

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

IN RE: : Chapter 7
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CYBERSIGHT LLC d/b/a Nine Dots, : Bankruptcy Case No. 02-11033
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Debtors. : :
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JEFFREY L. BURTON, Chapter 7 : :
Trustee for Cybersight LLC, : :
: :
Appellant : :
: :
v. : Civil Action No. 04-112 JJF
: :
: :
RICHARD B. GANNON, : :
: :
Appellee. : :

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Attorneys for Appellee.

MEMORANDUM OPINION

November 17, 2004
Wilmington, Delaware

Farnan, District Judge.

Presently before the Court is an appeal by Jeffrey L. Burtch ("the Trustee"), Chapter 7 Trustee for the Cybersight, LLC estate, from the January 13, 2004, Order of the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") denying in part the Trustee's motion to reclassify Appellee Richard B. Gannon's claim filed in Cybersight, LLC's chapter 7 bankruptcy case.

By his Motion, the Trustee requests the Court to overrule the Bankruptcy Court's determination that the Appellee's claim is not subject to the subordination requirements of 11 U.S.C. § 510(b).

For the reasons discussed, the Court will affirm the January 13, 2004 Order of the Bankruptcy Court.

BACKGROUND

On April 5, 2002, the Debtor, Cybersight LLC ("Cybersight"), filed a voluntary petition for relief under Chapter 7 of the Bankruptcy Code (the "Petition Date"). Prior to the Petition Date, Cybersight entered into an Amended and Restated Limited Liability Company Agreement (the "LLC Agreement") with Richard B. Gannon, the Appellee, wherein Mr. Gannon purchased a 1.5% membership interest in Cybersight LLC and was appointed Vice President of Finance and Administration, Secretary and Treasurer. Mr. Gannon remained an employee of Cybersight from July 13, 1998,

through October 25, 1999, when his employment was terminated. Appellee was not terminated for "cause."

Pursuant to Section 10.4 of the LLC Agreement, Cybersight was obligated to purchase Mr. Gannon's membership interests. The purchase price was to equal the fair market value of the shares. Cybersight and Mr. Gannon entered into arbitration to settle the purchase price of Mr. Gannon's shares and, after a hearing, the arbitrator ruled that Cybersight was obligated to pay Mr. Gannon \$1,290,746.19, plus interest from October 25, 1999. On March 26, 2001, prior to the Petition Date, the Circuit Court of the State of Oregon for Multnomah County entered the arbitration award as a judgment. This judgment was not appealed and became final approximately one year prior to the Petition Date. However, Cybersight did not make any payments under the judgment.

After the Petition Date, on September 4, 2002, Mr. Gannon timely filed a proof of claim against Cybersight (the "Gannon Claim"), including a secured claim for sums alleged due under the judgment. On October 15, 2003, the Trustee filed a motion challenging the secured status of the Gannon Claim and sought to reclassify the Gannon Claim as an equity interest subject to the subordination provision 11 U.S.C. § 510(b). Mr. Gannon subsequently conceded that the Gannon Claim was not secured, but challenged the Trustee's contention that the Gannon Claim was an equity interest subject to subordination. On November 20, 2003,

the Bankruptcy Court held oral argument and denied the Trustee's motion.

PARTIES' CONTENTIONS

By its appeal, the Trustee contends that the Bankruptcy Court erred by not reclassifying the Gannon Claim as an equity interest that should be subordinated pursuant to 11 U.S.C. § 510(b). Specifically, the Trustee contends that the Bankruptcy Court erred by relying on its decision in Montgomery Ward Holding Corp. v. Schoeberl (In re Montgomery Ward Holding Corp.), 272 B.R. 836 (Bankr. D. Del. 2001), because Montgomery Ward was overruled by the Third Circuit in In re Telegroup, Inc., 281 F.3d 133, 141 (3d Cir. 2002). The Trustee argues that Telegroup held that attempts, such as the one by Mr. Gannon in this case, to bootstrap an equity investment claim into a class of claims that have higher priority are prohibited by Section 510(b). The Trustee contends that Mr. Gannon's claim "arises from" his equity investment in Cybersight and thus must be subordinated. The Trustee further contends that the Bankruptcy Court erred by not considering the applicability of In re Alta+Cast, LLC, 301 B.R. 150 (Bankr. D. Del. 2003), and two Supreme Court cases.

