

# THE STATUS OF RESCINDING SECURITY HOLDERS IN BANKRUPTCY—THE PROPOSED BANKRUPTCY ACT OF 1973 AND ALTERNATIVES

A fruitful parent of injustice is the tyranny of concepts. They are tyrants rather than servants when treated as real existences and developed with merciless disregard of consequences to the limit of their logic.<sup>1</sup>

## I. INTRODUCTION

The Commission on the Bankruptcy Laws of the United States<sup>2</sup> submitted its recommendations for revising the federal bankruptcy law to the President, the Congress, and the Chief Justice of the United States on July 30, 1973.<sup>3</sup> The Commission's Report contained novel and controversial suggestions for both procedural changes in bankruptcy administration and substantive changes in the law of bankruptcy.<sup>4</sup> One

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1. B. CARDOZO, *THE PARADOXES OF LEGAL SCIENCE* 61 (1928) (footnotes omitted).

2. In 1970, Congress created the Commission on the Bankruptcy Laws of the United States [hereinafter referred to as the Commission] and extended its life by amendment of the Act in 1972 and 1973. Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468, *as amended*, Act of March 17, 1972, Pub. L. No. 92-251, 86 Stat. 63, *as amended*, Act of July 1, 1973, Pub. L. No. 93-56, 87 Stat. 140. The Commission consisted of nine members. The President appointed Harold Marsh Jr., Charles Seligson, and J. Wilson Newman. The Chief Justice of the United States appointed Judges Edward Weinfeld and Hubert L. Will. The President of the Senate appointed Senators Quentin Burdick and Marlow Cook. The Speaker of the House appointed Representatives Don Edwards and Charles Wiggins.

3. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, 93d Cong., 1st Sess. (1973) [hereinafter cited as COMMISSION REPORT]. The COMMISSION REPORT consists of three parts. Part I states the Commission's view of the problems found in the present bankruptcy law and its solutions to those problems. Part II contains the text of the Proposed Bankruptcy Act of 1973 and proposed amendments to the Internal Revenue Code and the Judicial Code. Part III consists of reports and summaries of the reports used by the Commission.

4. See generally Blum & Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651 (1974); Bobier, *Proposed Revision of the Bankruptcy Act: A Critique*, 28 PERS. FIN. L.Q. REP. 19 (1973); Brudney, *The Bankruptcy Commission's "Modifications" of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305 (1974); Coogan, *The Proposed Bankruptcy Act of 1973: Questions for the Non-Bankruptcy Business Lawyer*, 29 BUS. LAW. 729 (1974); Cyr, *The Bankruptcy Act of 1973: Back to the Drafting Board*, 48 AM. BANKR. L.J. 45 (1974); Francis, *The Commercial Secured Creditor and the Bankruptcy Act of 1973*, 28 PERS. FIN. L.Q. REP. 55 (1973); Kennedy, *The Report of the Bankruptcy Commission: The First Five Chapters of the Proposed New Bankruptcy Act*, 49 IND. L.J. 422 (1974);

of the recommended changes, section 4-406(a)(1) of the Proposed Bankruptcy Act of 1973,<sup>5</sup> has far-reaching implications for both the security holders of a bankrupt corporation and the continued vitality of the policies underlying present securities laws. This section provides for the subordination of "any claim for rescission of the purchase of securities issued by the debtor corporation or for damages resulting from the purchase or sale of such securities."<sup>6</sup> Since it is ordinarily unlikely that the assets of a bankrupt corporation will be sufficient to pay the claims of general creditors, whose claims are superior to rescission claims of security holders,<sup>7</sup> the practical effect of the proposed statute would be to prevent the satisfaction of rescission claims that are protected by the securities laws. Moreover, this section fails to distinguish adequately among the various positions of bankruptcy claimants.

This Note will examine the present law on the status of security holders' rescission claims in bankruptcy and analyze the various proposals for limiting such claims and the advisability of accommodating the bankruptcy and securities laws.

## II. LEGAL BASES FOR SECURITY HOLDERS' RESCISSION CLAIMS

### A. Federal Law

A security holder's right to rescind his purchase against the issuing corporation may arise because (1) the security was sold without being

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King, *The Business Reorganization Chapter of the Proposed Bankruptcy Code—Or Whatever Happened to Chapters X, XI and XII*, 78 COM. L.J. 429 (1973); Lavien, *Water a Myth and Watch It Grow*, 79 COM. L.J. 116 (1974); Twinem, *Bankruptcy Report: Some Limitations on Creditors' Rights*, 29 BUS. LAW. 353 (1974); Walker, *An Introduction to the Proposed Bankruptcy Act of 1973: From Revision to Revolution*, 41 TENN. L. REV. 635 (1974); Weintraub & Cramers, *Critique of Chapter VII and Related Sections of the Proposed Bankruptcy Act of 1973*, 48 AM. BANKR. L.J. 1 (1974); Weintraub & Levin, *Chapter VII (Reorganizations) as Proposed by the Bankruptcy Commission: The Widening Gap Between Theory and Reality*, 47 AM. BANKR. L.J. 323 (1973); *Symposium, Bankruptcy Reform—1973*, 21 U.C.L.A. L. REV. 381 (1973); Note, *The Proposed New Bankruptcy Act*, 7 IND. L. REV. 852 (1974).

5. COMMISSION REPORT, pt. II, at 115.

6. *Id.* Section 4-406(a)(2) provides for subordination of "any claim, whether secured or unsecured, of any principal officer, director, or affiliate of a debtor, or of any member of the immediate family of such officer, director, or affiliate . . ." *Id.* For some discussion, see King & Rosen, *An Introduction to the Proposed Bankruptcy Act of 1973*, 79 COM. L.J. 472 (1974). This section also has relevance to securities law, but is beyond the scope of this Note.

7. See Walker, *supra* note 4, at 655-56. For the purposes of this Note, the terms "security holder" and "rescinding security holder" shall refer only to the holders of equity securities.

properly registered or exempted from registration, (2) the transaction in which the security was sold was not exempt, or (3) the security was offered by means of a defective prospectus or misleading information.<sup>8</sup> Section 12(1) of the Securities Act of 1933<sup>9</sup> (Securities Act) imposes strict liability on the seller of a nonregistered, nonexempt security.<sup>10</sup> Section 12(2) of the Securities Act<sup>11</sup> imposes liability on a seller who sells the security through the use of information that is either untrue or contains a misleading omission.<sup>12</sup> Under section 12, a party may sue for rescission and recover the consideration paid for the securities, or sue for damages if the securities were disposed of prior to suit.<sup>13</sup> Likewise, among other possibilities, a defrauded security holder may sue the issuing corporation for rescission or damages<sup>14</sup> under section 17(a) of the Securities Act<sup>15</sup> and Securities and Exchange Commission Rule 10b-5.<sup>16</sup>

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8. Section 3 of the Securities Act, 15 U.S.C. § 77c (1970), describes exempted securities and section 4 of the Securities Act, 15 U.S.C. § 77d (1970), describes exempted transactions. Section 5 of the Securities Act of 1933, 15 U.S.C. § 77e (1970), sets out the basic prohibitions against offering or selling securities without their registration. Section 5 also requires that offerees be provided prospectuses. *See generally* 1 L. LOSS, SECURITIES REGULATION 178-206 (2d ed. 1961).

