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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

IN RE:	:	**Chapter 11**
ARCAPITA BANK B.S.C.(c), *et al.*,	:	**Case No. 12-11076 (SHL)**
Debtors.	:	**Jointly Administered**

DEBTORS' MEMORANDUM OF LAW IN SUPPORT OF SUBORDINATION OF THE TIDE CLAIMS PURSUANT TO THE CONFIRMATION OF THE SECOND AMENDED JOINT PLAN OF REORGANIZATION OF ARCAPITA BANK B.S.C.(c), et al.

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THERE IS ONLY ONE NARROW LEGAL ISSUE BEFORE THE COURT

Arcapita Bank B.S.C.(c) ("***Arcapita Bank***") and Falcon Gas Storage Co. Inc. ("***Falcon***") (collectively, the "***Debtors***") submit this memorandum of law in support of the subordination of claims filed by Tide Natural Gas Storage I, LP and Tide Natural Gas Storage II, LP (together, "***Tide***") [Claim Nos. 295-298] (the "***Tide Claims***") and the classification of the Tide Claims in Classes 10(a) (Arcapita Bank) and 10(g) (Falcon) in the Debtors' *Second Amended Joint Plan of Reorganization of Arcapita Bank B.S.C.(c), and Related Debtors Under Chapter 11 of the Bankruptcy Code* [Docket No. 1036] (the "***Plan***").[1]

The proper classification in the Plan of the Tide Claims against Falcon and Arcapita Bank presents a narrow legal issue of statutory interpretation that can be determined based on undisputed facts. The only fact material to the proper classification of the Tide Claims is undisputed: the Tide Claims against both Falcon and Arcapita Bank are for alleged damages arising from Tide's purchase from Falcon of 100% of the LLC membership interests in NorTex Gas Storage Company, LLC ("***NorTex LLC***"). The application of section 510(b) to the Tide Claims is beyond dispute, and the Tide Claims must be subordinated. Only the level of subordination is in dispute.

To determine the proper level of subordination, the single issue to be decided is the scope of the "common stock" exception in section 510(b) and whether the "common stock" exception applies to other securities besides common stock, including LLC membership interests.

Based upon the plain language of section 510(b), the proper application of the canons of statutory interpretation, the legislative history, and the opinion of the other courts that have considered this issue, the inescapable conclusion is that section 510(b) means exactly what it

[1] Capitalized terms used herein but not otherwise defined herein have the meanings ascribed to them in the Plan and *Second Amended Disclosure Statement in Support of the Second Amended Joint Plan of Reorganization of Arcapita Bank B.S.C.(c) and Related Debtors Under Chapter 11 of the Bankruptcy Code* [Docket No. 1038] (as amended and including all exhibits and supplements, the "***Disclosure Statement***").

says, and Congress's use of "common stock" in the exception to section 510(b) is not meant to also include LLC membership interests or other securities. Therefore, the classification in the Plan of the Tide Claims in Classes 10(a) and 10(g) complies with the proper application of bankruptcy law.

RELEVANT MATERIAL FACTS

1. The material facts that support subordination of the Tide Claims through the Debtors' Plan are beyond dispute and are all established through undisputed agreements and through filings and admissions in pleadings by Tide filed in both this Court and the District Court.

2. As of early 2010, the primary asset of Falcon was 100% of the LLC membership interests in NorTex LLC, a company that owns and operates two large underground natural gas storage facilities and associated equipment in northern Texas. *See* Complaint filed by Tide in *Tide Natural Gas Storage I, L.P. v. Falcon Gas Storage Co., Inc.*, Case No. 10-cv-05821-KMW (S.D.N.Y.) [Docket No. 1] (the "***Complaint***") ¶ 12;[2] *Tide Natural Gas Storage I, L.P. v. Falcon Gas Storage Co., Inc.*, 2011 U.S. Dist. LEXIS 111532, at *4 (S.D.N.Y. Sep. 29, 2011).[3]

3. On March 15, 2010, Falcon entered into a purchase agreement with Tide[4] (the "***NorTex LLC Purchase Agreement***")[5] to sell 100% of its LLC membership interests in NorTex LLC to Tide for $515 million (the "***NorTex LLC Sale***"). Compl. ¶¶ 13, 60; *Tide Natural Gas Storage*, 2011 U.S. Dist. LEXIS 111532, at *4. There is no dispute that at all relevant times NorTex LLC was an affiliate of Falcon and Arcapita Bank, and pursuant to a separate guarantee

