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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

HOPPER PARTIES POST-HEARING BRIEF ON SUBORDINATION AND LIFT STAY MATTERS (Relates to Docket No. 279)

John M. Hopper, Edmund A. Knolle, Jeffery H. Foutch, Keith L. Chandler, The Estate of Steven B. Toon, deceased, Thomas B. Wynne, Jr., Steven Jenkins, Tamara Jenkins, Dianne G. Foutch, Lesli Paige Leonard, Sally H. Hopper, Ellecia A. Knolle, Michelle P. Foutch, Deborah J. Toon, Rachel Ann Chandler, Daniel Leonard, and Alexander Cocke Trust, (collectively, the "Hopper Parties"), file this Response to Tide's Brief on Subordination Issues (the "Response") and show the Court as follows:

Background

1. On or about March 15, 2010, Falcon Gas Storage Co., Inc. ("Falcon") signed a purchase agreement by which it agreed to sell all of NorTex's assets to Tide's affiliates. Before

that sale closed, the Hopper Parties filed two lawsuits in Texas against Tide, Falcon, and others, to enjoin the NorTex sale, because, the Hopper Parties alleged, the Falcon officers and directors had breached their fiduciary duties to the Hopper Parties, and had agreed to sell the valuable NorTex assets at a price well below fair market value.

2. To persuade the Texas courts to not enjoin the sale, Tide and Falcon represented to the Courts and to the Hopper Parties that they would put $70 million of the sale consideration in escrow to compensate the Hopper Parties should they be successful on their claims.

3. On April 1, 2010, Tide and Falcon executed an Escrow Agreement with HSBC Bank USA ("HSBC"), and Tide paid $70 million (the "Escrowed Money") of the $515 million sale price into escrow with HSBC. Accordingly, on April 1, 2010, the NorTex sale closed.

4. In July 2010, the Hopper Parties agreed to settle their Texas cases for $14,750,000, payable in two installments. The first installment was paid at closing and the second installment of $8.25 million was to be paid out of the Escrowed Money. On July 27, 2010, the Hopper Parties executed the Settlement Agreement and General Release with Falcon and others (the "Settlement Agreement"). Tide received drafts of the Settlement Agreement before it was executed and the Settlement Agreement provides for a release of Tide by the Hopper Parties.

5. On August 2, 2010, Tide filed an action in federal court in the Southern District of New York (the "District Court"), against Falcon for damages Tide alleges it incurred from alleged false representations and failures to disclose by Falcon in connection with the Purchase Agreement and from alleged breaches of certain representations and warranties Falcon made in the Purchase Agreement (the "Federal Court Action").

6. August 2, 2010 was the first time the Hopper Parties were provided or had notice of Tide's claims against Falcon.

7. On April 12, 2012, the Hopper Parties filed a Motion to Intervene in the Federal Court Action. Tide initially opposed the Motion to Intervene, but after the Falcon bankruptcy case was filed, Tide has stated that it no longer opposes the Hopper Parties' intervention in the Federal Court Action.

8. On April 30, 2012, Falcon filed its chapter 11 petition, and on May 16, 2012, United States District Judge Kimba Wood stayed the Federal Court Action.

9. On May 21, 2012, the Hopper Parties filed their complaint in this Court initiating Adversary Proceeding No. 12-01662 alleging that $8.25 million of the Escrowed Money belongs to the Hopper Parties (the "Hopper Adversary").

10. On June 25, 2012, Tide filed its motion to lift the automatic stay.

11. On December 13, 2012, Falcon filed its motion for leave to amend its answer in the Hopper Adversary to include a counterclaim and cross-claim against Tide that the Escrowed Funds are property of the estate under § 541 of the Bankruptcy Code.

12. Tide opposes Falcon's motion for leave to amend.

Argument

1. Subordination of the Hopper Parties' Claims Is Not Appropriate

13. At the hearing on these matters on January 16, 2013, Tide argued that if its claims are subject to mandatory subordination under § 510(b) of the Bankruptcy Code then so are the Hopper Parties' claims. Tide repeated the argument in its post-hearing brief, and the Hopper Parties are compelled to respond to Tide's allegations.