In response, Mr. Gannon contends that the Bankruptcy Court properly denied the Trustee's attempt to subordinate his claim pursuant to Section 510(b). Mr. Gannon contends that his claim against Cybersight should not be subordinated pursuant to

Section 510(b) because his equity interest in Cybersight was converted to a debt obligation when he received a pre-petition judgment against Cybersight. Mr. Gannon argues that the Bankruptcy Court correctly analogized the instant case to Montgomery Ward and that Telegroup did not overrule the relevant portion of Montgomery Ward's holding. Mr. Gannon further argues that the facts in Alta+Cast are distinguishable from the instant case.

STANDARD OF REVIEW

The Court has jurisdiction to hear an appeal from the Bankruptcy Court pursuant to 28 U.S.C. § 158(a)(1). In undertaking a review of the issues on appeal, the Court applies a clearly erroneous standard to the Bankruptcy Court's findings of fact and a plenary standard to its legal conclusions. See Am. Flint Glass Workers Union v. Anchor Resolution Corp., 197 F.3d 76, 80 (3d Cir. 1999). With mixed questions of law and fact, the Court must accept the Bankruptcy Court's findings of "historical or narrative facts unless clearly erroneous, but exercise[s] 'plenary review of the trial court's choice and interpretation of legal precepts and its application of those precepts to the historical facts.'" Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 642 (3d Cir. 1991) (citing Universal Minerals, Inc. v. C.A. Hughes & Co., 669 F.2d 98, 101-02 (3d Cir. 1981)). The appellate responsibilities of the Court are further

understood by the jurisdiction exercised by the Third Circuit, which "conducts the same review of the Bankruptcy Court's order as ... the District Court." Telegroup, 281 F.3d at 136.

In the present appeal, there are no relevant factual disputes; the Trustee contends that the Bankruptcy Court committed legal error.

DISCUSSION

After review of the applicable legal authorities in light of the facts and circumstances of the instant appeal, the Court concludes that the Bankruptcy Court did not err in refusing to subordinate Appellee's claim pursuant to Section 510(b). The Court concludes that this ruling is consistent with the Third Circuit's holding in Telegroup and the legislative policies expressed in Section 510(b).

In Telegroup, the Third Circuit held that shareholders who filed proofs of claim seeking damages for a debtor's breach of its agreement to use its best efforts to ensure that its stock was registered and freely tradeable were properly subordinated pursuant to Section 510(b). 281 F.3d at 144. In reaching this conclusion, the Telegroup court analyzed the plain language and legislative history of Section 510(b). The Third Circuit emphasized Congress's intent that shareholders be prevented from recovering the value of their equity investment by filing bankruptcy claims disguised as tort or contract actions:

[B]ecause claimants retained the right to participate in corporate profits if [the Debtor] succeeded, we believe that § 510(b) prevents them from using their breach of contract claim to recover the value of their equity investment in parity with general unsecured creditors. Were we to rule in claimants' favor . . . , we would allow stockholders in claimants' position to retain their stock and share in the corporation's profits if the corporation succeeds, and to recover a portion of their investment in parity with creditors if the corporation fails.

Id. at 142. Thus, the Third Circuit found it significant that the claimants in Telegroup sought to recover a portion of their equity investments - a decline in the value of the debtor's stock - and held that subordination was proper.¹ Id.

The Court concludes that the Bankruptcy Court correctly determined that the instant case is distinguishable from the facts found to require subordination pursuant to Section 510(b) in Telegroup. Here, in contrast to the circumstances in Telegroup, Mr. Gannon's equity stake in Cybersight extinguished pre-petition and with it Mr. Gannon's ability to participate in any of Cybersight's profits or losses. Once the state court entered Mr. Gannon's judgment, the judgment became a fixed debt obligation of Cybersight and Mr. Gannon was entitled to general unsecured claimant status. See Raven Media Inv. v. DirectTV Latin Am., LLC (In re DirectTV Latin Am., LLC), 2004 WL 302303, at *4 (D. Del. Feb. 4, 2004) (holding that both participation in profits

