GIBSON, DUNN & CRUTCHER LLP
Michael A. Rosenthal (MR-7006)
Craig H. Millet (admitted *pro hac vice*)
Jeremy L. Graves (admitted *pro hac vice*)
Matthew G. Bouslog (admitted *pro hac vice*)
200 Park Avenue
New York, New York 10166-0193
Telephone: (212) 351-4000
Facsimile: (212) 351-4035

Attorneys for the Debtors and Debtors in Possession

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' REPLY MEMORANDUM OF LAW IN SUPPORT OF SUBORDINATION OF THE TIDE CLAIMS

INTRODUCTION: SUBORDINATION IS A GIVEN; ONLY THE LEVEL OF PRIORITY IS IN DISPUTE

Tide's Opposition has narrowed the issues and makes clear that certain matters are not in dispute:

(i) The underlying facts are undisputed, and there are no material issues of fact pertinent to the determination of the subordination issues.

(ii) Section 510(b) applies, and the Tide Claims against both Arcapita and Falcon must be subordinated; however, the final level of priority is in dispute.

(iii) Tide does not dispute the procedure of subordinating a claim through a plan of reorganization.

In addressing the level of priority of the Tide Claims against Falcon and Arcapita, Tide does not cite any authority addressing claims based on securities other than common stock, and Tide dismisses or ignores the appellate level cases that have addressed subordination of claims based on securities other than common stock. Instead, Tide cites to a handful of bankruptcy level cases that each applied a very different and contorted approach to "interpret" section 510(b). Nevertheless, the cases generally arrive at the same result. However, none of those cases addressed securities such as the NorTex LLC membership interests and none support treating the Tide Claims represented by "such security" at a level other than at the common stock level of Arcapita and Falcon, before subordinating the Tide Claims to all Claims senior to or equal to the Tide Claims.

ARGUMENT

A. This Court Should Rely on the Statute Rather Than Trying to Reconcile the Divergent Analyses of the Case Law

The application of section 510(b) is comparatively straight forward when "such security" on which the claim is based is a security of the same debtor against whom the claim is asserted. Before the 1984 amendment to section 510(b), claims arising from the purchase or sale of a

security were required to be subordinated below the security on which the claim was based—without exception. After the amendment, the "common stock" exception provided that the level of subordination would be equal to, rather than below, the common stock class. However, the application of section 510(b) becomes more complex when the claim against the debtor is based on the purchase of a security of the debtor's affiliate or when securities other than common stock are involved. Here, there is no common or clear approach, and the bankruptcy courts have struggled to identify the "claim or interest represented by such security" to be subordinated, leading to divergent and tortured interpretations of the statute. However, where the security is common stock, despite pursuing different paths, the cases tend to get to the same result: a claim based on the common stock of an affiliate is treated in the common stock class of the debtor. The Debtors do not quarrel with the results in those cases, as far as they go. However, those cases do not address claims based on securities other than common stock.

Failing to extend the application of the common stock exception to securities other than common stock may lead to arguably inequitable result, but expanding the common stock exception to apply the alleged perceived intent of Congress would force an extreme interpretation of the statute. As illustrated in the Debtors' opening brief, Congress has had ample opportunity to revise and clarify section 510(b) but has elected not to do so. Professor Georgakopoulos (cited by Tide[1] and the *National Farm*[2] and *VF Brands*[3] opinions) also acknowledges the dilemma and notes that "at least twice an attempt was made to pass a corrective amendment" to section 510(b) to prevent claims from being "excessively subordinated." Nicholas L. Georgakopoulos, *Strange Subordinations: Correcting Bankruptcy's § 510(b)*, 16 Bankr. Dev. J. 91, 98 (1999). However, as Professor Georgakopoulos also notes, "[n]o corrective attempt has succeeded." *Id*. Thus, until

[1] Tide Opp. ¶ 23.
[2] *In re National Farm Financial Corporation*, 2008 WL 410236, at *4 (Bankr. N.D. Cal. Feb. 12, 2008).
[3] *In re VF Brands, Inc.*, 275 B.R. 725, 729 (Bankr. D. Del. 2002).

Congress acts, it cannot be argued that Congress intended anything other than the strict application of section 510(b).