9. 15 U.S.C. § 77l(1) (1970).

10. *See* 3 L. LOSS, SECURITIES REGULATION 1692-93 (2d ed. 1961).

11. 15 U.S.C. § 77l(2) (1970).

12. *See* 3 L. LOSS, SECURITIES REGULATION 1699 (2d ed. 1961).

13. 15 U.S.C. § 77l (1970). *See* 3 L. LOSS, SECURITIES REGULATION 1721 (2d ed. 1961).

14. For a discussion of § 17(a) of the Securities Act, see *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *B & B Investment Club v. Kleinerts, Inc.*, 391 F. Supp. 720, 726 (E.D. Pa. 1975); *Reid v. Mann*, 381 F. Supp. 525, 526 (N.D. Ill. 1974); *Crowell v. Pittsburgh & L.E. R.R.*, 373 F. Supp. 1303 (E.D. Pa. 1974); *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890, 903 (D. Me. 1971); *Weber v. CMP Corp.*, 242 F. Supp. 321 (S.D.N.Y. 1965); *Dack v. Shanman*, 227 F. Supp. 26 (S.D.N.Y. 1964); *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955). Section 11 of the Securities Act, 15 U.S.C. § 77k (1970), provides for liability in the event "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . ." Section 11 provides only for damages. For a discussion of damages available in suits based upon SEC Rule 10b-5, see 2 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 §§ 9.1, 9.2 (1971); 3 L. LOSS, SECURITIES REGULATION 1792-97 (2d ed. 1961).

15. 15 U.S.C. § 77q(a) (1970).

16. 17 C.F.R. § 240.10b-5 (1975).

## B. *State Law*

All states regulate securities transactions under some kind of blue sky law.<sup>17</sup> These laws generally require registration before the offer and sale of securities and prohibit the use of fraudulent or misleading information in the sale of securities.<sup>18</sup> Actions for rescission or damages are normally provided for violations of state blue sky laws.<sup>19</sup>

## C. *Common Law*

A security holder also may have a claim based on the common law actions of deceit<sup>20</sup> or rescission.<sup>21</sup> The Securities Act and most state blue sky laws specifically provide that their remedies are in addition to those available at law or in equity,<sup>22</sup> and therefore, a security holder's right to base his claim on a common law action has not been abridged.

## D. *Categories of Rescission Claims Under Securities Law*

The basic policy of federal securities law is to give investors adequate information to enable them to make an informed purchase decision.<sup>23</sup> Rescission remedies were incorporated in the statutory scheme to effectuate this policy. Therefore, a security purchaser who either did not receive the required information or received misinformation is entitled to rescind his purchase.<sup>24</sup> To insure further that the required information is made available, the securities laws incorporated a vast array of registration and reporting requirements.<sup>25</sup> The issuer's failure to follow

17. See CCH BLUE SKY L. REP. for a collection of current state blue sky laws. See generally L. LOSS & E. COWETT, BLUE SKY LAW (1958).

18. See 3 L. LOSS, SECURITIES REGULATION 1631-82 (2d ed. 1961).

19. *Id.* at 1638-39. See also Slain & 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, 266 (1973) [hereinafter cited as Slain & Kripke].

20. See 3 L. LOSS, SECURITIES REGULATION 1628 (2d ed. 1961).

21. *Id.* at 1626-27. See generally Shulman, *Civil Liability and The Securities Act*, 43 YALE L.J. 227 (1933) (discussion of common law actions as they relate to securities).

22. Securities Act § 16, 15 U.S.C. § 77p (1970); UNIFORM SECURITIES ACT § 409 (h).

23. S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933); SEC Securities Act Release No. 1 (May 27, 1933); 1 L. LOSS, SECURITIES REGULATION 184-85 (2d ed. 1961).

24. See notes 12-16 *supra* and accompanying text.

25. See generally 2 L. LOSS, SECURITIES REGULATION 784-827 (2d ed. 1961).

these requirements also may provide purchasers of the corporation's securities with rescission claims.<sup>26</sup>

Rescission claims can be divided into two broad categories under the securities laws. Those claims based on either the issuer's failure to provide a purchaser with the required information or the provision of misinformation will be referred to as claims based on informational defects. Those claims based on the issuer's failure to follow the registration and reporting requirements of the securities laws will be referred to as claims based on noninformational defects.<sup>27</sup> Obviously, there are many situations in which a rescission claim may fall into both categories.<sup>28</sup> This distinction, developed more fully in this Note, will be important in determining the extent to which the rescission claimant will be allowed to share in the assets of the bankrupt corporation.<sup>29</sup>

### III. PRESENT STATUS OF RESCISSION CLAIMS IN BANKRUPTCY

#### A. *The Absolute Creditor Priority Rule*

A basic maxim of bankruptcy law is that general creditors take prior to equity holders in a corporate bankruptcy. The Supreme Court in 1899 stated that "the familiar rule [is] that the stockholder's interest in

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26. Section 12(1) of the Securities Act, 15 U.S.C. § 77I(1) (1970), makes it unlawful to sell an unregistered security that is not exempt from registration.

27. Claims based on noninformational defects are those claims in which the facts that must be alleged in the suit for rescission need not include allegations of misstatement or omission by the seller. A third situation is also possible, in which an issuer failed to provide accurate information required in a registration statement or report, and this failure deprived an investor of information upon which he would otherwise have relied. Because in this situation the failure involves more than a failure to register, this situation will be classed with claims based on informational defects. For further discussion and analysis of the distinction between claims based on informational defects and those based on noninformational defects see notes 133-138 *infra* and accompanying text.

28. A claim based upon the seller's failure to register could be advanced by a purchaser who had also been defrauded. Under section 12(1) a purchaser need only show a lack of registration and the nonexempt status of the security and the transaction in which it was sold. A suit based on fraud must allege the informational defect. It appears likely that a claimant who could rescind on both bases would plead both bases but rely upon the former as a matter of convenience.

It could be argued that the existence of a noninformational defect is information the purchaser should possess, and therefore, all rescission claims are based on informational defects. This argument, however, fails to recognize the compliance policy that underlies some rescission claims. Claims based upon informational defects recognize only the underlying securities policy of providing purchasers with adequate information prior to the purchase decision.

29. See notes 86-89 *infra* and accompanying text.

the property is subordinate to the rights of creditors; first of secured, and then of unsecured . . . ."<sup>30</sup> This doctrine has been reaffirmed on many occasions and has come to be known as the absolute creditor priority rule.<sup>31</sup> The rationale for the rule appears to stem from the relationship between the equity holder and the corporation in which he invested. The purchase of a corporation's equity securities entitles the purchaser to share in the corporation's earnings and profits, and makes the purchaser liable to the corporation's creditors up to the amount of his investment.<sup>32</sup> Therefore, if the corporation becomes bankrupt, the equity holder cannot be allowed to compete with creditors for the limited funds available.

