



**The Standards the Court Uses to Determine the Priority of a Party's Entitlement to  
Dividends in a Bankruptcy Proceeding**

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**Introduction**

Although the entitlement to receive dividends is not explicitly addressed in the United States Bankruptcy Code (the "Bankruptcy Code"), it is likely this right will be categorized as a security interest and thus be subordinated to creditors' interests in a bankruptcy proceeding.

Creditors are entitled to be paid ahead of shareholders in the distribution of corporate assets.<sup>1</sup> Furthermore, securities are subordinated to claims by creditors of the debtors.<sup>2</sup> Presently, all interests not captured by the Bankruptcy Code are analyzed under the residual clause.<sup>3</sup> This clause provides that unless the interest in dispute is explicitly excluded from the definition of a "security", it will be considered a security if it bears the hallmarks commonly found in securities.<sup>4</sup> The primary inquiry is: Does the interest make this claimant more like an investor or a creditor?

Part I of this memorandum will explain what constitutes a security and the role of the residual clause in bankruptcy cases. Part II will assess when a court is likely to declare an interest

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<sup>1</sup> See *SeaQuest Diving LP*, 579 F.3d 411, 417 (5th Cir. 2009).

<sup>2</sup> 11 U.S.C. § 510(b).

<sup>3</sup> 11 U.S.C. § 101 (49)(A)(xiv).

<sup>4</sup> *Id.*

a “security” despite parties’ attempts to evade the term. The goal is to ensure fair treatment of both shareholders and creditors during Bankruptcy proceedings, in accordance with bargained-for interests.

## **Securities**

Under the Bankruptcy Code, interests are securities if they “bear the hallmarks of interest commonly known as securities.”<sup>5</sup> Though not exhaustive, the traditional hallmarks include the lack of any fixed value, the ability to sell, bequeath, or otherwise transfer the interest, voting rights based on number of shares one owns, the ability to demand dividend payments, and the right to share in the financial success of the company over time.<sup>6</sup> Courts have used these hallmarks to guide their interpretation of whether or not something is a security and to extend the circumstances constituting the formation of securities, thereby allowing the policy rationales for 11 U.S.C. § 101 (49)(A)(xiv) to guide their interpretation and application to particular facts.<sup>7</sup>

For example, the Supreme Court, in *Landreth Timber Co.*, stated that the label the parties use to define the interest is not definitive.<sup>8</sup> Here, the Court noted the term security “includes both instruments whose names alone carry well-settled meaning, as well as instruments of more variable character that were necessarily designated by more descriptive terms.”<sup>9</sup> Thus the Court found that sale of all outstanding stock involved the sale of securities.<sup>10</sup> This is true notwithstanding the fact that the sale amounted to sale of the entire business since the interest bore all the characteristics usually associated with common stock.<sup>11</sup> These characteristics

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<sup>5</sup> *In re Lehman Brothers Holdings, Inc.*, 855 F.3d 459, 475 (2d Cir. 2017).

<sup>6</sup> *Id.*

<sup>7</sup> *See Matter of Linn Energy, LLC*, 936 F.3d 334, 338 (5th Cir. 2019).

<sup>8</sup> *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

included the right to receive dividends, the conferring of voting rights in proportion to number of shares owned, and the capacity to appreciate in value.<sup>12</sup>

### ***The role of the residual clause***

The residual clause of the Bankruptcy Code provides that if a claimant's interest does not neatly fit into any of the specific examples provided in the Code and is not explicitly excluded from the definition of a "security," it will be considered a security if it is the type of interest usually categorized as a security.<sup>13</sup> Section 101 (49) of the Bankruptcy Code contains two subsections.<sup>14</sup> Subsection (A) lists fifteen interests explicitly included in the definition of a "security."<sup>15</sup> Fourteen are specific examples; the remaining interest is known as the residual clause, which states an interest will be considered a security if it is any "other claim or interest commonly known as a security."<sup>16</sup> Thus, the list found in subsection A is non-exhaustive, and subsection (A)(xiv) opens the door to securities not specifically listed.<sup>17</sup> The result is that whether or not the parties intended to categorize the interest as a security by using one of the terms listed in subsection A becomes irrelevant. Instead, the courts use the residual clause and look to the nature of the interest itself, as well as the rights and risks that accompany that interest, in categorizing it for the purpose of subordination.

For example, in *In re Tristar Esperanza Properties*, the Ninth Circuit decided that a membership interest in an limited liability company ("LLC") constituted a security as defined by the residual clause in the Bankruptcy Code.<sup>18</sup> Here, the court stated that the statutory list of what constitutes a security at 11 U.S.C § 101 (49)(A)(xiv) is non-exclusive, and it looked for an

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<sup>12</sup> *Id.*

<sup>13</sup> 11 U.S.C § 101 (49)(A)(xiv).

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*; see also *SeaQuest Diving LP*, 579 F.3d 411, 417 (5th Cir. 2009) (noting that subsection (A)(xiv) is a "broad residual category").