[2] Tide included a copy of the Complaint with each of its proofs of claim. Copies of Tide's proofs of claim are annexed as ***Exhibits 5-8*** to the *Debtors' Appendix of Material Documents in Support of Subordination of the Tide Claims* (the "***Appendix***").
[3] A copy of the District Court's opinion is annexed as ***Exhibit 4*** to the Appendix.
[4] Tide Natural Gas Storage I, LP and Tide Natural Gas Storage II, LP were formally known as Alinda Gas Storage I, LP and Alinda Gas Storage II, LP.
[5] A copy of the NorTex LLC Purchase Agreement is annexed as ***Exhibit 1*** to the Appendix.

agreement, certain potential liabilities of Falcon to Tide arising from the NorTex LLC Sale were guaranteed by Arcapita Bank.

4. John Hopper and other minority shareholders of Falcon filed an action against Falcon and its board of directors alleging that Falcon's board of directors had breached their fiduciary duties by agreeing to a sales price for the NorTex LLC membership interests purportedly below fair value (the "***Hopper Litigation***"). In response, Falcon and Tide created an amendment to the NorTex LLC Purchase Agreement (the "***Purchase Amendment***")[6] and agreed to place $70 million of the purchase price into an escrow account (the "***Escrowed Money***") pending the outcome of the Hopper Litigation. Compl. ¶ 13 n.2; *Tide Natural Gas Storage*, 2011 U.S. Dist. LEXIS 111532, at *4-5. Pursuant to the terms of the Purchase Amendment, Falcon and Tide executed an Escrow Agreement[7] that provided for the deposit of the Escrowed Money in an account with HSBC Bank USA, National Association. The NorTex LLC Sale closed on April 1, 2010, when Tide purchased 100% of the LLC membership interests in NorTex LLC from Falcon. Compl. ¶ 13; *Tide Natural Gas Storage*, 2011 U.S. Dist. LEXIS 111532, at *5.

5. After the Hopper Litigation was settled, Falcon informed Tide that the condition to the release of the Escrowed Money had been satisfied and requested that Tide provide release instructions for disbursement of the Escrowed Money. Tide refused to provide release instructions and instead, on August 2, 2010, Tide filed an action in the Southern District of New York against Falcon, Arcapita Bank and non-debtor Arcapita Inc., alleging "fraud in the inducement," intentional misrepresentations, and breach of contract in connection with the purchase and sale of securities (the "***District Court Action***"). Compl. ¶¶ 41-75; *Tide Natural Gas Storage*, 2011 U.S. Dist. LEXIS 111532, at *2.

[6] A copy of the Purchase Amendment is annexed as ***Exhibit 2*** to Appendix.
[7] A copy of the Escrow Agreement is annexed as ***Exhibit 3*** to the Appendix.

6. On August 29, 2012, Tide filed proofs of claim against Arcapita Bank and Falcon based on the same damages alleged in the District Court Action [Claim Nos. 295-298]. Pursuant to section 510(b) of the Bankruptcy Code, the Debtors' proposed Plan treats the Tide Claims as subordinated to all other claims or interests of Falcon and Arcapita Bank and classified the Tide Claims in Classes 10(a) and 10(g). *See* Plan § 4.10; Disclosure Statement § V.H.1.

THERE CAN BE NO DISPUTE THAT THE TIDE CLAIMS MUST BE SUBORDINATED; ONLY THE LEVEL OF SUBORDINATION IS IN DISPUTE

A. Section 510(b) Applies to the Tide Claims

7. Because the Tide Claims are for breach of contract and fraud arising from the purchase of Falcon's LLC membership interests in the Debtors' affiliate, NorTex LLC, the Tide Claims must be subordinated pursuant to the plain language of section 510(b) of the Bankruptcy Code.

8. Section 510(b) of the Bankruptcy Code provides for mandatory subordination of claims for damages arising from the purchase of a security:

> [A] claim arising from rescission of a purchase or sale of a security of the debtor or of 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 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.