14. At the January 16, 2013, hearing the Court responded to Tide's argument and noted that the Hopper Parties' claims are in fact different than Tide's claims. The Court was correct and the Court's view is supported by case law from this district.

15. Tide contends that the Hopper Parties' claims fit within § 510(b) and quotes a portion of the Hopper Parties' proofs of claim. Tide fails to state, however, that the Hopper Parties' collective $8.25 million claim stems not from their prior ownership of the NorTex assets, but from the Settlement Agreement in which their equity interests were cancelled and replaced by a promise to pay a certain and limited sum of money. This critical distinction removes the Hopper Parties' claims from the mandatory subordination of § 510(b).

16. Judge Gropper in *In re CIT Group Inc.*, 460 B.R. 633 (Bankr. S.D.N.Y. 2011) *aff'd with summary order,* 479 F. App'x 393 (2d Cir. 2012) was confronted with an even closer case of mandatory subordination than the one at bar. That case stemmed from Tyco's former ownership of the debtor, CIT. Tyco divested itself of its interest in CIT through a merger transaction and as a key part of the consideration for the transaction, Tyco was to receive a payment from CIT under a tax agreement (the "Tax Agreement') based on the tax savings CIT would realize from the carry-forward of Tyco's net operation losses ("NOL"). *Id.* at 636. The Tax Agreement was executed at the time of the merger and CIT was required to pay Tyco based on a formula derived from the tax savings CIT would receive by utilizing Tyco's NOL carryforward. *Id.* Importantly, Tyco did not retain any interest in CIT's future equity value or in its management. *Id*. at 641. Judge Gropper described the transaction as Tyco contracting for the "status as a creditor and not a holder of equity." *Id.* at 639.

17. In his ruling, Judge Gropper relied on the Second Circuit's decision in *Rombro v. Dufrayne (In re Med Diversified),* 461 F.3d 251 (2d Cir. 2006). In that case, the issue was

whether a claim for fraudulent inducement and breach of contract for failure to issue stock in the debtor was one "arising from" an agreement to purchase or sell a security. *Id.* at 254. The Second Court held that the term "arising from" the purchase or sale of a security could be read broadly, as encompassing the transaction at issue there, or narrowly, as excluding the contract claim of the plaintiff. *Id.* at 256–57. The Second Circuit held that the intent and purpose of § 510(b) would have to be reviewed in order to construe the phrase "arising from" and apply it to the facts of the case. *Id.* at 255.

18. The Second Circuit found that Congress enacted § 510(b) so that claims would be subordinated if the claimant "(1) took on the risk and return expectations of a shareholder, rather than a creditor, or (2) seeks to recover a contribution to the equity pool presumably relied upon by creditors in deciding whether to extend credit to the debtor." *Id.* at 256. The claimant in *Med Diversified* took on the "risk and return expectations of a shareholder" because he "bargained not for cash but to become a stockholder in the debtor. . . . [H]e became bound by the choice he made to trade the relative safety of cash compensation for the upside potential of shareholder status . . ." *Id.*

19. Judge Gropper then applied the rationale behind § 510(b) to Tyco's claim and found that it was not "arising from" a purchase or sale of a security.[1] He found that the critical difference between a creditor's claim and an investor's interest is that a creditor can only recover her investment while an investor expects to participate in profits. *CIT Group, Inc.*, 460 B.R. at 640. The Tax Agreement, which was the genesis of Tyco's claim, did not provide a recovery to Tyco consistent with the expectations of an equity holder. *Id.*

[1] Tide only alleges that the Hopper Parties' claims are "arising from" a purchase or sale of securities. There is no question that the Hopper Parties' claim does not arise from the rescission of a purchase or sale of a security, or for reimbursement or contribution under § 502.

20. In addressing Congress's first policy for mandatory subordination under § 510(b), Judge Gropper determined that Tyco's claim:

> [a]rises from a Tax Agreement that provides for payments in the future based on a variable metric, but it does not include an interest in the firm's future equity value or management. When the Tax Agreement is viewed as a whole, with both the tax indemnification rights for CIT and the TCH NOL reimbursement rights for Tyco, it resembles an exchange as part of a corporate sale with consideration being paid over time and in to-be-determined amounts. Although the amount owed to Tyco under the Tax Agreement was based on CIT's future revenues and thus on financial metrics that might correlate with share price, Tyco could not have expected a return similar to that of shareholders, who as the residual owners of a corporate enterprise are entitled to share in profits *with no limitation.*

Id. at 641 (emphasis in original).