Since the establishment of the absolute creditor priority rule, commentators have recognized another reason for its existence. Creditors of a corporation extend credit, either directly or indirectly, in reliance upon the equity base reflected in the corporation's books.<sup>33</sup> A creditor views the equity base as insurance that, if the corporation becomes insolvent, there will be some funds to pay the debt owed to him. Thus, a creditor's willingness to extend credit is directly related to the amount of the equity base.<sup>34</sup>

Consequently, there are two rationales for the present use of the absolute creditor priority rule. First, since an equity purchaser has made a conscious decision to assume the inherent risks of an equity holder, he should be bound by his decision. Second, since creditors rely on the equity base of the corporation to determine whether to extend credit, their reliance should be protected. As will be shown, however, this rule does not always prevent a rescinding equity security holder from sharing ratably in the assets of the insolvent corporation with the general creditors.

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30. *Louisville Trust Co. v. Louisville, N.A. & C. Ry.*, 174 U.S. 674, 684 (1899).

31. *See, e.g.*, *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510 (1941); *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939). These cases involved reorganization proceedings in which an attempt was made to avoid the rule. *See also* *Spitzer v. Stichman*, 278 F.2d 402, 405 (2d Cir. 1960). From the Court's discussions, it is clear that this rule is applicable in a straight bankruptcy proceeding.

32. This is the basic concept of limited shareholder liability. *See generally* Note, *Limited Liability in Commercial Enterprises*, 57 COLUM. L. REV. 83 (1957).

33. *See* *Slain and Kripke*, *supra* note 19, at 288-89. *See also* cases cited at note 55 *infra* (examples of the application of the rule on the basis of creditor reliance).

34. Within certain bounds this proposition is axiomatic. A creditor will not extend credit to a small closely held corporation with limited equity in the amount it would to General Motors.

## B. *Claims Given General or Secured Creditor Status*

Upon bankruptcy, claimants both must prove their claims<sup>35</sup> and have them allowed<sup>36</sup> before they can share in the assets of the bankrupt. A security holder with a rescission claim against a bankrupt corporation must file a "proof of claim" in the bankruptcy court to establish that he will attempt to gain general creditor status.<sup>37</sup> The Supreme Court in *Oppenheimer v. Harriman National Bank & Trust Co.*<sup>38</sup> held that a rescinding shareholder was entitled to share equally with general creditors in the assets of an insolvent bank.<sup>39</sup> *Oppenheimer* dealt with the issue whether a shareholder should be allowed to forgo his status as an equity holder and gain general creditor status when his claim was based upon common law fraudulent misrepresentations. The Court held that because the bank was liable in rescission, the shareholder should be given general creditor status.<sup>40</sup> Several lower courts have reached this result by using a similar rationale,<sup>41</sup> and the Securities and Exchange Commission has lent support to this view in its Corporate Reorganization Releases.<sup>42</sup>

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35. Section 63 of the Bankruptcy Act, 11 U.S.C. § 103 (1970), provides a list of debts that may be proved. Proof of claim is the device by which a creditor enters his claim before the bankruptcy court so that it may determine if a dividend will be allowed.

36. Section 57 of the Bankruptcy Act, 11 U.S.C. § 93 (1970), provides for allowance of claims. The bankruptcy court may consider the equities of the case in determining whether to grant the creditor his claim out of the bankrupt's assets under § 57(k), 11 U.S.C. § 93(k) (1970). See also notes 48-57 *infra* and accompanying text.

37. See Schrag & Ratner, *Caveat Emptor—Empty Coffers: The Bankruptcy Law Has Nothing to Offer*, 72 COLUM. L. REV. 1147, 1170 (1972) [hereinafter cited as Schrag & Ratner].

38. 301 U.S. 206 (1937).

39. 301 U.S. at 215. Since *Oppenheimer* the Supreme Court has not dealt with this issue. The issue arose in *Tcherepnin v. Knight*, 389 U.S. 332 (1967), but was held to have been premature.

40. The Court, however, did allude to certain facts that could adversely affect the nature of the claim. For example, if there had been a long delay in bringing the claim after knowledge of the facts, or if the claim were based on a ground other than fraud, the outcome of the case might have been different. 301 U.S. at 214 (1937). See notes 48-64 *infra* and accompanying text.

41. See *Woods v. Deck*, 112 F.2d 739 (9th Cir. 1940); *Flor v. Jandreu*, 15 F.2d 765 (5th Cir. 1926); *Davis v. Louisville Trust Co.*, 181 F. 10 (6th Cir. 1910); *Cawthon v. Bancokentucky Co.*, 52 F.2d 850, 852 (W.D. Ky. 1931); *In re Bancunity Corp.*, 36 F.2d 595, 598 (S.D.N.Y. 1929). *SEC v. Insurance Investors Trust Co.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,259 (W.D. Ky. 1971), explicitly followed *Oppenheimer*. See also 3A W. COLLIER, BANKRUPTCY ¶ 59.06 (14th ed. 1975).

42. See SEC Corporate Reorganization Release No. 310, at 41 (Mar. 16, 1972); SEC Corporate Reorganization Release No. 226, at 13-14 (Mar. 8, 1965).

As an alternative, the rescinding equity security holder may file a petition for reclamation in the bankruptcy court<sup>43</sup> to establish that he will use tracing principles to gain secured creditor status.<sup>44</sup> By tracing the funds he used to purchase the security, the rescinder can have a constructive trust in these funds established for his benefit.<sup>45</sup> Although there is precedent that a rescinding equity security holder who successfully traces his funds may take as a priority creditor,<sup>46</sup> success is unlikely because to obtain secured creditor status he must identify the actual funds he used to purchase the securities.<sup>47</sup>

### C. *Claims Subordinated*

Section 65(a) of the Bankruptcy Act<sup>48</sup> states that “[d]ividends of an equal per centum shall be declared and paid on all claims except such as have priority . . . .”<sup>49</sup> It would appear, therefore, that all provable rescission claimants should be allowed to take as general creditors.<sup>50</sup> Section 2(a) of the Bankruptcy Act,<sup>51</sup> however, confers on bankruptcy courts “such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act . . . .”<sup>52</sup> This language has been interpreted to mean that bankruptcy courts are courts of equity.<sup>53</sup> As courts of equity, bankruptcy courts could subordinate security holder rescission claims.

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43. See Schrag & Ratner, *supra* note 37. Filing one kind of claim or the other may constitute an election of remedies. Therefore, the security holder should file in the alternative both a “proof of claim” and a “petition for reclamation.” See 4A W. COLLIER, BANKRUPTCY §§ 70.39[4] at 479, 70.41[2] at 498 (14th ed. 1975).

44. See Schrag & Ratner, *supra* note 37.

45. RESTATEMENT OF RESTITUTION §160 (1937) provides for the creation of a constructive trust in favor of one whose property is in the hands of another who would be unjustly enriched if he were allowed to retain the property. See also RESTATEMENT OF CONTRACTS § 476 (1932); 12 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 1500 (3d ed. W. Jaeger 1970).

46. See *In re Rhine*, 241 F. Supp. 86 (D. Col. 1965) (court allowed rescinding purchasers of working interests in an oil and gas enterprise to trace their funds and attain secured creditor status). Cf. Schrag & Ratner, *supra* note 37. But see *In re Morris Bros., Inc.*, 293 F. 294, 296 (9th Cir. 1923) (even if funds are traceable, rescinding shareholder cannot establish trust against those who became creditors while rescinder was shareholder) (dictum).