The material difference in the positions urged by the Debtors and Tide is that the Debtors argue that this Court should adopt a resolution that applies section 510(b) as written and that is consistent with the conclusion of the appellate level courts that have considered it. Remedying potential inequities should be left to Congress. Relying on the inconsistent reasoning of bankruptcy court level decisions alone, Tide argues that this Court should interpret section 510(b) to arrive at a result contrary to its plain language and contrary to any actual holding in the cases cited by the Debtors or Tide.

B. Although They Pursue Different Paths, the Cases that Apply Section 510(b) to Claims Based on the Common Stock of an Affiliate Achieve the Same Result

As demonstrated in the Debtors' opening brief, it is beyond dispute that a claim against a debtor arising from the purchase of its affiliate's securities is subject to subordination. *See* Debtors' Opening Brief ¶¶ 12-14; *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). However, the courts have pursued divergent approaches in analyzing the proper treatment of such claims.

1. *In re Lernout & Hauspie Speech Products, N.V.*

In 2001, the bankruptcy court in Delaware addressed the application of section 510(b) to claims against a subsidiary debtor based on the common stock held by the claimant in the parent. *Lernout & Hauspie Speech Prods., N.V. v. Baker (In re Lernout & Hauspie Speech Prods., N.V.)*, 264 B.R. 336 (Bankr. D. Del. 2001).

In *Lernout*, the claimants merged their company into a subsidiary ("LH Holdings") of parent Lernout & Hauspie Speech Products, N.V. ("LH Parent") and received common stock in LH Parent. *In re Lernout & Hauspie Speech Prods., N.V.*, 264 B.R. at 338-39. When LH Parent and LH Holdings both filed bankruptcy, the claimants asserted fraud and rescission claims against both debtors. *Id.* at 338. The key issue addressed by the *Lernout* court was how to treat the claim against LH Holdings based on the securities held by the claimants in LH Parent and whether the claim "followed the security." *Id.* at 340-41.

The *Lernout* court found that the claim against LH Holdings based on the claimants' common stock of LH Parent must be subordinated to the general unsecured creditors of LH Holdings. *Id.* at 343. In doing so, the *Lernout* court reasoned that, although the claimants "do not hold an equity security position in [LH] Holdings [that fact] does not preclude the treatment of their claim against [LH] Holdings in pari passu with the existing common stock of [LH] Holdings." *Id*. Notably, the court treated the claim against LH holdings based on the common stock of its affiliate LH Parent pari passu with LH Holding's common stock, and not in an intermediate class between creditors and holders of common stock.

2. *In re VF Brands, Inc.*

Only a year after the *Lernout* decision, the bankruptcy court in Delaware addressed the issue of the application of section 510(b) to claims against a parent based on the common stock of a subsidiary. Although agreeing that claims against multiple affiliated debtors represented by the security of one affiliate are subject to subordination as to each affiliate/debtor, the *VF Brands* court pursued an analysis very different from *Lernout* to determine the appropriate level of priority. *In re VF Brands, Inc*., 275 B.R. at 727. Nevertheless, the *VF Brands* decision reached the very same result with respect to a claim based on the common stock of a debtor's affiliate, holding that such claim has the same priority as the common stock of the debtor. *Id.* at 730.

In determining the proper level of subordination, the *VF Brands* court did not cite any supporting authority, and it did not analyze the part of section 510(b) providing that the reference point for subordination is the "claims . . . represented by such security." *Id.* at 727. Instead, the court simply assumed that the starting reference point for a securities-related claim is a general unsecured claim, and it held that the securities-related claim at issue should be subordinated below other general unsecured claims. *Id.* The court then concluded, without any analysis of the common stock exception, that because the claim was based on common stock, the claim would be given the same priority as common stock. *Id.*

The *VF Brands* court's use of general unsecured claims as a starting reference point is unusual, and its analysis has not been followed by other courts. In fact, the court's analysis conflicts with the Tenth Circuit's interpretation of section 510(b), which states that the proper reference point is the security on which the claim is based. *See Allen v. Geneva Steel Co. (In re Geneva Steel Co.)*, 281 F.3d 1173, 1177 (10th Cir. 2002) ("In 1984, Congress amended [section 510(b)] to make clear that fraud claims springing from the purchase or sale of common stock are treated on the same level as common stock. **All other claims are subordinated to their underlying security**.").