21. The Settlement Agreement among the Hopper Parties and Falcon not only "resembles" an "exchange as part of a corporate sale with consideration being paid over time" that is exactly what it is. The Hopper Parties exchanged all indicia of equity ownership for a fixed consideration payable in two installments. The first of those two installments has been paid; the second, for $8.25 million, has not.

22. The Hopper Parties' case is even easier than the *CIT* case. CIT argued that Tyco's claim should be subordinated because (1) Tyco's potential upside was undefined, and (2) Tyco's payments, if any, were dependent on CIT's future revenues. *Id*. at 640. Even though those arguments were not successful, the Hopper Parties' claims are not undefined, and the second payment (the $8.25 million) does not depend on Falcon's future revenues.

23. The second policy reason behind § 510(b) mandatory subordination, creditor reliance on the equity investment, also is not implicated by the Hopper Parties' claims. Like Tyco in the *CIT* case, the Hopper Parties ceased to be shareholders after the sale. Thus, creditors, if any, could not have relied on the Hopper Parties' previous investment because it no longer existed.

24. The *CIT* case is not an anomaly. Other cases in the Southern District of New York and in other jurisdictions also refuse to apply mandatory subordination when former shareholders trade their equity interests for creditor claims. *See Nisselson v. Softbank AM Corp. (In re MarketXT Holdings Corp.),* 361 B.R. 369, 388–90 (Bankr. S.D.N.Y. 2007) (mandatory subordination not appropriate when claim was based on fixed amount pursuant to state court default judgments on defaulted promissory notes, even though the claimant originally held preferred stock and original consideration was the liquidation preference of the stock); *Official Comm. Of Unsecured Creditors v. Am. Capital Fin. Servs., Inc. (In re Mobile Tool Int'l, Inc.),* 306 B.R. 778, 782 (Bankr. D. Del. 2004) (claims for payment on promissory notes issued as consideration in stock repurchase agreements not subject to mandatory subordination under § 510(b)); *In re Wyeth Co.*, 134 B.R. 920 (Bankr. W.D. Mo. 1991) (claims of former shareholder under promissory notes issued to buy back former shareholder's company stock not subject to mandatory subordination under § 510(b)).

25. Accordingly, the Hopper Parties' claims are not subject to mandatory subordination under § 510(b) of the Bankruptcy Code.

2. <u>Automatic Stay Should Not Be Lifted for 541 and 510(b) Issues</u>

26. While the Court may be inclined to lift the automatic stay to allow Judge Wood to determine whether Tide has a claim in this case, and, if so, what the amount of that claim should be, the stay should not be lifted for any other purpose. Contrary to Tide's argument at the hearing, Judge Wood never considered any bankruptcy related issues such as whether the escrowed funds are property of Falcon's estate under § 541 of the Bankruptcy Code, or whether Tide's claims, if any, should be subordinated under § 510(b). The reason is simple and logical--these bankruptcy cases did not exist when her rulings were issued.

27. What was at issue is determined by the pleadings of the parties. Tide's Complaint in no way raises the issue of who owns the escrowed funds. *See* Tide Exhibit 2, pp. 16, 18, 19. 24, and 25. Tide argues that its denial of Falcon's First Cause of Action which seeks a declaration "that [Falcon] is entitled to the immediate disbursement of all funds remaining in the Escrow Account" puts the property of the estate issue before Judge Wood. First, Tide's denial of Falcon's cause of action is not tantamount to a claim of *ownership* of the funds. Nowhere does Tide claim that it owns the funds in the escrow account and nothing in Judge Wood's decisions address ownership of the funds, and she certainly did not address ownership in the context of § 541 because the bankruptcies had not yet been filed.

28. Judge Wood only ruled that Tide's allegations of fraud in the inducement (which only survived the motion stage) excused Tide from complying with the mandate of the Escrow Agreement that it "shall" provide notice to the HSBC to release the funds to Falcon. That is all.[2] Judge Wood repeatedly found, and Tide admitted as much in open court, that the underlying Escrow Breakage Trigger conditions had occurred. Saying that an allegation of fraud, if proven, excuses Tide from performing an obligation under the Escrow Agreement is a far cry from holding that the escrowed funds belong to Tide.