47. The problems with the various theories of tracing are beyond the scope of this Note. For elucidation see Schrag & Ratner, *supra* note 37, at 1153-56; Slain & Kripke, *supra* note 19 at 272-79.

48. 11 U.S.C. § 105(a) (1970).

49. *Id.*

50. See notes 35-47 *supra* and accompanying text.

51. 11 U.S.C. § 11(a) (1970).

52. *Id.*

53. See, e.g., *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934).

Generally, claims of rescinding equity security holders could be subordinated in three situations. First, the court could subordinate the rescission claim of a security holder who was aware of his rescission right, but continued to collect dividends or to participate in shareholders' meetings.<sup>54</sup> Second, the court could subordinate the rescission claim of a security holder if there was creditor reliance on the apparent equity base provided by the rescinder's purchase.<sup>55</sup> Third, the court arguably could subordinate the rescission claim of a security holder if the claim were based on a violation of the registration provisions of the securities laws.<sup>56</sup> It should be emphasized that there has been no consistent application of the bankruptcy courts' power to subordinate rescission claims of security holders.<sup>57</sup>

#### D. *Claims Disallowed*

Some courts have disallowed a rescission claim when the claimant has either collected dividends or participated in the management of the corporation after he had knowledge of his claim.<sup>58</sup> In some cases these acts by the security holder would not affect the validity of his rescission claim outside the context of bankruptcy because the securities laws deny the defenses of laches and estoppel to defendants in rescission suits.<sup>59</sup>

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54. *In re Groenleer-Vance Furniture Co.*, 23 F. Supp. 713, 715 (W.D. Mich. 1938); *cf. Horn v. Abts*, 19 F.2d 350 (8th Cir. 1927); *Ratcliff v. Clendenin*, 232 F. 61 (8th Cir. 1916); *In re National Pressed Brick Co.*, 212 F. 878 (6th Cir. 1914). Although in these cases the courts disallowed the claims, they could have used the same rationale to subordinate them. See cases cited note 58 *infra* and accompanying text.

55. See *In re Morris Bros., Inc.*, 293 F. 294 (9th Cir. 1923); *In re Groenleer-Vance Furniture Co.*, 23 F. Supp. 713, 715 (W.D. Mich. 1938); *cf. Julian v. Stewart*, 56 F.2d 32 (5th Cir. 1932); *Horn v. Abts*, 19 F.2d 350 (8th Cir. 1927). The *Julian* and *Horn* cases resulted in the disallowance of the claims. Subordination would have been a more appropriate result.

56. *Cf. Lincoln Theatres Corp. v. Fleming*, 66 F.2d 441 (4th Cir. 1933); *In re R. Rombach & Co.*, 9 F.2d 359 (3rd Cir. 1925).

57. See 3A W. COLLIER, *BANKRUPTCY* ¶ 63.06, at 1784 & nn. 26 & 27 (14th ed. 1975); Annot., 51 A.L.R.2d 989 (1957).

58. See *Julian v. Stewart*, 56 F.2d 32 (5th Cir. 1932); *Horn v. Abts*, 19 F.2d 350 (8th Cir. 1927); *Ratcliff v. Clendenin*, 232 F. 61 (8th Cir. 1916).

59. See Note, *Applicability of Waiver, Estoppel, and Laches Defenses to Private Suits Under the Securities Act and S.E.C. Rule 10b-5: Deterrence and Equity in Balance*, 73 YALE L.J. 1477 (1964). These defenses are not available generally in registration suits because such suits are based upon the *in terrorem* policy inducing compliance. *Id.* at 1481, 1484. See also L. LOSS, *SECURITIES REGULATION 1693-94* (2d ed. 1961). These defenses, however, have been available sporadically in suits for both informational and noninformational defects. See Note, *supra* at 1477 n.6, *citing* *Royal Air Properties*,

There appears to be no valid rationale for the disallowance of claims against which no defense would exist outside the context of bankruptcy.<sup>60</sup> When allowance of a claim would constitute an injustice to other claimants, subordination is the proper remedy in equity.<sup>61</sup> Disallowance of a claim denies the claimant any relief even if the assets of the bankrupt are more than sufficient to satisfy fully all priority, general, and subordinated claims.<sup>62</sup> Subordination, however, merely denies the claimant a dividend until those who have been determined to be in an equitably superior position are fully satisfied.<sup>63</sup> By subordinating rather than disallowing claims of rescinding equity security holders, a bankruptcy court would not find itself in conflict with the policies of securities laws that deny corporations certain defenses to such claims.<sup>64</sup>

#### IV. PROPOSED ALTERNATIVES FOR DETERMINING THE STATUS OF RESCINDING SECURITY HOLDERS IN BANKRUPTCY

##### A. *Slain-Kripke Proposal*

Professors Slain and Kripke proposed an analysis for limiting the claims of rescinding security holders in corporate bankruptcies.<sup>65</sup> They framed the issue as one of risk allocation in which the risk of both business insolvency and an illegal securities issuance is allocated between creditors of the bankrupt and rescinding shareholders.<sup>66</sup> To reach an equitable balance Professors Slain and Kripke relied on the traditional absolute creditor priority rule,<sup>67</sup> the possible leverage of a

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Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962), Straley v. Universal Uranium & Milling Corp., 289 F.2d 370 (9th Cir. 1961), and Dale v. Rosenfeld, 229 F.2d 855 (2d Cir. 1956).

60. See 3 W. COLLIER, BANKRUPTCY ¶ 57.14 (14th ed. 1975); 3A *id.* ¶ 63.03; Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83 (1961) [hereinafter cited as Herzog & Zweibel]; Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013 (1953) [hereinafter cited as Hill].

61. See Herzog & Zweibel, *supra* note 60, at 113.

62. Cf. Hill, *supra* note 60, at 1049.

63. *Id.* This is, however, the same as disallowance in a straight bankruptcy. See Walker, *supra* note 4. In a reorganization case it may be very important to be subordinated rather than disallowed because a subordinated claimant may still participate, while a disallowed claimant cannot.

64. For example, defenses are denied to defendants in suits brought under § 12(1) of the Securities Act to insure the effectuation of the *in terrorem* policy underlying those claims. See Note, *supra* note 59, at 1481.

65. Slain & Kripke, *supra* note 19.

66. *Id.* at 286.

67. The absolute creditor priority rule refers to the basic distributional rule developed by the Supreme Court in *Consolidated Rock Prods. Co. v. Du Bois*, 312 U.S. 510

security holder who had knowledge of his rescission right,<sup>68</sup> and the proposition that creditors rely on the apparent equity base of a debtor corporation in deciding whether to extend credit.<sup>69</sup>

Using these factors, the authors' proposal emphasizes creditor reliance on the debtor's equity base to determine the equitable balance between the competing classes of claimants.<sup>70</sup> First, the authors would establish a rebuttable presumption that post-issuance creditors relied on the apparent equity base resulting from prior security issues.<sup>71</sup> If a rescinding equity security holder is to share equally with a post-issuance creditor, he must rebut the presumption of creditor reliance.<sup>72</sup> Conversely, a pre-issuance creditor is presumed not to have relied on the equity base resulting from a later security issue.<sup>73</sup> Therefore, a pre-issuance creditor must prove his reliance to take prior to security purchasers with rescission claims resulting from a particular issue of securities.<sup>74</sup> For example, a pre-issuance creditor could prove reliance by showing that in reliance on the new equity base he extended repayment dates or granted further credit before the previous debt was satisfied.