<sup>18</sup> *In re Tristar Esperanza Properties, LLC*, 488 B.R. 394, 399 (Bankrp. App. 9th Cir. 2013), *aff'd*, 782 F.3d 492 (9th Cir. 2015).

analogous entry on the list.<sup>19</sup> The court reasoned that the statute stated that an “interest of a limited partner in a limited partnership is a security.”<sup>20</sup> In addition, the court held that the similarities between the interest of a limited partner in a limited partnership and a membership interest in an LLC are substantial, as each owns an interest in the enterprise and shares in net revenues and increases in value.<sup>21</sup> Accordingly, it follows that, if the interest of a limited partner in a limited partnership is a “security” under the Bankruptcy Code, then the interest of a member in an LLC is also a “security for purposes of the Bankruptcy Code.”<sup>22</sup> Thus, even though membership interest in an LLC was not explicitly included in the text of the code, the nature of the interest itself, as well as the rights and risks accompanying it, confirmed the interest to be a security under the residual clause.

### **When courts have categorized interests as “securities”**

Additionally, several courts have defined “security” in terms of an interest tied to a firm’s overall success, allowing their decisions to be guided by the policy rationales behind the provision.<sup>23</sup> Thus, actions seeking to recover a portion of claimant’s equity investments, regardless of how parties agreed to label the interest, are subordinated in bankruptcy proceedings.<sup>24</sup> The primary inquiry is: Does this interest make the claimant look more like an investor or a creditor?<sup>25</sup> Additionally, if the claimant’s interest allowed her to participate in “the success of the enterprise and the distribution of profits, the claim will be subordinated”.<sup>26</sup>

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<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

<sup>23</sup> See *In re KIT Digital, Inc.*, 497 B.R. 170, 183 (Bankr. S.D.N.Y. 2013) (treating a debtor’s obligation to pay stock to a claimant as a security under § 510(b) because “by agreeing to accept stock instead of cash, the claimant subjected itself to the greater risk that the price of the stock it would then receive might go down” while ensuring that it “would get the benefits if the price of the stock went up.”).

<sup>24</sup> *Id.*

<sup>25</sup> See *Matter of Linn Energy, LLC*, 936 F.3d 334, 338 (5th Cir. 2019) (finding because “the deemed dividends gave the Estate benefits normally reserved for equity holders . . . subordination of all the Estate’s claims was appropriate.”).

<sup>26</sup> *In re WorldCom, Inc.*, 2006 WL 3782712 at 6 (Bankr. S.D.N.Y. 2006).

Finally, even in instances where parties have attempted to create new categories with their own contrived purpose, if this newly created category is actually a security interest in disguise the court will not hesitate to treat it as such regardless of the creative intent of the parties.<sup>27</sup> In *In re Lehman Brothers.*, the Second Circuit found that the term security includes a “warrant or right to subscribe to or purchase or sell[] a security” and found that employees “purchase[d] the stock options at issue because they “willingly accepted [them] in return for labor” even if they “were required to receive [them as] a portion of their compensation”.<sup>28</sup> Here the court noted, the employees agreed to be paid a portion of their compensation through these stock options at the conclusion of a five-year holding period.<sup>29</sup> They had accepted the risk and return expectations of shareholders and became bound by that choice.<sup>30</sup> Accordingly, even though they did not yet receive the shares and thus could not sell, bequeath, transfer the interest, vote, or demand dividends, they were treated akin to shareholders.<sup>31</sup> Thus their claims were subordinated in the Bankruptcy proceeding.<sup>32</sup>

For these reasons, although the code does not explicitly define an entitlement to receive dividends, this right likely will be treated as an equity interest akin to that of a shareholder under the residual clause of the Bankruptcy Code and thus be subordinated in a bankruptcy proceeding. Here in the case before us, even though claimants did not purchase this interest, they did accept an equity interest in a company and thus became bound by this choice to share in the company’s profits. They therefore cannot seek to recover ahead of other equity holders as creditors. This practice is forbidden because it would allow claimants to upset the delicate equity cushion creditors had relied upon when they chose to extend the company credit in return for fixed

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<sup>27</sup> See *Matter of Linn Energy, LLC*, 936 F.3d 334, 338 (5th Cir. 2019).

<sup>28</sup> *In re Lehman Brothers Holdings Inc.*, 855 F.3d 459, 472 (2d Cir. 2017).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

payments and a pre-determined rate of interest. In these circumstances, it does not matter whether the claimant enjoyed the traditional rights of shareholders such as the right to vote, participate in corporate management, or sell or bequeath deemed dividend payments to a third party. As long as the claimant expects to share in the company's profits, the court likely will hold that a security interest has been created and thus subordinate the claim. Therefore, the court likely will find that the entitlement to receive dividends will be subordinated in the bankruptcy proceeding.

## **Conclusion**

The most important factor in determining whether the claimant's interest is more akin to that of a shareholder or creditor is whether the claimant's interest afforded him the opportunity to "participate in the success of the business and the distribution of profits."<sup>33</sup> For this reason, claimant's entitlement to receive dividends, should the company decide to distribute them, will likely be found to be more akin to the rights of a shareholder. Therefore, the court will likely categorize claimant's entitlement as a 'security interest' and thus subordinate this claim in the bankruptcy proceeding.

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<sup>33</sup> *In re WorldCom, Inc.*, 2006 WL 3782712 at 6 (Bankr. S.D.N.Y. 2006).