¹ The Third Circuit also stated that the claimants in Telegroup had not forsaken their ability to retain their equity interests and share in the Debtor's profits if the share value had risen. Id.

and the risk of loss are crucial to the existence of an equity interest). Accordingly, the Court concludes that subordinating Mr. Gannon's claim would not further the legislative prerogatives of Section 510(b). See Telegroup, 281 F.3d at 139-41 (discussing Congress's reliance on the article by John J. Slain and Homer Kripke, The Interface Between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors, 48 N.Y.U. L. Rev. 261, 286-88 (1973), when enacting Section 510(b), and the authors' discussion of the proper allocation of risk on shareholders in a bankruptcy).

Further, the Court concludes that the decision in In re Alta+Cast, LLC, 301 B.R. 150 (Bankr. D. Del. 2003), does not suggest a contrary result. In Alta+Cast, Bankruptcy Judge Walrath held that a claim based on the breach of an agreement that the debtor would purchase the claimant's stock upon termination must be subordinated pursuant to Section 510(b), even though the claimant had obtained a post-petition judgment against the debtor. Id. at 154-55. In In re Mobile Tool International, Inc., 306 B.R. 778 (Bankr. D. Del. 2004), however, Judge Walrath distinguished her decision in Alta+Cast and held that Section 510(b) did not apply to a claimant that exchanged his or her equity interest for a separate debt interest, in this case a promissory note, and whose status had changed from owner to

creditor. Id. at 781. Under these circumstances, Judge Walrath held that the “nexus or causal connection required to employ section 510(b)” ceases to exist. Id.

The Court finds that the instant case is analogous to Mobile Tool to the extent that Mr. Gannon’s claim does not retain the nexus or causal connection necessary for subordination under Section 510(b). The Court agrees with the Bankruptcy Court’s observation in this case that there is no material difference between the exchange of a promissory note for equity interests, which has been held not to be subject to Section 510(b), see Mobile Tool, 306 B.R. at 781, and the judgment Mr. Gannon received in this case. In both instances, the claimants, pre-petition, were no longer able to participate in the benefits and risks associated with being equity holders of the debtors, and therefore, Section 510(b) did not require subordination.²

² The Court is not persuaded that the cases Brown v. Felsen, 442 U.S. 127 (1979), and Archer v. Warner, 538 U.S. 314 (2003), compel a different result. First, the Supreme Court in Brown and Archer was faced with the issue of whether res judicata or novation would prevent bankruptcy courts from looking beyond a consent decree or settlement stipulation to see if the debt was “for money . . . obtained by . . . fraud.” 11 U.S.C. § 523(a)(2)(A). Archer, 538 U.S. at 319-21 (discussing the holding and applicability of Brown). The Court concludes that Archer and Brown are inapplicable to the present appeal. In this case, the Court is not faced with the applicability of 11 U.S.C. § 523(a)(2)(A), the issue presented to the Supreme Court in Archer and Brown. In addition, the Appellee has not asserted that the Court cannot look beyond the judgment entered in his favor in state court and, in fact, the Court has evaluated Appellee’s former equity interest and determined that it has been converted into a fixed debt obligation.

CONCLUSION

For the reasons discussed, the Court will affirm the Bankruptcy Court's ruling that Mr. Gannon's claim is not subject to subordination pursuant to Section 510(b).

An appropriate Order will be entered.

IN RE: : Chapter 7
CYBERSIGHT LLC d/b/a Nine Dots, :
Debtor. : Bankruptcy Case No. 02-11033
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JEFFREY L. BURTCH, Chapter 7 :
Trustee for Cybersight LLC, :
Appellant :
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RICHARD B. GANNON, :
Appellee. :

FINAL ORDER

At Wilmington, this 17th day of November 2004, for the reasons set forth in the Memorandum Opinion issued this date;

IT IS HEREBY ORDERED that the January 13, 2004, Order of the Bankruptcy Court is **AFFIRMED**.

JOSEPH J. FARNAN, JR.
UNITED STATES DISTRICT JUDGE