The Slain-Kripke proposal would also incorporate the defenses of laches<sup>75</sup> and estoppel<sup>76</sup> to prevent a claimant from using his claim as

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(1941), and *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939). The rule provides that senior interests are to be paid in full before junior interests receive any dividends. See notes 30-34 *supra* and accompanying text.

68. This leverage refers to the possibility that a security holder who has a rescission claim can either wait to bring his claim if the corporation begins to have difficulty or forego rescission if the company prospers.

69. See Slain & Kripke, *supra* note 19, at 288-91.

70. *Id.*

71. *Id.* at 289.

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.* at 291. This defense applies to the timing of the claim. It would prevent the security holder from using his right to rescind as a device to wait and see how the investment develops. The statute of limitations for claims under sections 11 and 12 of the Securities Act is as follows:

No action shall be maintained to enforce any liability created under section [11] or [12(2)] . . . unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made . . . or, if the action is to enforce a liability created under section [12(1)] . . . unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability created under section [11] or [12(1)] . . . more than three years after the security was bona fide offered to the public, or under section [12(2)] . . . more than three years after the sale.

leverage after he has discovered the claim. Finally, the proposal would prohibit the use of tracing doctrines by rescinding security holders in order to prevent the rescinders from attaining secured creditor status.<sup>77</sup>

The authors' proposed distribution formula, however, would effectively negate any claim by a rescinding equity security holder, regardless of creditor reliance. Their proposal produces this result by implying an assignment of all assets initially distributed to rescinding security holders to those creditors who have shown that they relied on the equity base represented by the securities being rescinded.<sup>78</sup> This result can be illustrated by the following hypothetical. Assume that after all costs and priority claims have been paid<sup>79</sup> the remaining assets total \$300,000. Assume further that relying creditors<sup>80</sup> have claims in the amount of \$500,000; nonrelying creditors<sup>81</sup> have claims in the amount of \$300,000; and rescinding security holders have claims in the amount of \$200,000. Relying creditors would receive a dividend of \$150,000 ( $300,000 \times \$500,000 / \$1,000,000$ ),<sup>82</sup> nonrelying creditors would receive a dividend of \$90,000, and rescinding equity security holders would receive a dividend of \$60,000. Then, the \$60,000 dividend of the rescinders would be equitably assigned to the relying creditors.

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§ 13, 15 U.S.C. § 77m (1970). Professors Slain and Kripke suggest a reasonable time limitation for bringing rescission claims in a bankruptcy situation. Moreover, "[b]ecause there is no federal statute of limitations applicable to rule 10b-5 or section 17 cases, a statute of the state in which the court sits is applied. These typically are longer than the periods provided in the securities acts for express rights of action." Slain & Kripke, *supra* note 19, at 290 n.97.

76. *Id.* at 281-84.

77. *Id.* at 294.

78. *Id.* at 295-96. As a practical matter, it is unlikely that the dividend of the rescinding shareholders would be sufficient to satisfy fully the claims of relying general creditors. Only if the relying general creditors were completely satisfied would the rescinding security holders be allowed to participate.

79. Claims entitled to priority such as administration costs are set out in § 64 of the Bankruptcy Act, 11 U.S.C. § 104 (1970).

80. Under the Slain-Kripke analysis relying creditors are those who either were able to preserve the presumption that they relied on the equity base represented by the rescinded shares or proved their reliance on an issuance of securities that took place after they extended credit. See Slain & Kripke, *supra* note 19, at 289.

81. Nonrelying creditors are both those who did not rebut the presumption of non-reliance on an issuance that was subsequent to their granting credit and those creditors against whom the rescinder rebutted the presumption of reliance on an issuance that was prior to their extension of credit. *Id.*

82. Under a pro rata distribution, each claimant's dividend equals the total asset to be dispersed multiplied by the ratio of the particular claimant's claim to the total amount of allowable claims.

Rescinders would take nothing unless their dividend was greater than the difference between the relying creditors' claims and dividends. As Slain and Kripke admit, "[i]n practical terms . . . [rescinding shareholders] will not participate at all in the overwhelming majority of straight bankruptcies."<sup>83</sup>

There are two assumptions implicit in the Slain-Kripke proposal. First, it assumes that the absolute creditor priority rule should apply as against an equity security holder who rescinds his purchase of securities. The absolute creditor priority rule developed from the belief that because an equity purchaser took the risk of the corporation's failure, he should not be allowed to compete with creditors in the event of bankruptcy.<sup>84</sup> Arguably, a rescinding equity security holder is no longer a security holder upon the distribution of assets because his claim has been proved and his purchase has been rescinded. Slain and Kripke circumvent this argument by recognizing a second rationale for the absolute creditor priority rule, namely, creditor reliance on the equity base represented by the rescinded securities.<sup>85</sup> By incorporating the creditor reliance concept in their analysis, Slain and Kripke have justified the application of the absolute creditor priority rule to claims of rescinding equity security holders.

Second, the authors assume that all rescission claims should be treated similarly, and that the absolute creditor priority rule should be applied uniformly. Security holder rescission claims, however, can be placed into two categories: (1) claims under which the purchaser did not have either adequate or truthful information necessary to make an informed purchase decision, and (2) claims under which the purchaser had adequate and truthful information, but the issuing corporation failed to follow the registration requirements of the securities laws or the misinformation it provided would not have affected the rescinder's purchase decision.<sup>86</sup> This distinction is important because the basic rationale of the absolute creditor priority rule is that an equity holder is a conscious risk taker who should not be allowed to forego the risk.<sup>87</sup>

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83. Slain & Kripke, *supra* note 19, at 296.

84. See notes 30-32 *supra* and accompanying text.

85. Slain & Kripke, *supra* note 19, at 288-91.

86. See notes 23-29 *supra* and accompanying text.

87. The argument is that if the absolute creditor priority rule is based on the proposition that an equity purchaser is a conscious risk taker, then there must be some test for determining what constitutes risk taking. The word "conscious" implies that an element of knowledge must be present. If under securities law the purchaser had inad-

Rescission claims based on informational defects may evidence a lack of information necessary to make an intelligent decision to accept the equity risks, and thus show that the rescinder was not a conscious risk taker.<sup>88</sup> If such a security holder was not a conscious risk taker, an equitable distinction between kinds of rescission claims becomes important to the application of the absolute creditor priority rule.<sup>89</sup> In this regard, the Slain-Kripke proposal is imprecise because it fails to recognize an important distinction between different kinds of rescission claims.