11 U.S.C. § 510(b).

9. The Second Circuit has "interpret[ed] section 510(b) broadly" to require subordination of any claim arising from the purchase or sale of securities, regardless of the legal theory upon which the claim is based. *Rombro v. Dufrayne (In re Med Diversified, Inc.)*, 461 F.3d 251, 259 (2d Cir. 2006) (subordinating claim for fraudulent inducement and breach of contract arising from the purchase of securities); *see also In re Motor Liquidation Co*., 2012 WL 398640, at *3 (S.D.N.Y. Feb. 07, 2012) (plaintiff's fraudulent inducement and fraudulent retention claims based on his purchase of GM stock "fall squarely within the scope of § 510(b)

and were properly subordinated by the Bankruptcy Court"); *In re WorldCom, Inc*., 329 B.R. 10 (Bankr. S.D.N.Y. 2005) ("To summarize, the debtors' objection . . . to Merck's claim for damages based upon the allegation that it 'was fraudulently induced to purchase and retain holdings in WorldCom, causing Merck damages of at least $850,000 . . . ' is unarguably within the scope of Section 510(b) of the Bankruptcy Code. In accordance with that provision, Merck's damage claim must be subordinated."); *see also Tekinsight.Com, Inc. v. Stylesite Marketing, Inc. (In re Stylesite Marketing, Inc.)*, 253 B.R. 503, 510 (Bankr. S.D.N.Y. 2000) (section 510(b) prevents a claimant from avoiding subordination by asserting a constructive trust over funds paid for a security even when claims are based on fraud in the inducement). Liability based on fraud is relevant only to the amount of the claim and not the priority of the claim.

10. LLC membership interests fall within the broad definition of "securities" subject to the application of section 510(b). *See* 11 U.S.C. § 101(49); *Alfa, S.A.B. de C.V. v. Enron Creditors Recovery Corp. (In re Enron Creditors Recovery Corp.)*, 422 B.R. 423, 435 (Bankr. S.D.N.Y. 2009) (citing *In re Grafton Partners, L.P. v. Circle Trust F.B.O.*, 321 B.R. 527, 531–32 (9th Cir. BAP 2005)) (membership interest in an LLC is a security under section 101(49) of the Bankruptcy Code); *USA Capital Realty Advisors, LLC v. USA Capital Diversified Trust Deed Fund, LLC (In re USA Commercial Mortgage Company)*, 377 B.R. 608, 620 (9th Cir. BAP 2007) (holding that section 510(b) applies to claim based on purchase of LLC membership interest).

11. Thus, because the Tide Claims are based on alleged fraud and breach of contract arising from Tide's purchase of Falcon's LLC membership interests in NorTex LLC, section 510(b) clearly applies.

B. Section 510(b) Applies to a Claim Against a Parent/Debtor Arising From the Purchase of a Security in a Non-Debtor Subsidiary

12. The fact that the Tide Claims against Falcon and Arcapita Bank arise from the purchase of LLC membership interests in their non-debtor affiliate does not alter the application of section 510(b). Where the claim against a debtor arises from the purchase of an equity interest in an affiliate of the debtor, the claim against the debtor must be subordinated. *See In re VF Brands, Inc.*, 275 B.R. 725, 730 (Bankr. D. Del. 2002). Further, where the alleged damages are based on the purchase of equity interests in an affiliate of more than one debtor, the related claims against any debtor must be subordinated to all other claims and interests in each debtor. *Lernout & Hauspie Speech Prods., N.V. v. Baker (In re Lernout & Hauspie Speech Prods., N.V.)*, 264 B.R. 336, 344 (Bankr. D. Del. 2001). This means here that the Tide Claims against both Falcon and Arcapita Bank are subject to subordination pursuant to section 510(b).

13. In *VF Brands*, the creditor's claim against the parent/debtor was based on damages arising from the creditor's purchase of all of the common stock in the debtor's wholly-owned subsidiary. *In re VF Brands, Inc.*, 275 B.R. at 726. Just as Tide has argued, the creditor argued that if its claim were against the subsidiary, and if the subsidiary were in bankruptcy, then its claim should be subordinated to other claims against the subsidiary. *Id.* at 727. Like Tide, the creditor also argued that its claim against the debtor should be structurally senior to equity interests in the debtor because the creditor never purchased any shares of the debtor. *Id*. The court rejected the creditor's arguments and held that, because the creditor's claim against the debtor arose from the purchase of the subsidiary's common stock, section 510(b) applied to the claim against the debtor, and the claim against the debtor should be subordinated to the level of the debtor's equity interests. *Id.* at 730. Because the claim was based on the purchase of common stock, the *VF Brands* court did not address whether the claim would have been further subordinated had it been based on the purchase LLC membership interests.