29. Nor did Falcon put the ownership of the escrowed funds in issue. Few references were found in all of Falcon's pleadings in which it alleged that the funds "belonged" to Falcon. The parties were focused on the distribution of the funds, not on ownership. Falcon claimed to

[2] Judge Wood's placing "conditions" in quotes in her footnote 7 can only mean that the ministerial act (so-called by Judge Wood), i.e. the "condition", of Tide's providing notice to HSBC did not occur and was excused by virtue of the alleged fraud. In the text prior to footnote 7 Judge Wood acknowledges, and it was admitted by Tide, that the Escrow Breakage Trigger conditions had occurred. Tide Exhibit 8, p. 11 ("Tide acknowledges that the Escrow Breakage Triggers have been met . . .") and at p. 12 ("In the case before the Court, however, the conditions for the release of the escrowed funds contained in the agreement have been met . . . Nevertheless, Tide argues that fraud in the inducement of the contract means it should not be required to perform its obligations.")

be entitled to the "immediate disbursement" of the funds because the Escrow Breakage Trigger conditions had been satisfied--and there was no dispute that they had. Nothing in Falcon's claim to be entitled to the immediate payment of the funds in the escrow agreement, and Tide's denial of such claim, implicated a decision by Judge Wood as to the ownership of the escrowed funds.

3. Tide, In Effect, Is Seeking a Constructive Trust

30. Even though it never pleaded for the relief in the District Court or in this Court, Tide in essence is seeking a constructive trust on the funds in the escrow account. The effect of a constructive trust in bankruptcy is "profound," because it removes the trust *res* from the bankruptcy estate and "places its beneficiary ahead of other creditors with respect to the trust *res*." *Cadle Co. v. Mangan (In re Flanagan*), 503 F.3d 171, 180–81 (2d Cir. 2007); *accord In re Ades & Berg Group Investors*, 550 F.3d 240, 245 (2d Cir. 2008); *In re First Cent. Fin. Corp.*, 377 F.3d 209, 217–18 (2d Cir. 2003). The *Flanagan* court explains the issue this way: "It is ... not the debtor who generally bears the burden of a constructive trust in bankruptcy, but the debtor's general creditors. This type of privileging of one unsecured claim over another clearly thwarts the principle of ratable distribution underlying the Bankruptcy Code." *Flanagan*, 503 F.3d at 182; *accord Ades & Berg*, 550 F.3d at 245 ("[R]etention by the bankruptcy estate of assets that, absent bankruptcy, would go to a particular creditor is not inherently unjust."). Tide's strategy in this Court is to use Judge Wood's decisions to effectively obtain a constructive trust over property of the estate. Tide never pleaded for such relief, and in any event, now that Falcon is a chapter 11 debtor, this Court would be better positioned to determine whether the Escrowed Money is property of the estate, or whether a constructive trust should be applied. *See Brenner v. Heller (In re Lincoln Logs Ltd.),* No. 11-CV-481, 2011 U.S. Dist. LEXIS 137072 (N.D.N.Y. Nov. 29, 2011) ("In remanding, this Court expressly declined to address the Brenners'

alternative argument for the imposition of a constructive trust, stating that [Chief United States Bankruptcy] Judge Littlefield was in the best position to consider the equities of the matter.").

31. The Hopper Parties contend that the Court should not lift the automatic stay to allow anything more than the allowance and quantification of Tide's claim to proceed in the District Court. Allowing the District Court to determine issues of property of the estate under § 541 and subordination under § 510(b) would be tantamount to giving a report and recommendation to the District Court to withdraw the reference of the Falcon bankruptcy case. If that is this Court's intention then it should make a report and recommendation to the District Court and let her decide which issues should be decided in this Court versus in the District Court.

32. Based on the foregoing, the Hopper Parties respectfully request that the Court grant Falcon's motion for leave to amend its answer, and deny Tide's motion to lift the stay to allow the District Court to decide any issues except for the allowance and quantification of Tide's unsecured claim in the Falcon bankruptcy case.

Dated: February 1, 2013
New York, New York

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