The implication of the Slain-Kripke proposal is that all policies underlying securities law rescission claims should be subordinated to the traditional bankruptcy policy of absolute general creditor priority over claims by equity holders.<sup>90</sup> This implication ignores the inequity that arises if a defrauded security holder is not allowed to pursue his claim effectively simply because the issuing corporation went bankrupt. This neglect of securities law policies invites a floundering corporation to make a fraudulent issue to protect the postbankruptcy relationship between corporate insiders and corporate creditors.<sup>91</sup> This result is possible largely because the authors' analysis attempts to extend the concept of absolute creditor priority without any regard for the different kinds of rescission claims.

### B. *Proposed Bankruptcy Act of 1973*

The Commission on the Bankruptcy Laws of the United States, in recommending section 4-406(a)(1) of the Proposed Act, stated that "claims by stockholders of a corporate debtor for rescission or damages, which if allowed will promote them to the status of creditors, be

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quate information to make an informed purchase decision, it can be argued that he also had insufficient information to consciously assume the risk of an equity holder. The quantum of information may be different in the two situations. See notes 134-38 *infra* and accompanying text.

88. See note 124 *infra* and accompanying text.

89. The application of the rule would vary with the allegation and proof of facts that would establish whether the rescinder was a conscious risk taker. If the claim did show such facts, then the court would not apply the rule.

90. Because of the proposed distributional formula, the practical result of the Slain-Kripke analysis is that rescinding security holders will receive nothing. See Slain & Kripke, *supra* note 19, at 296.

91. Under the Slain-Kripke approach, the general creditors who relied on the equity represented by such an issuance of securities would receive a larger percentage of their claims than they would have had there not been such an issuance.

subordinated to the claims of the real creditors."<sup>92</sup> Section 4-406(b) of the Proposed Act provides that "[a]ny . . . trust securing a claim subordinated under subdivision (a) [rescission claim] shall pass to the trustee for the benefit of all claims allowed but not subordinated."<sup>93</sup> This provision prevents tracing, which might otherwise give the rescinding security holder secured creditor status, because tracing results in an equitable trust.<sup>94</sup>

The Commission's proposal is not discussed in its *Report*, and therefore, only speculation about the rationale for this proposal is possible. The few commentators who have discussed these specific sections of the Proposed Act assume that the Commission's rationale is based upon a strict application of the absolute creditor priority rule in bankruptcy.<sup>95</sup> This assumption seems correct because the Slain-Kripke article appears to have been the only source material used by the Commission on this issue.<sup>96</sup> Basically, section 4-406 achieves the same result for equity rescission claimants as the Slain-Kripke proposal<sup>97</sup> without recognizing, for analytical purposes, the equitable importance of actual creditor reliance.<sup>98</sup> Perhaps the Commission believed it was a needless gesture to distinguish between rescission claims which, for all practical purposes, would be subordinated. Consequently, the Commission's recommendation is subject to the same criticism as the Slain-Kripke proposal.<sup>99</sup>

The policy implication of the Proposed Act's approach is that once a person becomes an equity holder, even if through the issuing corporation's fraud, he is treated as having made an informed decision to

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92. COMMISSION REPORT, pt. I, at 22.

93. Proposed Bankruptcy Act of 1973, § 4-406(b), COMMISSION REPORT, pt. II, at 115.

94. By tracing his funds in the issuer's possession, the rescinding security holder has a right to the funds through the imposition of a constructive trust. See RESTATEMENT OF RESTITUTION § 160 (1937); Schrag & Ratner, *supra* note 37, at 1153.

95. See Walker, *supra* note 4, at 655. Cf. Coogan, *supra* note 4, at 737-38; King & Rosen, *supra* note 6, at 474.

96. The Commission's *Report* does not cite any source material for this portion of the *Report*. Professors Slain and Kripke, however, submitted a draft of their article to the Commission. See Slain & Kripke, *supra* note 19, at 299-300.

97. In effect both approaches arrive at the same result; rescinding security holders do not participate in the distribution of the assets of the bankrupt corporation.

98. Section 4-406 of the Proposed Act does not incorporate the Slain-Kripke creditor reliance approach.

99. See notes 84-91 *supra* and accompanying text.

assume the traditional risks that accompany the status of an equity holder.<sup>100</sup> This approach is susceptible of two explanations. First, the Commission may have made a policy decision that the securities law policy underlying rescission rights must be subordinated to the absolute creditor priority policy of the bankruptcy law.<sup>101</sup> Second, the Commission may have failed either to frame the issue properly or to consider the policy conflict between the securities and bankruptcy laws.<sup>102</sup> Under either explanation, it appears that a more careful consideration of the problem is necessary before Congress adopts the Commission's recommendation.

### C. *The Securities and Exchange Commission (SEC) Approach*

The SEC has not promulgated a recommended solution to the issue of a rescinding security holder's status in a corporate bankruptcy proceeding. The SEC's probable position can be gleaned, however, from its views expressed in Corporate Reorganization Releases<sup>103</sup> and its position in litigation.<sup>104</sup> In one release, the SEC held that a plan for corporate reorganization was unfair when it did not allow shareholders to bring actions for rescission based on both fraud and violations of the registration requirements of the securities laws.<sup>105</sup> In a second release quoted by Slain and Kripke,<sup>106</sup> the SEC stated that security holder rescission claims "are on parity with unsecured claims generally . . . ."<sup>107</sup> Finally, in *SEC v. Insurance Investors Trust Co.*,<sup>108</sup> the SEC supported the position of the stockholders who argued that after establishing rescission claims based on the bankrupt's fraudulent acts and violations of the securities laws, the stockholders should share ratably with the general

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100. The Proposed Act approach also contains the policy implication discussed in the text accompanying notes 90-91 *supra*.

101. This explanation is unlikely because the Commission did not discuss this issue in its *Report*. It is reasonable to assume that if an extensive analysis of this issue had been made, such analysis would be reflected in the Commission's *Report*.

102. The Securities and Exchange Commission was not asked to testify before the Commission, and there is no source material listed by the Commission that presents the policies of the securities laws.

103. See SEC Corporate Reorganization Release No. 310 (Mar. 16, 1972); SEC Corporate Reorganization Release No. 226 (Mar. 8, 1965).

104. See *SEC v. Insurance Investors Trust Co.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,259 (W.D. Ky. 1971).

105. See SEC Corporate Reorganization Release No. 226 (Mar. 8, 1965).

106. Slain & Kripke, *supra* note 19, at 270 & nn.38 & 39.

107. SEC Corporate Reorganization Release No. 310, at 41 n.32 (Mar. 16, 1972).

108. [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,259 (W.D. Ky. 1971).

creditors.<sup>109</sup> From these positions it can be inferred that the SEC would support the proposition that all rescinders with proven claims, regardless of the basis of the claim, creditor reliance, laches, or estoppel, should be allowed to share pro rata with all other general creditors.<sup>110</sup>

The basic assumption underlying the apparent position of the SEC is that regardless of any conflict with other policies, the securities law policy must be given effect. The implication of this view is that general creditors must share with the rescinding equity security holders the risk of an illegal securities issue by the debtor corporation.<sup>111</sup> Under this view, an equity security holder with a valid rescission claim could use his claim to escape the risks he intelligently undertook when he made his purchase.<sup>112</sup> This result is possible because a rescission claim could be based solely on a noninformational defect. Two explanations of the SEC position are possible. First, the SEC may have taken the view that its duty is to further the policies of the securities laws in all situations. Second, the SEC may have made a policy decision that the equities favor a rescinding security holder over a general creditor regardless of the circumstances in which the conflict arises.<sup>113</sup>

#### D. *An Alternative Approach*

The approaches discussed thus far present three contrasting views. The first view is that some balance of the equities is necessary to determine the application of the absolute creditor priority rule and securities law policy, but subject to creditor reliance on the apparent equity base provided by equity security purchases that are the focus of

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109. *Id.*

110. See sources cited notes 105-09 *supra* and accompanying text. The SEC as of yet, however, has not distinguished between claims brought on an antifraud theory and claims based upon violations of the registration provisions of the securities laws.