14. In *Lernout*, the claimants purchased stock only in the parent corporation. *In re Lernout & Hauspie Speech Prods., N.V.*, 264 B.R. at 340. When the parent and subsidiary both filed bankruptcy, the claimants asserted fraud claims against both debtors. *Id.* at 338. The debtors argued that, because the claims were based on the stock of the parent, all claims should be allowed only at the parent level and then subordinated to the claims against the parent/debtor. *Id.* at 341. The court applied the clear language of section 510(b), treated the claims against the parent and the subsidiary separately, and the court subordinated claims against the parent to the parent's creditors and the claim against the subsidiary to the subsidiary's creditors. *Id.* at 344. *See also Liquidating Trustee Comm. of the Del Biaggio Liquidating Trust (In re Del Biaggio)*, 2012 WL 5467754, at *5 (Bankr. N.D. Cal. Nov. 8, 2012) ("Courts have held expressly that a damage claim asserted against a debtor concerning a security of an affiliate of the debtor must be subordinated to creditor's claims against the debtor.") (emphasis in original).

15. The above cases make it clear that, if a claim arises from the purchase of a security of the debtor or an affiliate, a claim asserted against any debtor arising from the purchase is controlled by the express language of section 510(b) and must be fully subordinated in the same manner without regard to whether the claim arises from the purchase of the security of the debtor or the debtor's affiliate. Thus, the plain language of section 510(b) applies to subordinate the Tide Claims against both Falcon and Arcapita Bank even though the Tide Claims are based on its purchase of membership interests in the Debtors' affiliate, NorTex LLC.

C. Based on the Express Language of Section 510(b) and the Proper Application of Statutory Interpretation, the "Common Stock" Exception Should Not be Expanded Beyond its Plain Meaning

16. The language of section 510(b) is clear, and but for the final phrase that applies a specific and narrow exception, there would be little dispute as to the treatment of the Tide Claims. After providing that claims for damages arising from the purchase or sale of security shall be subordinated to **all claims** and **all interests** that are senior to or equal the claim or

interest on which the claim is based, section 510(b) then applies one narrow exception to claims based on a particular type of interest. Section 510(b)'s sole exception is plainly worded as follows: "except that if such security is common stock, such claim has the same priority as common stock." 11 U.S.C. § 510(b). Although Congress was certainly aware that securities and interests come in many flavors, many of which are listed in section 101(16) & (49), Congress expressly chose to limit the exception in section 510(b) to common stock without expressing its intent to have the exception apply to interests similar to common stock.

17. To have the common stock exception apply to LLC membership interests, Tide must convince this Court to interpret section 510(b) in a manner utterly inconsistent with the principles of statutory interpretation and in a manner no court, to date, has been willing to do.

18. When interpreting a statute, courts follow the guiding principal that "[w]here . . . the statute's language is plain, the sole function of the courts is to enforce it according to its terms." *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989) (citation and internal quotation marks omitted); *see also Connecticut Nat'l Bank v. Germain*, 503 U.S. 249, 253-54 (1992) ("We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there."). The Supreme Court has also stated that "[i]f Congress enacted into law something different from what it intended, then it should amend the statute to conform it to its intent. 'It is beyond our province to rescue Congress from its drafting errors, and to provide for what we might think . . . is the preferred result.'" *Lamie v. U.S. Trustee*, 540 U.S. 526, 542 (2004) (quoting *United States v. Granderson*, 511 U.S. 39, 68 (1994) (concurring opinion)); *see also Patterson v. Shumate*, 504 U.S. 753, 760 (1992) (party seeking to defeat plain meaning of Bankruptcy Code text bears an "exceptionally heavy burden").

19. The "common stock exception" was added to section 510(b) through the Bankruptcy Amendment and Federal Judgeship Act of 1984, Pub. L. No. 98–353, 98 Stat. 333,

41 (1984). Prior to the modification, section 510(b) required all claims arising from the purchase or sale of a security to be subordinated below the security on which the claim was based—without exception. *See* 11 U.S.C. § 510(b) (1978). Because Congress chose to add only one limited exception, the principal of *unius est exclusio alterius* requires the Court to interpret the exception narrowly. *See TRW Inc. v. Andrews*, 534 U.S. 19, 28 (2001) (where Congress enumerates a specific exception, "additional exceptions are not to be implied, in the absence of evidence of a contrary legislative intent"); *United States v. Brockamp*, 519 U.S. 347, 352 (1997) ("explicit listing of exceptions" to running of limitations period considered indicative of Congress' intent to preclude "courts [from] read[ing] other unmentioned, open-ended, 'equitable' exceptions into the statute").