Based on the *VF Brands* court's analysis, Tide argues that the common stock exception in section 510(b) is an operative phrase used to affirmatively subordinate, rather than as a back-stop for common stock to prevent further subordination. Tide Opp. ¶ 29. Tide further argues that in the absence of the common stock exception, the claim "would have remained between general unsecured claims and [the Debtor's] interests." *Id.* However, the *VF Brands* court makes no reference to an intermediate class manufactured to be between general unsecured creditors and common stock. Instead, the court simply determined that because the claim was based on common stock, "it will be given the same priority as common stock." *In re VF Brands*, 275 B.R. at 727. Moreover, Tide's interpretation of section 510(b) runs contrary to the legislative intent behind the

inclusion of the common stock exception in section 510(b). *See* S. Rep. No. 98-65, at 79 (1983) ("[The 1984 amendment] makes clear that the subordination of a rescission **claim for stock cannot be below the common stock class**.") (emphasis added). Tide's position is also contradicted by the decision in *Lernout, National Farm*, and other cases.

3. *In re National Farm Financial Corp.*

Tide also cites *In re National Farm Financial Corp.*, 2008 WL 410236 (Bankr. N.D. Cal. Feb. 12, 2008), as supporting the analysis of *VF Brands*. However, *National Farm* did not apply the analysis of *VF Brands* and instead applied the "follow the security" approach rejected by *Lernout.* Quite the opposite of *VF Brands*, *National Farm* did not merely assume that, before subordination under section 510(b), a claim against a parent/debtor represented by a breach in the sale of any security of the debtor's affiliate is an unsecured claim.

In *National Farm*, the debtor corporation owned 100 percent of the common stock of a domestic insurance company. *In re Nat'l Farm*, 2008 WL 410236, at *1. After the debtor breached an agreement to sell its shares in the subsidiary insurance company, the purchaser obtained a judgment against the debtor and its directors. *Id.* Post-petition, a motion was made for the appointment of a trustee based upon debilitating conflicts between creditors and the debtor. *Id.* In opposing the motion, the debtor argued against any debilitating conflicts because the judgment creditor's claim should be subordinated to the level of the debtor's equity pursuant to section 510(b). *Id.* at *3. In ultimately granting the motion to appoint a trustee and, as to section 510(b), in a discussion that is purely dicta, the court discussed the subordination issues, but emphasized that it did "not at this time rule finally on the merits of the [subordination issues], or find that every aspect of those positions is wholly without merit." *Id.* at *5.

Rather than assume that, before subordination, the claim against a debtor based on a security of an affiliate was an unsecured claim, the *National Farm* court concluded that the "such

security" language in section 510(b) means that the claim against the debtor "follows the security and has the same priority as the security that gave rise to the claim." *Id.* at *4.

In *National Farm*, because the sale of the subsidiary insurance company had not closed and it was solvent, the subsidiary's common stock still represented an asset of the debtor; therefore, the court determined that the claim against the debtor could not be subordinated to the extent of the debtor's equity in the subsidiary. *Id*. However, the *National Farm* court reasoned that if the subsidiary was not solvent and, hence the parent's interest in the subsidiary had no value, then "the claim would be subordinated at the parent level," and the claim would have "the priority of the subsidiary's common stock." *Id.* n. 3 (emphasis added) (citing *In re VF Brands, Inc.*, 275 B.R. at 727). Phrased differently, the *National Farm* court determined that, before subordination under section 510(b), if the debtor's subsidiary is insolvent or the debtor has no interest in the subsidiary, then any resulting claim against the parent/debtor "represented by such security" is at the level of the debtor's equity class. Section 510(b) then subordinates that claim to all claims senior to or equal to that claim "represented by such security," unless the claim is based on common stock.

Although the analyses differ, the common theme in cases like *Lernout*, *VF Brands*, and *National Farm* is that a claim against a debtor based upon the common stock of an affiliate is treated in the class of common stock at the debtor. However, none of these cases considered the application of section 510(b) to securities other than common stock, such as LLC membership interests and limited partnership interests. Those cases that have considered the subordination of claims based on securities other than common stock have subordinated those claims **below** the level of the equity class.