111. Since general creditor status is given to all rescinding security holders under the SEC approach, both classes of claimants will share in the assets of the bankrupt. Therefore, the risk of an illegal security issuance is also borne by rescinding security holders.

112. If the security holder's rescission claim was based on a violation of the registration provisions of the securities laws, adequate information may have been available to him. Therefore, if he knew of his rescission claim and delayed in bringing it, he would still have the right to rescind if the corporation experienced financial trouble, as long as he did so within the period of the statute of limitations. *But see* note 75 *supra* and accompanying text (application of the defense of laches in this situation).

113. This policy decision would be supported by the argument that all rescission claims are based upon a lack of relevant information or that rescission is an effective tool to induce compliance with the registration provisions of the securities laws.

rescission claims.<sup>114</sup> The second view is that the absolute creditor priority rule should apply in all circumstances.<sup>115</sup> The third view is that securities law policy should be paramount in all cases.<sup>116</sup> The situation, however, requires an alternative approach that will attempt to give effect to both securities and bankruptcy law policies.

This alternative approach incorporates the creditor reliance analysis proposed by Professors Slain and Kripke<sup>117</sup> with a distinction drawn between rescission claims based on the policies underlying the securities statutes that grant the rescission right. The two categories of rescission claims are based on informational and noninformational defects.<sup>118</sup> The former kind of claim provides relief to a purchaser who was unable to make an informed purchase decision because of insufficient information.<sup>119</sup> The latter kind of claim acts in an *in terrorem* manner to insure compliance with the registration and reporting requirements of the securities laws.<sup>120</sup> This analysis also recognizes that the basis for the absolute creditor priority rule is the purchaser's conscious decision to accept the risks of an equity holder.<sup>121</sup>

There are four different situations in which a conflict between bankruptcy law policy and securities law policy is present. First, there is the situation in which an equity security holder whose rescission claim is based on an informational defect is competing against a nonrelying creditor.<sup>122</sup> The rescinding security holder has not had adequate information to make an informed decision to accept the risks of an equity holder,<sup>123</sup> and therefore, the primary policy for the absolute creditor

114. Slain & Kripke, *supra* note 19.

115. Proposed Bankruptcy Act of 1973, § 4-406, COMMISSION REPORT, pt. II, at 115.

116. This position is the Securities and Exchange Commission approach. See notes 105-14 *supra* and accompanying text.

117. Slain & Kripke, *supra* note 19, at 288-91.

118. See notes 23-29 *supra* and accompanying text.

119. See S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933); SEC Securities Act Release No. 1 (May 27, 1933).

120. See S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933); Note, *supra* note 59. For the purposes of this Note, the term "*in terrorem*" will be used to signify the policy that requires compliance with the securities laws in order to protect the securities markets and to foster disclosure regardless of specific injury to investors through noncompliance. See Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173 & n.7 (1933).

121. See notes 31-32 *supra* and accompanying text.

122. For explanation of the terms nonrelying and relying creditor, see notes 80-81 *supra*.

123. This assertion assumes that the same quantum and kind of information is necessary both for a purchaser consciously to take the risks of an equity holder and to meet

priority rule is absent. Furthermore, since there is no creditor reliance, the second rationale for the absolute creditor priority rule is also absent. In this situation, the rescinding equity security holder should be allowed to share ratably with the nonrelying general creditor.

The second, and most difficult, situation occurs when a security holder with a rescission claim based on an informational defect is competing with a relying creditor. The rationale for the absolute creditor priority rule based on conscious risk taking is absent, but the rationale based on creditor reliance is present. Arguably, the rescission claim should be subordinated because there is justification for applying the absolute creditor priority rule. This result would, however, completely ignore the securities law policy to allow rescission when there is an informational defect. It is proposed that the claimants should share ratably in this instance. This result allows the relying creditor and the rescinding equity security holder to share the risk of the corporation's insolvency by receiving equal proportions of their respective claims. If the rescinder's claim is subordinated, the total risk of insolvency falls on him although he did not have sufficient information available consciously to take this risk.<sup>124</sup> There is precedent for the proposition that general creditors have some duty to investigate the possibility of an illegal securities issuance by the debtor corporation.<sup>125</sup> A creditor's failure to discover such a defect provides another reason for requiring him to share the risk of debtor insolvency. The proposed result is an attempt to balance the conflicting policies in an equitable manner.

The third situation occurs when an equity security holder with a rescission claim based upon a noninformational defect is competing with a nonrelying general creditor. The investor has made an informed

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the requirements of the securities laws. This appears to be a reasonable assumption because a purchaser with a rescission claim is allowed to forego the risks of being an equity holder. By allowing a security purchaser the right to rescind on the basis of an informational defect, the law that grants the right appears to recognize implicitly the inability of the rescinder consciously to have taken the risk of being an equity holder. It can be argued, however, that the two policies of securities laws, *see* notes 23-29 *supra* and accompanying text, overlap, and a rescission claim based on an informational defect is, in part, based on the *in terrorem* policies of the securities laws. An alternative test for determining what information is required for conscious risk taking is presented at notes 133-38 *infra* and accompanying text.

124. The risk would be on the rescinder because it would be unlikely that he would share in the assets of the bankrupt, whereas the creditor would be allowed to participate.

125. *See* SEC v. Insurance Investors Trust Co., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,259, at 91,533 (W.D. Ky. 1971).

decision to take the risks of an equity holder. Since the creditor did not rely on the equity base represented by the rescinded shares, however, the absolute creditor priority rule is not completely relevant. The question is whether the investor should be allowed to share in the assets of an insolvent corporation although he has made an informed decision to risk the complete loss of his investment. This situation does not justify ignoring the *in terrorem* policy underlying this kind of rescission claim.<sup>126</sup> It appears that the rescinding equity security holder should be allowed to share ratably with a nonrelying general creditor. Since, the creditor, at the time he extended credit, had no expectation that this equity would be present, he is not actually injured by the result.

When a security holder whose rescission claim is based on a noninformational defect is competing with a relying creditor, the *in terrorem* policy underlying the rescission claim should be subordinated. The investor has made an informed decision to accept the risks of corporate insolvency, and the creditor has relied on the equity base represented by the purchase. Both rationales for the absolute creditor priority rule are present and it should be applied. The indicated result is the subordination of the rescission claim.