20. The Supreme Court has also instructed that "[w]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Kucana v. Holder*, 558 U.S. 233, 249 (2010) (citation and internal quotation marks omitted). Here, Congress created the defined term "equity security" and defined it broadly to include:

> (A) share in a corporation, whether or not transferable or denominated "stock", or similar security;
>
> (B) interest of a limited partner in a limited partnership; or
>
> (C) warrant or right . . . to purchase, sell or subscribe to a share, security, or interest of a kind specified in subparagraph (A) or (B) of this paragraph.

11 U.S.C. § 101(16);[8] *see* 101(49) (defining "security").

21. Within the definition of "equity security," Congress understood that "stock" is a limited term and does not generally apply to partnerships or other unincorporated entities. As evidenced by section 101(16)(A) and its use of the additional language—"or similar security"—to expand the definition of "equity security," Congress knew how to expand the meaning of

[8] The definition of "equity security" has not changed since it was drafted by Congress in 1978. *Compare* 11 U.S.C. § 101(16) *with* 11 U.S.C. § 101(15) (1978).

"common stock" to business combinations other than incorporated entities, but it expressly chose not to do so. Instead of using the more expansive term "equity security" in section 510(b), Congress instead chose to use the limited term "stock" and further limited the exception to "common stock" without any further qualifier such as "or similar security." Based upon the express words chosen by Congress, and those that could have been used, but were not, it would be inconsistent with the canons of statutory interpretation to conclude that Congress intended anything other than what it expressly said or to interpret the common stock exception in section 510(b) to apply to LLC membership interests, limited partnership interests or other unincorporated entities.

22. If Congress intended something different than what it expressly said, it has had ample opportunity to amend section 510(b), but it has not done so. Congress has amended other sections of the Bankruptcy Code at least five times since the amendments in 1984; however, Congress has made no change to the common stock exception in section 510(b). *See, e.g.*, Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3088 (1986); Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994); Religious Liberty and Charitable Donation Protection Act of 1998, Pub. L. No. 105-183, 112 Stat. 517 (1998); Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005); Bankruptcy Technical Corrections Act of 2010, Pub. L. No. 111-327, 124 Stat. 3557 (2010).

23. Even if the Court were to determine that Congress likely erred in failing to exclude LLC interests from the operative phrase in section 510(b), it would still be improper for the Court to read in additional exceptions to the statute. Creating additional exceptions "would result 'not [in] a construction of [the] statute, but, in effect, an enlargement of it by the court, so that what was omitted, presumably by inadvertence, may be included within its scope.'" *Lamie*, 540 U.S. at 538 (quoting *Iselin v. United States*, 270 U.S. 245, 251 (1926)). "With a plain,

nonabsurd meaning in view, [courts] need not proceed this way." *Id.*; *Iselin*, 270 U.S. at 251 ("To supply omissions transcends the judicial function."). Therefore, the Court should determine that the common stock exception does not apply to LLC membership interests. As discussed below, the cases that have expressly addressed this issue agree.

D. The Legislative History of Section 510(b) and Subsequent Case Law Are Consistent with its Plain Meaning

24. The Ninth Circuit Bankruptcy Appellate Panel ("***BAP***") in *USA Commercial Mortgage Company* confronted the exact issue of the application of the "common stock" exception in section 510(b) to LLC membership interests and engaged in an in-depth analysis of the statute and its legislative history. In *USA Commercial Mortgage Company*, certain investors who purchased LLC membership interests in USA Capital Diversified Trust Deed Fund, LLC ("***Diversified***") filed proofs of interest on account of the LLC membership interests and also filed proofs of claim for damages suffered as a result of those purchases. *In re USA Commercial Mortg. Co.*, 377 B.R. at 611. Just like the Tide Claims, the investors' claims were based on breach of contract and fraud arising from their purchase of the Diversified LLC membership interests. *Id.* The Official Committee of Equity Holders objected to the investors' proofs of claim as duplicative of their proofs of interest, and the bankruptcy court disallowed the investors' claims. *Id*. at 613. On appeal, in a unanimous opinion of the Ninth Circuit BAP authored by Judge Barry Russell, the BAP reversed, holding that the proofs of claim were not duplicative of the proofs of interest, but the claims were subject to mandatory subordination pursuant to section 510(b) of the Bankruptcy Code. *Id*. at 621.