C. As the Appellate Level Cases Make Clear, the Debtors' Position Is Well Grounded in the Plain Language of Section 510(b)

Relying only on disparate bankruptcy court level cases, Tide dismisses or ignores the only appellate level cases that have addressed the application of section 510(b) to a security other

than common stock. Tide appears to contend that it is irrelevant that "such security" here is an interest in an LLC and not common stock. But the appellate cases that have addressed a security other than common stock disagree.

Tide fails to address at all the Fifth Circuit decision in *SeaQuest Diving, LP v. S&J Diving, Inc. (In re SeaQuest Diving, LP)*, 579 F.3d 411, 418 (5th Cir. 2009), where the court found that based on the plain language of the statue, the common stock exception did not apply to a subordinated claim based on the sale of Class A limited partnership interests. Accordingly, the court determined that the claim "must be subordinated to all claims that are senior to or equal [the claimant's] Class A limited partnership interest." *Id*.

Just like the creditors in *USA Commercial Mortgage*, Tide "confuse[s] the oft-stated rationales for § 510(b) for what the statute actually says." *USA Capital Realty Advisors, LLC v. USA Capital Diversified Trust Deed Fund, LLC (In re USA Commercial Mortg. Co.)*, 377 B.R. 608, 620 (9th Cir. BAP 2007). Section 510(b) clearly states that claims "shall be subordinated to all claims or interests that are senior to or equal to the claim or interests **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) (emphasis added).

"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." *In re USA Commercial Mortg.*, 377 B.R. at 619. "While 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.* Subordinating below the priority of the claim represented by such security is appropriate even if

the "effect of subordination may be functionally equivalent to disallowance *(i.e*., no distribution on the claims)." *Id.* at 620. "This adverse treatment carries serious implications for investors, because a Chapter 11 reorganization plan, as is the case here, may deny distributions to entire classes of inferior security interests." *In re Geneva Steel Co*., 281 F.3d at 1177.

Other cases are equally in accord. *See, e.g.*, *In re Geneva Steel Co*., 281 F.3d at 1177 ("In 1984, Congress amended [section 510(b)] to make clear that fraud claims springing from the purchase or sale of common stock are treated on the same level as common stock. **All other claims are subordinated to their underlying security**.") (emphasis added); *In re NAL Fin. Group, Inc.*, 237 B.R. 225, 234 (Bankr. S.D. Fla. 1999) (claim based on purchase of debentures subordinated to creditors and to same level of priority as equity security holders).

D. Under Any Analysis, the Tide Claims Represented By "Such Security" Have the Priority of the Debtors' Common Stock and Then Are Subordinated

Here, the securities that gave rise to the Tide Claims were the NorTex LLC membership interests purchased by Tide. It is undisputed that the NorTex LLC membership interests represented materially all of the assets of Falcon. Therefore, purchasing or holding 100% of the NorTex LLC membership interests was materially the same as purchasing or holding 100% of the equity of Falcon. NorTex LLC is no longer an asset of the Falcon or the Arcapita estates, and there is no equity in NorTex LLC owned by Falcon or Arcapita to which the Tide Claims may attach. Furthermore, the proceeds of the sale of the NorTex LLC membership interests do not represent an equity interest in NorTex LLC to which Tide's claim may attach. *See 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).

Therefore, any claim represented by "such security" arising from the purchase of nearly 100% of the assets of Falcon (the NorTex LLC membership interests) is materially the same as purchasing or holding the equity of Falcon, and the claim at Falcon (or Arcapita) should, in the first instance, be deemed to be at the Debtors' equity level. Applying subordination, the Tide Claims should then be subordinated to all Claims senior to or equal to that Claim, unless "such security" was common stock. Because the securities here are not common stock, the Tide Claims should be subordinated below the Falcon and Arcapita equity Classes.

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Respectfully submitted,

/s/ Craig H. Millet

Michael A. Rosenthal (MR-7006)
Craig H. Millet (admitted *pro hac vice*)
Jeremy L. Graves (admitted *pro hac vice*)
Matthew G. Bouslog (admitted *pro hac vice*)
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