Moreover, since there is no apparent reason for treating rescinding security holders differently than other creditors seeking to use tracing, rescinders should be allowed to use tracing to gain secured creditor status.<sup>127</sup> Finally, in order that the balance not swing too far, defendants should be able to use laches and estoppel<sup>128</sup> against rescinding security holders in a bankruptcy action. Once a security holder realizes he has a claim for rescission and decides not to proceed with his claim, it can be said that he has made a conscious decision to accept the risks of an equity holder.<sup>129</sup> These defenses should not influence the provability

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126. See notes 31-32 *supra* and accompanying text. The purchaser is allowed the rescission right to further the basic securities law policy of disclosure. The creditor has no equitable argument for claiming injury by the allowance of the rescission claim. Therefore, the policy of the securities law should be furthered since rescission is not to the detriment of bankruptcy law policy.

127. See notes 43-67 *supra* and accompanying text.

128. See note 59 *supra*.

129. It seems that by delaying the enforcement of his claim, the equity holder is making the same decision as one who initially purchases securities. He is deciding to hold the securities in the hope of receiving a profit through either dividends or an increase in the securities' market value. At the same time, however, the possibility exists that the corporation will fail and the equity holder will lose his investment,

or allowability of the claim,<sup>130</sup> but rather, regardless of the actual basis, should cause the claim to be treated as one based on a noninformational defect.<sup>131</sup>

This recommended approach presents problems both in the distinction to be made between kinds of rescission claims and in the distribution of assets once the priorities are determined. In distinguishing between rescission claims based on informational defects and those based on noninformational defects, an attempt is being made to distinguish between purchasers with adequate information to accept the risks of equity holders and those without such information.<sup>132</sup> The information required by securities law, however, may exceed the information required for the purchaser to make a conscious decision to assume the risks of an equity holder.<sup>133</sup> The securities laws are recognized as being very broad because their purpose is to insure that adequate information is dispersed to safeguard the entire system of public securities trading, not just the individual purchaser.<sup>134</sup> To protect creditors, however, bankruptcy policy only requires that the purchaser have made a conscious decision to accept the equity risks.<sup>135</sup> Arguably, less information is required for a purchaser to make a conscious decision to accept the equity risks than is required under securities law to protect the securities market.<sup>136</sup> Therefore, a "but for" test may be required. This test would distinguish between rescission claims based on facts that, if known, would not have altered the reasonably prudent purchaser's decision to buy and those claims based on facts that, if known, would have prevented the prudent purchaser from entering the transaction.<sup>137</sup>

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130. The claim is still valid, and defenses not allowed outside the context of bankruptcy should not be allowed to defeat the claim in the context of bankruptcy. See notes 60-64 *supra* and accompanying text.

131. In other words, the claim should not be disallowed, but should be subordinated to claims of relying creditors who can invoke the absolute creditor priority rule.

132. This is information that would have made a difference in the purchaser's decision to take the risks of an equity holder. The assumption is made that if all securities laws are followed, adequate information is provided.

133. *But see* note 123 *supra*.

134. See S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933).

135. See Slain & Kripke, *supra* note 19, at 265, 268, 284-86. See also note 87 *supra*.

136. This argument is discussed in note 123 *supra*.

137. This test would insure that the securities laws would not define what information is necessary for a purchaser to make a conscious decision to accept the risks of an equity holder. It would, however, cause the bankruptcy court to examine the facts underlying every rescission claim to decide if there existed conscious risk taking by the purchaser.

Another problem with the proposed analysis involves the distribution of assets once the relative priorities of the claimants have been determined. Under the proposal, it is possible that a rescinding equity security holder, whose claim is based on a noninformational defect, would share pro rata with some general creditors and be subordinated to others.<sup>138</sup> All general creditors, however, have a right to a pro rata share in the bankrupt's assets.<sup>139</sup> To effectuate the distributional priorities that result from the application of the proposed analysis, it is necessary to incorporate an implied assignment. A portion of the assets to which rescinding equity security holders, whose claims are based on noninformational defects, are entitled, must be assigned to general creditors who relied on the equity base provided by those rescinded shares.<sup>140</sup> For example, assume a straight bankruptcy in which secured parties and section 64 priority claims are paid.<sup>141</sup> Four classes of claimants remain:

1. Rescinding equity security holders whose claims are based on informational defects;
2. Rescinding equity security holders whose claims are based on non-informational defects;;
3. General creditors who relied on the apparent equity base represented by the securities being rescinded by class 2;
4. General creditors who did not rely on the equity base represented by the securities being rescinded by class 2.

Assume further than each class has a claim of \$150,000, and that the remaining assets of the bankrupt are \$100,000. Each class would received a dividend of \$25,000.<sup>142</sup> Then, a percentage of the class 2 dividend equal to the proportion that the amount of relying general creditor class (class 3) bears to the total general creditor claims (50% in this example)<sup>143</sup> would be equitably assigned to the relying creditors.

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138. For example, A extended credit, then an issue was sold that was technically defective. B purchased, and then C extended credit. B would be entitled to a pro rata share with A, but would be subordinated to C.

139. Bankruptcy Act § 65(a), 11 U.S.C. § 105(a) (1970).

140. This apportionment is necessary to insure that relying creditors are not penalized by the allowance of rescission claims based on noninformational defects.

141. 11 U.S.C. § 104 (1970).

142. Each class is entitled to 25% of the assets because each class has an equal claim (25% of \$100,000).

143. This proportion was selected because it seems to most realistically reflect the equities of the analysis. Noninformational defect rescission claims should be allowed to participate, but not to the detriment of relying creditors. Furthermore, nonrelying

The result would be that class I would receive a dividend of \$25,000, class 2 a dividend of \$12,500, class 3 a dividend of \$37,500, and class 4 a dividend of \$25,000. This distribution formula would recognize the validity of rescission claims based on noninformational defects, but would also recognize the equitable rights of relying general creditors to the equity base provided by rescinded stock purchases.

## V. CONCLUSION

After years of contradictory treatment by the courts, a move is now being made to enact a statutory solution to the issue of a rescinding security holder's status in a bankruptcy proceeding. As has been shown, this is an area in which two deep-rooted policies of law conflict. To resolve this conflict satisfactorily, Congress must have a complete understanding of the underlying policies. Apparently, neither the Commission on the Bankruptcy Laws of the United States nor the Securities and Exchange Commission has considered all the factors. Nevertheless, their approaches to the problem highlight the strong arguments in favor of both the bankruptcy and securities law policies. Their approaches, however, offer easily applied solutions to a very difficult problem. The solution to this issue is not simple, but rather must be an imaginative one that will most effectively further the conflicting policies while being flexible enough for application in all circumstances. The approach suggested in this Note is not intended to be a perfect solution to the problem. It is hoped that it will provide both a basis for further alternatives, as the Slain-Kripke article did for this Note, and ultimately a satisfactory statutory solution.

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creditors should not be allowed to benefit from the equity added by the rescinded shares. An alternative formula might assign fixed percentages of the bankrupt's assets to the different classes of claimants. Since the assets that remain in the corporation at bankruptcy will not normally reflect any one security issuance, a percentage may be just as effective to carry out the policy of the analysis.