25. The BAP then addressed the level to which the investors' claim should be subordinated and, after an analysis of the plain language of the statute and its history, determined that the investors' claims should be subordinated "**to a level beneath all membership**

interests." *Id*. at 620 (emphasis added). The court found that the language of section 510(b) was "plain on its face" and, therefore, mandated that result. *Id.* at 617.

26. With respect to the legislative history, the court noted that the House Report to the Bankruptcy Reform Act of 1978 had phrased section 510(b) to state that "[i]f the security is an equity security, the damages or rescission claim is subordinated to all creditors and **treated the same as the equity security itself**." *Id.* at 618 (quoting H.R. Rep. No. 95-595, at 359 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6315) (emphasis added). However, as the court correctly identified, the version of section 510(b) ultimately enacted required subordination to "'all claims or interests that are **senior or equal** to the claim or interest represented by the security.'" *Id.* at 617 n.7 (quoting 11 U.S.C. § 510(b) (1978)) (emphasis added). Because Congress rejected the language in the House Report, the court came to "the firm conclusion that, except where the Code directs otherwise, Congress intended that claims subordinated under [section] 510(b) be subordinated to a level below the priority of the securities upon which the claims are based." *Id.* at 618.

27. The BAP in *USA Commercial Mortgage Company* reasoned that its decision was reinforced by the common stock exception added in 1984 and that because Congress created such a limited exception, "Congress did not intend for [section] 510(b) to subordinate claims based on securities other than common stock (*i.e.*, limited partnership interests) to a level on par with those securities." *Id.* at 619. Moreover, "[w]hile Congress likely did not specifically have LLC membership interests in mind when enacting either the Bankruptcy Reform Act of 1978 or the Bankruptcy Amendments and Federal Judgeship Act of 1984 [because LLCs were new creations at the time], this does not change the fact that, under the plain meaning of [section] 510(b), [claims arising from the purchase of LLC membership interests] would be subordinated below the priority of [the debtor's equity interests], not given an equal priority with them." *Id.*

28. The *USA Commercial Mortgage Company* court's interpretation of the common stock exception is consistent with the decisions of courts in other contexts, which have consistently held that the term "stock" does not include LLC membership interests.[9] *See*, *e.g.*, *Gilmore v. Gilmore*, 2011 WL 3874880, at *5 (S.D.N.Y. Sep. 1, 2011) (distinguishing LLC membership interests from stock); *Robinson v. Glynn*, 349 F.3d 166, 173 (4th Cir. 2003) (holding that LLC interests are not "stock" because "the term 'stock' refers to a narrower set of instruments with a common name and characteristic"); *Nelson v. Stahl*, 173 F. Supp. 2d 153, 166 (S.D.N.Y. 2001) (holding that LLC membership interests are not "stock" and, instead, analyzing whether LLC membership interests constituted "investment contracts"); *Great Lakes Chemical Corp. v. Monsanto Co*., 96 F. Supp. 2d 376, 389 (D. Del. 2000) (analyzing whether LLC membership interests constituted "investment contracts" because, although LLC membership interests "are 'stock-like' in nature, [they] are not traditional stock").

29. The *USA Commercial Mortgage Company* decision determined that common stock does not include LLC membership interests, even though it acknowledged that the resulting "effect of subordination may be functionally equivalent to disallowance *(i.e*., no distribution on the claims)." *In re USA Commercial Mortg. Co.*, 377 B.R. at 620. In over 20 years since LLCs have become common place and are frequently debtors in Chapter 11 proceedings, and in the almost six years since the decision in *USA Commercial Mortgage Company*, Congress has not acted to amend section 510(b) to include LLC membership interests in the common stock exception or to otherwise expand the common stock exception.

