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BANKRUPTCY, FINANCIAL REORGANIZATION & CREDITORS' RIGHTS

IN RE LEHMAN BROTHERS HOLDINGS, INC.: RESTRICTED STOCK UNITS ARE "EQUITY SECURITIES" RATHER THAN "CLAIMS"

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On November 3, 2014, the United States Bankruptcy Court for the Southern District of New York issued a memorandum decision (the "Opinion") in the chapter 11 bankruptcy cases[2] of Lehman Brothers Holdings Inc. regarding the characterization of former employees' claims against the Debtors on account of various restricted stock units and contingent stock awards ("RSUs") the employees received as part of their compensation packages. At issue was whether the RSU Claims should be treated as "claims" under the Bankruptcy Code or reclassified as "equity". The court's opinion lends additional clarity to an issue that has been the subject of debate in complex corporate chapter 11 cases for a long time.

Prior to bankruptcy, the Debtors established an equity award program (the "**Program**") whereby the recipients received RSUs that gave them a contingent right to own LBHI common stock, which would be issued five years after the grant (the "**Hold Period**") upon fulfillment of certain employment-related conditions. As of September 15, 2008, the date on which the Debtors commenced their chapter 11 cases (the "**Petition Date**"), hundreds of the Debtors' employees were holding RSUs that had not led to the issuance of common stock because the Hold Period had not passed. Certain holders of RSUs filed claims in the chapter 11 cases seeking payment in cash of the amounts allocated to RSUs in their respective employment records.

Earlier in the Chapter 11 Cases, the Debtors filed a slew of objections seeking to reclassify the RSU claims as equity and subordinating them to general unsecured claims. At a hearing on several of Debtors' objections, the court instructed the RSU claimants to submit argument as to why the RSU claims were outside the reasoning of a prior ruling in the *Enron* bankruptcy, which held that claims for damages arising from the ownership of employee stock options should be subordinated pursuant to section 510(b) of the Bankruptcy Code.

The RSU claimants submitted their argument as directed, and the court subsequently determined the RSU claimants failed to establish their claims should be allowed. The court pointed to section 510(b) of the Bankruptcy Code, which provides that a "claim arising from the rescission of a purchase or sale of a security of the debtors or an affiliate 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 or equal to the interest represented by such security, except if such security is common stock, such claim has the same priority as common stock." 11 USC § 510(b). The court determined that the RSUs constituted a *contingent right* to participate in or receive and/or purchase LBHI's common stock, which the court found to be consistent with the Bankruptcy Code's definition of "security." The court further determined that the RSUs constituted a security because they (1) had no fixed value, (2) were eligible for any declared dividends, (3) provided recipients with limited voting rights, and (4) allowed the recipients to share in LBHI's financial success over time.

In addition, the court held the RSU claimants' exchange of labor for the RSUs constituted the "purchase" of a security. The court determined that the RSU Claimants voluntarily and continuously accepted payment partially in the form of RSUs as part of their employment. Such bargain and exchange constituted a purchase of securities for the purpose of subordination pursuant to Bankruptcy Code section 510(b), according to the court.

The court applied the above reasoning to a subset of RSU claimants who argued their claims were distinguishable from the other RSU claimants because they had no choice but to accept the terms of the Program when their employer (Neuberger Berman) elected to merge with Lehman. These claimants pointed to their non-compete agreements as evidence of economic duress. The court held these claimants failed to meet their heavy burden to satisfy their claims of economic duress, the relevant non-compete agreements were not unlawful, and the claimants were free at all times to accept Lehman's terms of employment (including the terms of the Program) or seek employment elsewhere.

Finally, the court held that the RSU claims were for damages arising from the purchase of securities as opposed to claims for unpaid debt or services rendered. The court determined that Lehman had the right to determine whether to pay its employees in cash or equity-based awards and that the RSU claimants did not bargain for the right to receive cash in lieu of RSUs. The court further determined that the RSU claimants could not assert a claim under any relevant wage laws for earned but unpaid compensation because the RSU claimants already received their earned compensation in the form of RSUs.

Accordingly, the court held that the RSU claims were subject to subordination pursuant to section 510(b) of the Bankruptcy Code because (1) the RSUs warranted treatment as securities as that term is defined in the Bankruptcy Code and (2) the RSU claims are for damages arising from the purchase of such securities.

The court also found the RSUs could constitute "equity securities" as defined in section 101(16) of the Bankruptcy Code. The Bankruptcy Code defines "equity security" to include shares in a corporation. The court determined that the RSUs were, in many respects, almost identical to common stock because (1) the RSUs constituted shares in the corporation; (2) the value of the RSUs shifted based on the value of the Debtors' common stock; (3) the RSUs provided the right to receive dividends in the form of additional RSUs; (4) the number of additional RSUs received as a result of the dividend event was based on the share price of the Debtors' common stock at the time of the dividend event; and (5) the RSUs provided the holders thereof with certain voting rights.

Even if the RSUs did not constitute equity securities, the court held that the RSUs constituted a "warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind described" in 11 U.S.C. §§ 101(16)(A), (B). The court determined the RSUs provided their holders with a nontransferable, non-assignable right to the Debtors' common stock at a specified future date and upon the satisfaction of certain conditions. Accordingly, the court held the RSUs fell squarely within the Bankruptcy Code's definition of equity securities as set forth in 11 U.S.C. 101(16)(C).

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[2] The Debtors' Chapter 11 cases are styled *In re: Lehman Brothers Holdings, Inc., et al.*, Case No, 08-13555 (Bankr. S.D.N.Y.). The Opinion is available at Docket No. 46797.