WHAT IS IT?

YOLO Investing and Treatment of Equity-Related Litigation Claims in Bankruptcy

Financial news headlines of 2020 and 2021 (at least so far) have been dominated by self-described "YOLO" (you only live once) investors piling into distressed and secularly challenged companies such as GameStop and AMC Entertainment. To the surprise of no one, many of these companies have taken advantage of the interest in their equity by issuing new stock and using the proceeds to paydown debt and shore up liquidity. For many of these companies, the lifeline from YOLO investors may merely delay the inevitable bankruptcy and, in turn, leave such investors with significant losses.

Whereas most debt investors are generally familiar with the subordination provisions in Section 510(a) (providing that a subordination agreement, such as an intercreditor agreement, is enforceable in bankruptcy to the same extent that such agreement is enforceable under applicable nonbankruptcy law) and 510(c) of the Bankruptcy Code (equitable subordination), the lesser-known provision of Section 510(b) deserves attention given in this era of YOLO investing.

YOLO Investing and Treatment of Equity-Related Litigation Claims in Bankruptcy (cont'd)

Overview of Section 510(b)

Section 510(b) of the Bankruptcy Code provides that for purposes of bankruptcy distributions, "a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under Section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock."

While the term "security" is defined in Section 101(49) of the Bankruptcy Code and includes debt instruments[1], most of the relevant case law under Section 510(b) involves equity securities. Courts have construed Section 510(b) broadly to include a wide variety of causes of actions arising out of securities transactions.[2] Congress enacted Section 510(b) to prevent equity holders (who would normally be at the bottom of the bankruptcy distribution) from using equity-related litigation claims to bootstrap their way to being pari passu with general unsecured claims (which would otherwise include civil litigation claims).[3] Unlike equitable subordination under Section 510(c), subordination under Section 510(b) is ***mandatory*** (i.e., it is not within the debtor's discretion to apply it).

Section 510(b) Applied to a Hypothetical Bankruptcy

The impact of Section 510(b) is perhaps best conveyed through a hypothetical. RocketCo, a highly leveraged public company engaged in a secularly declining business exacerbated by COVID, observes a significant spike in its stock price notwithstanding no discernable change in its business outlook. With its equity reaching a new 52-week high on a daily basis, RocketCo commences a secondary stock offering, the proceeds of which are used to paydown some of its debt and for general corporate purposes.

RocketCo completes the secondary offering; however, it is still highly leveraged and navigating significant secular and non-secular headwinds to its operating business. Many months later, as stock market exuberance fades and investors sober up, RocketCo's stock bottoms out.

RocketCo's YOLO investors, with their "diamond hands" (i.e., they never sell), have significant losses on their RocketCo stock holdings and are not happy. The YOLO investors begin to file securities class action lawsuits against RocketCo alleging, among other things, that RocketCo's offering memorandum for its secondary stock offering contained material misstatements or "half-truths" in violation of section 10(b) of the Exchange Act (the "RocketCo Securities Litigation Claims").[4]

Section 510(b) Applied to a Hypothetical Bankruptcy (cont'd)

Meanwhile, RocketCo is running out of money and eventually negotiates a comprehensive balance sheet restructuring and recapitalization that proposes to refinance its senior debt, equitize its junior bond debt (including a new money equity rights offering), and wipe out its existing equity. RocketCo and its funded debt creditors seek to effectuate this restructuring through a prepackaged chapter 11 bankruptcy (the "RocketCo Plan"), with the holders of general unsecured claims unimpaired and "riding through" unaffected by the bankruptcy cases. This means that all general unsecured claims, including "contingent unliquidated claims" (e.g., pending litigation claims) remain unaffected by the bankruptcy cases and plan discharge, and are proposed to be paid in full in the ordinary course.

The RocketCo Plan, however, provides that existing equity claims and "securities claims subordinated pursuant to Section 510(b)" are not entitled to any recovery and are deemed to reject the Mooning Plan under Section 1126(g) of the Bankruptcy Code. Thus, not only is existing equity wiped out, the RocketCo Plan discharges the pending RocketCo Securities Litigation Claims as well.

