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# Recent Bankruptcy Court Decision Finds Control Liability Claim Ranks Pari Passu With Claims Of Other Unsecured Creditors

A recent Delaware bankruptcy court decision clarifies when a control liability claim against a debtor for alleged violations of federal and state securities laws will be statutorily subordinated under section 510(b) of the Bankruptcy Code. The court in In re Washington Mutual, Inc., No. 08-12229 (MFW), 2011 WL 6739076 (Bankr. D. Del. Dec. 20, 2011), held that Tranquility Master Fund, Ltd. ("Tranquility") had properly asserted a general unsecured claim against Washington Mutual, Inc. ("WMI") for control person liability when one of WMI's subsidiaries allegedly sold residential mortgage backed securities ("RMBS") through offering materials containing material misrepresentations and omissions. Significantly, the court analyzed and rejected WMI's argument that Tranquility's control liability claim should be statutorily subordinated under section 510(b) of the Bankruptcy Code, which prevents a shareholder's interest in the debtor from rising to the level of a creditor, because section 510(b) only applies to securities issued by the debtor. The decision paves the way for control person liability claims against debtors to rank pari passu with claims of other unsecured creditors. Because subordinated creditors often receive no meaningful recoveries, and given the potential magnitude of claims at issue, the decision has important implications for creditors of debtors with exposure to control liability claims.

## The Facts

WMI and WMI Investment Corp. (collectively, the "Debtors") are debtors under Chapter 11 of the Bankruptcy Code. WMI owned non-debtor Washington Mutual Bank ("WMB") and its subsidiaries, including WaMu Asset Acceptance Corp. ("WaMu Asset Acceptance") and WaMu Capital Corp. ("WaMu Capital," and with WaMu Asset Acceptance, the "WMB Subsidiaries"). WMB originated residential mortgages that were pooled into special purpose trusts. WaMu Asset Acceptance then sold certificates issued by the trusts – the RMBS – to investors.

Tranquility owned $71 million in RMBS sold by the WMB Subsidiaries, and Tranquility alleges that the RMBS offering materials contain material misrepresentations and omissions regarding the quality of the underlying mortgages. Tranquility filed a proof of claim against WMI alleging that: (i) WMI controlled the WMB Subsidiaries within the

meaning of section 15(a) of the Securities Act of 1933 (the "Securities Act") and California law, which makes WMI jointly liable for the WMB Subsidiaries' material misrepresentations and omissions ("Control Liability"); and (ii) WMI materially assisted the WMB Subsidiaries with the intent to deceive or defraud investors in violation of California law ("Material Assistance Liability"). In response, WMI argued that Tranquility failed to satisfy the pleading standards under Rule 12(b)(6), and that, even if the pleading standards were satisfied, the claim should be statutorily subordinated under section 510(b) of the Bankruptcy Code[1] because the claim arises from the purchase or sale of a security of a WMI affiliate.

## The Bankruptcy Court's Decision

Judge Walrath's opinion can be separated into a discussion of (1) Rule 12(b)(6)'s pleading requirements, and (2) subordination under section 510(b) of the Bankruptcy Code.

### 1. Rule 12(b)(6) Pleading Requirements

The court concluded that Tranquility sufficiently stated a claim for relief, ruling that:

- Tranquility alleged sufficient facts to establish Control Liability by referring to WaMu's organizational structure, SEC filings, company handbooks, employee reporting structures, common management oversight responsibilities, and post-bankruptcy congressional testimony, all of which showed that WMI controlled the WMB Subsidiaries.

- Tranquility's prima facie case for Control Liability only requires pleading that (i) a primary violation of section 15(a) occurred, and (ii) WMI exercised control over the primary violator. While Tranquility may be required to prove WMI's culpable participation under Third Circuit law for liability to attach, such a requirement does not exist at the pleading stage because it places an unreasonable burden on Tranquility to assert undiscovered information.

- Tranquility alleged sufficient facts to establish Material Assistance Liability by referring to congressional testimony and internal emails, which demonstrate specific knowledge and intentional actions on behalf of WMI and its executives.

[1] Section 510(b) provides that "[f]or the purpose of distribution under this title, 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."

In addressing the control liability pleading requirements, the court wades into a debate among lower courts over whether plaintiffs must prove, and whether complaints must allege, "culpable participation" on the part of the controller for the purposes of liability under section 15(a) of the Securities Act and section 20(a) of the Securities Exchange Act of 1934 (the "Exchange Act"). The debate includes an apparent conflict in the Second Circuit over whether plaintiffs must plead "culpable participation" for Exchange Act claims. See SEC v. First Jersey Sec., Inc., 101 F.3d 1450 (2d Cir. 1996) (requiring a showing of "culpable participation" for Exchange Act claims); Poptech, L.P. v. Stewardship Credit Arbitrage Fund., LLC, 792 F.Supp.2d 328 (D. Conn. 2011) (holding that "culpable participation" is a pleading requirement while noting a conflict among district courts over whether that is required). The Second Circuit has not reached the issue of whether a showing of "culpable participation" is required for Securities Act claims. See In re Lehman Bros. Mortg.-Backed Sec. Lit., 650 F.3d 167 (2d Cir. 2011). Although Judge Walrath cites cases discussing whether a plaintiff needs to show culpable participation under the Securities Act, the opinion does not answer that question and simply concludes that it is not a pleading requirement.

2. Subordination Under Section 510(b) of the Bankruptcy Code

The court concluded that WMI did not state a basis for subordination under section 510(b) of the Bankruptcy Code, ruling that:

- Section 510(b)'s provision that subordinates claims related to the "purchase or sale of a security of the debtor or an affiliate of the debtor" only applies to securities *issued by* the debtor or its affiliate. Section 510(b) subordination does not apply to securities that are merely sold by the debtor or its affiliates.

- The issuing RMBS trusts are not "affiliates" of WMI for the purpose of section 510(b) subordination. While a person may be an "affiliate" of a debtor if that person's business is operated under an "operating agreement" with a debtor, the pooling and servicing agreements that govern the rights and responsibilities of the various parties to an RMBS is not an "operating agreement" under the plain meaning of the Bankruptcy Code. *See* 11 U.S.C. § 101(2)(C).

The court's section 510(b) analysis could have significant implications for debtors that supervise or control entities that trade in securities (i.e. broker-dealers), as well as creditors holding claims against those debtors under section 15(a) of the Securities Act or section 20(a) of the Exchange Act. Significantly, the court's holding means that control liability claims will not be statutorily subordinated if the security serving as the basis for that control claim is not issued by the debtor or one of its affiliates. Harmed investors in these securities, should they successfully assert control liability claims against debtors, will not have their claims subordinated under the court's approach, under which such claims will

receive unsecured creditor treatment. Given the potential magnitude of control liability claims, this could also have significant effects on trade and other unsecured creditors, whose recoveries could be diluted by securities-related claims that are not subject to subordination.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Bankruptcy and Restructuring" in the "Practices" section of our website (www.clearygottlieb.com).

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