecured claim for the sum owed by the company. Caprock objected to Hall's claim, arguing that it should be subordinated and treated as common stock pursuant to Section 510(b) of the Bankruptcy Code. Under Section 510(b), "a claim arising from 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 . . . shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock." According to Caprock, since Hall's claim originated from his equity interest in the company, it was a claim "arising from" the purchase or sale of Caprock's shares. Hall retorted that once his stock was redeemed, he became the holder of a debt obligation rather than an equity interest, entitling him to the status of a general unsecured creditor.

The bankruptcy court ruled for Caprock. Under relevant Fifth Circuit precedent,[2] the court reasoned, it may look "behind the transaction" giving rise to the claim to determine whether subordination would satisfy Section 510(b)'s legislative goal, which is to ensure that the risk of loss is borne by equity holders who invest with the potential for significant financial gains rather than creditors who expect a fixed rate of return from a transaction. The court reasoned that because Hall's claim was rooted in his equity interest, characterizing his debt on par with other general unsecured creditors would upset the priority scheme of the Bankruptcy Code at the expense of other creditors.

Declining to follow a line of New York and Delaware cases holding that a debtor's debt obligation issued to repurchase its own stock is not subject to subordination because a former shareholder

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[1] In *In re Caprock Oil Tools*, Case No. 17-80109, 2018 Bankr. LEXIS 664 (Bankr. S.D. Tex. Mar. 9, 2018).

[2] *SeaQuest Diving, L.P. v. S&J Diving, Inc. (In re SeaQuest Diving, L.P.)*, 579 F.3d 411 (5th Cir. 2009).

does not share in the debtor's profits after it relinquished its stock,[3] the Texas court indicated that those decisions wrongly ignored the genesis of such obligation. Hall's claim must be subordinated, the court reasoned, because of his *initial election* to hold an equity interest that rose and fell with the fate of Caprock, regardless of whether he later exchanged it for debt.

The *Caprock* decision, if followed, could prove significant in various situations. Notably, legacy shareholders who received debt in exchange for their shares in a leveraged buyout may be subject to subordination under Section 510(b) even if their claims are not subject to attack under fraudulent conveyance law. Owners selling their company in a leveraged buyout should consider this additional risk before agreeing to receive debt rather than cash in exchange for their shares. Conversely, *Caprock* may provide traditional unsecured creditors with new opportunities for enhanced recoveries in bankruptcy cases involving failed leveraged buyouts. As a result, the Texas court's divergence from Delaware and New York case law on this issue could affect parties' choice of venue for bankruptcy cases.

Kasowitz Benson Torres LLP's bankruptcy litigation and restructuring practice group has been at the forefront of many of the most notable bankruptcy-related leveraged buyout litigations over the past two decades, including:

- **Tribune Company**. We represent the trustee for the senior notes in the Chapter 11 cases of Tribune. Focusing on fraudulent conveyance claims related to the $11 billion leveraged buyout of Tribune, we have prosecuted numerous claims against recipients, including CalPERs, of fraudulently conveyed assets, against which we have successfully defeated numerous defenses.

- **Refco**. We represent the Official Committee of Unsecured Creditors and several other key creditor parties in the wind-down of Refco's Chapter 11 estates. We successfully handled the prosecution and settlement of claims relating to a $1.4 billion leveraged recapitalization.

- **Adelphia Communications**. We represented the Official Committee of Unsecured Creditors and Adelphia Recovery Trust in the prosecution of numerous actions, including for intentional and constructive fraudulent conveyances, against commercial banks and their investment bank affiliates, resulting in hundreds of millions of dollars in recoveries.

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[3] *See., e.g., Official Comm. of Unsecured Creditors v. Am. Capital Fin. Servs., Inc. (In re Mobile Tool Int'l, Inc.)*, 306 B.R. 778, 781 (Bankr. D. Del. 2004); *Nisselson v. Softbank AM Corp. (In re MarketXT Holdings Corp.)*, 361 B.R. 369, 388-90 (Bankr. S.D.N.Y. 2007).