Although the YOLO investors could object to the RocketCo Plan, they are in an incredibly tough position for a variety of reasons, including the following:

- Given RocketCo's significant new money need and equitization of the bonds, no credible RocketCo valuation shows equity in the money, as the junior bond debt claims are significantly impaired;
- Unless they successfully petition the Bankruptcy Court to appoint a committee of equity holders under section 1102(a)(2) of the Bankruptcy Code[5], the YOLO investors will need to pay for their restructuring advisor fees out-of-pocket;
- Among the primary factors bankruptcy courts look at when determining whether to appoint an equity committee is the likelihood of debtor solvency, which cannot be demonstrated here;[6]
- Any credible challenge to the debtors' proposed plan valuation will require expensive litigation, including expert witnesses;
- Depending on the jurisdiction, the direct (i.e., held by the third-party equity holder plaintiffs and not the company itself) securities litigation claims against non-debtor entities (such as RocketCo's directors, insurers or lenders) may be released under the RocketCo Plan;[7] and
- Any derivative claims against the Board or other third parties relating to the RocketCo Securities Litigation Claims are bankruptcy estate claims and will be part of the releases provided by the debtor to third parties under the RocketCo Plan.

YOLO Investing and Treatment of Equity-Related Litigation Claims in Bankruptcy (cont'd)

Key Takeaways

In sum, equity holders in bankruptcy almost always have an extremely tough time realizing any recovery on account of their equity holdings because most debtors are deeply insolvent at the time of filing a bankruptcy case. Any securities law claims that equity holders have (whether liquidated to settlement/judgment or pending court disposition) will not be elevated in the debtor's claim waterfall as a result of Section 510(b). If history is any guide, at least some of the distressed companies that have seen their common stock rise even as their business prospects remain dim will find themselves in bankruptcy at some point in the near future. Thus, it is incumbent upon investors to think about how specific Bankruptcy Code provisions may affect their recoveries in such companies, particularly with respect to lesser-known Bankruptcy Code provisions such as Section 510(b).

[1] When a claimant holds a direct debt claim, there is less of a need to resort to damages arising from the purchase of the debt instrument, since both roads generally get you to the same recovery against the debtor. As noted, it is the attempt to elevate a claim arising from an equity security to the debt level that generally necessitates the Section 510(b) inquiry.
[2] *See* 4 Collier on Bankruptcy ¶ 510.04[3] (Richard Levin & Henry J. Sommer eds., 16th ed.).
[3] *See In Re Telegroup, Inc*., 281 F.3d 133, 142 (3d Cir. 2002).
[4] YOLO investors could also assert claims under Section 11 of the Securities Act of 1933 for damages caused by untrue statements of fact or material omissions of fact within registration statements. This would relieve the YOLO investors of the burden to establish scienter—they need not prove intent to defraud to prevail under Section 11—though plaintiffs would instead face the difficult task of establishing that they had purchased shares RocketCo sold in the secondary stock offering, and not shares that had been previously trading in the market.
[5] Section 1102(a)(2) provides in relevant part that "on request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if ***necessary*** to assure adequate representation of creditors or of equity security holders". (emphasis added). The U.S. Trustee may appoint an official committee of equity security holders pursuant to Section 1102(a)(1) of the Bankruptcy Code.
[6] *See In re Oneida Ltd.*, 2006 WL 1288576, at *2 (Bankr. S.D.N.Y. May 4, 2006) (noting that "one of the principal issues on any motion for the appointment of an equity committee is whether the debtor is solvent or it appears likely that there will be a return (or a substantial return) for equity")).
[7] Notwithstanding the plain language of Section 524(e) of the Bankruptcy Code, which provides (in relevant part) that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt", the Second, Third, Fourth, Sixth, Seventh and Eleventh Circuits have held that non-consensual third-party releases are permissible under the Bankruptcy Code under extraordinary circumstances.