

THE
NATIONAL LAW REVIEW

Second Circuit Holds that Contingent Equity-Based Compensation of Former Lehman Employees are Subordinate to Creditor Claims

Wednesday, June 21, 2017

In *In re Lehman Bros. Holdings Inc.*, 855 F.3d 459 (2d Cir. 2017), the United States Court of Appeals for the Second Circuit affirmed a district court order subordinating the claims of former Lehman Bros. (“Lehman”) employees for undelivered equity-based compensation to those of the defunct bank’s general creditors. The Court determined the compensation benefits were securities that had been purchased by the former employees when they agreed to receive them in exchange for their labor and the asserted damages arose from those purchases, requiring the claims’ subordination under the Bankruptcy Code. The decision is important to employees and employers weighing the value of hybrid compensation packages and creditors seeking to safeguard their priority position among bankruptcy claimants.

In *Lehman Bros.*, claimants received, as part of their compensation package, restricted stock units (“RSUs”) that gave them a contingent right to own Lehman common stock at the conclusion of a five-year holding period. However, RSUs that remained unvested when Lehman filed for bankruptcy became effectively worthless, leading affected employees holding these RSUs to feel shortchanged. Seeking relief, claimants filed proofs of claim in Lehman’s bankruptcy proceeding for cash payments equivalent to the amounts previously paid to them in RSUs. Lehman in turn filed omnibus objections to the claims on the grounds that, as the claims arose from the purchase or sale of securities, 11 U.S.C. § 510(b) required that they be subordinated to the claims of Lehman’s general creditors.

Section 510(b) of the Bankruptcy Code provides in part that, in bankruptcy proceedings, claims for damages arising from the purchase or sale of a security of the debtor must be subordinated to all claims or interests that are senior to or equal the claim or interest represented by the security. This section safeguards the “absolute priority rule” in bankruptcy which holds that creditors are entitled to be paid ahead of shareholders in the distribution of corporate assets. In other words, security holders may not gain parity with creditors simply by alleging claims arising from the purchase of the securities.

The [United States Bankruptcy Court for the Southern District of New York](#) sustained Lehman’s objections. The [United States District Court for the Southern District of New York](#) affirmed, and the claimants appealed to the Second Circuit.

The Second Circuit affirmed. It held that, pursuant to Section 510(b), the former employees’ claims were subordinated to general creditor claims because (1) the RSUs are securities, (2) the claimants acquired them in a purchase, and (3) the claims for damages arose from those purchases.

In determining the RSUs are securities, the Court turned to 11 U.S.C. § 101(49), which sets forth fifteen interests that are included in the definition of “security” and seven interests that are excluded. The Court explained that the inclusive list is not exhaustive and contains a residual clause that covers any “other claim or interest commonly known as ‘security.’” 11 U.S.C. § 101(49)(A)(xiv) (the “Residual Clause”). The Court held that while RSUs *arguably* qualify as securities pursuant to one of Section 101(49)’s specific examples, they nonetheless qualify as securities pursuant to the Residual Clause as they possess hallmark characteristics of securities, including voting rights, receipt of dividends, and of most significance, the “same risk and benefit expectations as



Article By [Christopher J. Bosch](#)
[John P. Stigi III](#)
[Sheppard, Mullin, Richter & Hampton LLP](#)
[Corporate & Securities Law Blog](#)
[Bankruptcy & Restructuring](#)
[Financial Institutions & Banking](#)
[2nd Circuit \(incl. bankruptcy\)](#)

shareholders.” However, the Court cautioned that not all RSUs are necessarily created equal, leaving open the possibility that other interests may fall outside the definition of securities under different facts.

The Court then concluded the RSUs were “purchased,” a term that has been construed broadly in this context to include the receipt of equity securities in exchange for labor. This “bargained-for exchange,” the Court affirmed, was the result of claimants’ “economic decision based on rational self-interest” and therefore qualified as a purchase for purposes of Section 510(b).

Finally, the Court held that the claims for damages arose from the purchase of RSUs. The Court reasoned that the asserted claims would not have arisen but for claimants’ agreement with Lehman to receive part of their compensation in RSUs, demonstrating the requisite causal link.

The claimants advanced several other arguments that the Court found unpersuasive. First, claimants argued that Lehman had an obligation alternatively to perform their obligations by paying cash in exchange for claimants’ labor because the promised RSUs never vested. However, the Court held claimants received all the compensation they were due under the governing employee incentive agreement in the form of the RSUs themselves.

Second, claimants asserted that they are entitled to restitution since Lehman repudiated its contractual obligation to issue stock to RSU holders when it filed for bankruptcy, entitling claimants to the reasonable value of the services they rendered to Lehman. The Court held that such a claim requires a legal injury that was lacking where the RSUs claimants were entitled to receive were no longer of value.

Finally, claimants argued that a decision by Lehman to remove certain contractual provisions relating to RSUs that stated RSUs were to be subordinated to creditor claims in bankruptcy evinced Lehman’s intent to treat RSU holders as general creditors in the event of bankruptcy. The Court dismissed this argument as resting entirely on speculation.

The decision in *Lehman* appears to reaffirm courts’ willingness to broadly construe the concepts of security, purchase and causation that are central to the claim subordination mandate of Section 510(b). The ruling has important implications for a number of potential stakeholders, including employees with similar equity-based compensation interests, employers seeking to utilize creative equity-based benefits in hybrid compensation packages and creditors concerned with preserving the seniority of their claims in bankruptcy.

Copyright © 2019, Sheppard Mullin Richter & Hampton LLP.

Source URL: <https://www.natlawreview.com/article/second-circuit-holds-contingent-equity-based-compensation-former-lehman-employees>