30. Because the bankruptcy court in *USA Commercial Mortgage Company* had initially disallowed the investors' claims, the confirmed chapter 11 plan had not provided for

[9] The issue most frequently arises in the context of interpreting the Securities Act of 1933 and the Securities Exchange Act of 1934, which have similar definitions of "security" as the Bankruptcy Code. *Compare* 15 U.S.C. § 77b(a)(1) *and* 15 U.S.C. § 78c(a)(10) *with* 11 U.S.C. § 101(49). While the definitions include many of the same undefined terms (*e.g.*, stock, bond, debenture, etc.), and the case law interpreting those terms is therefore instructive, the Bankruptcy Code definition of "security" is "significantly broader." *In re Enron Creditors Recovery Corp.*, 422 B.R. at 434.

subordination of the investors' claims, and an adversary proceeding was required to obtain subordination. Fed. R. Bankr. P. 7001(8). Accordingly, the Equity Committee subsequently filed an adversary proceeding seeking subordination of the investors' claims, and based on section 510(b), the bankruptcy court entered a judgment subordinating the investors' claims to a level below all other membership interests. *USA Capital Diversified Trust Deed Fund, LLC v. Margaret B. McGimsey Trust (In re USA Commercial Mortgage Co.)*, Case No. 07-01165 (LBR) (Bankr. D. Nev. Jun. 13, 2008).

31. Like the investors in *USA Commercial Mortgage Company*, the Tide Claims are also based on alleged damages arising from the purchase and sale of securities in the form of LLC membership interests. As explained above, it is of no moment that the Tide Claims arise from the purchase of the NorTex LLC membership interests rather than equity securities in the Debtors—section 510(b) operates to subordinate the Tide Claims against both Arcapita Bank and Falcon alike. Accordingly, the Tide Claims must be subordinated below other equity interests in Arcapita Bank and Falcon and are, therefore, properly classified in Classes 10(a) and 10(g) of the Plan.

32. In its consideration of the proper application of the common stock exception to a claim based on limited partnership interests, the Fifth Circuit reached the same conclusion as the court in *USA Commercial Mortgage Company*. *See SeaQuest Diving, LP v. S&J Diving, Inc. (In re SeaQuest Diving, LP)*, 579 F.3d 411 (5th Cir. 2009). In *SeaQuest* the debtors initiated an action to subordinate the claim filed by a former limited partner of the debtor based on a prepetition judgment for rescission of the limited partner's purchase of Class A limited partnership shares of the Debtor. *Id.* at 416. The bankruptcy court held that the claim should be subordinated pursuant to section 510(b). *Id*. On appeal, the Fifth Circuit affirmed, determined that based on the express language of section 510(b) the common stock exception did not apply,

and it held that the claim "must be subordinated to all claims that are senior to or equal [the claimant's] Class A limited partnership interest." *Id*. at 418.

33. The provisions of section 510(b) speak for themselves, and the courts that have directly considered the issue have found that LLC membership interests are not included within the meaning of "stock," and the common stock exception in section 510(b) simply has no application to claims based on limited partnership interests, LLC membership interests or anything other than common stock.

IT IS PROCEDURALLY PROPER TO SUBORDINATE THE TIDE CLAIMS THROUGH THE DEBTORS' CHAPTER 11 PLAN

34. In Tide's objections to the Disclosure Statement [Docket Nos. 898-99], it objected to the subordination of the Tide Claims through the Plan and argued that the Debtors must file a separate adversary action. This Court overruled Tide's objection and held that the Debtors may seek subordination of the Tide Claims through the Plan and without filing a separate adversary action. This Court's ruling was absolutely correct.

35. Section 1123(b)(6) of the Bankruptcy Code provides that a plan may "include any other appropriate provision not inconsistent with the applicable provisions of this title." 11 U.S.C. § 1123(b)(6). Bankruptcy Rule 7001(8) provides that an adversary proceeding is not necessary if a "chapter 11 . . . plan provides for subordination." Fed. R. Bankr. P. 7001(8); *see also In re Washington Mut., Inc*., 462 B.R. 137, 145 (Bankr. D. Del. 2011) ("An adversary proceeding is only required for claim subordination if subordination is not provided for under a chapter 11 plan."); *In re Best Prods. Co., Inc.*, 168 B.R. 35, 65 (Bankr. S.D.N.Y. 1994) ("Objectants' procedural argument that I may deal with . . . subordination only in the context of an adversary proceeding is simply wrong").

36. Hence, consistent with section 1123(b)(6) and Bankruptcy Rule 7001(8), the Plan provides for subordination of the Tide Claims as stated in Section 4.10 of the Plan and as further discussed in Section V.H.1 of the Disclosure Statement.

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Respectfully submitted,

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