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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' SUPPLEMENTAL BRIEF REGARDING
SUBORDINATION OF TIDE'S CLAIM

1. Arcapita Bank B.S.C.(c) ("***Arcapita Bank***"), and Falcon Gas Storage Company, Inc. (*"**Falcon**"*), hereby responds to Tide's Brief on Subordination Issues related to Falcon's Motion for Leave to File Counterclaim and Third Party Claims (the "***Motion to File Claims***") [Docket No. 11 in Adv. Proc. No. 12-01662 (SHL)] and the Debtors' Objection to Tide's Motion to Lift the Automatic Stay (the "***Objection***") [Docket No. 354].[1]

I. TITLE AND SUBORDINATION ISSUES ARE INDEPENDENT OF THE ISSUES PENDING IN THE DISTRICT COURT ACTION

2. Tide misstates Falcon's position. To be clear, Falcon contends that subordination is intertwined with the determination of whether the Escrowed Money is property of the Falcon estate and arose for the first time upon the filing of the Falcon bankruptcy case. Neither issue was relevant to the District Court Action prior to Falcon's bankruptcy filing. These intertwined issues may be resolved independent of any determination of fraud and may be decided by this Court based on the terms of agreements and undisputed facts even assuming, for purpose of the analysis only, that Falcon in fact committed fraud.

3. It is beyond dispute that Tide's claims against Falcon and Arcapita Bank must both be subordinated under section 510(b) of the Bankruptcy Code; only the level of subordination is in issue. The determination of the level to which Tide's claims, in any amount, must be subordinated under section 510(b) may obviate the need to liquidate Tide's claims if its claims are subordinated below equity. Contrary to Tide's claims, the cases cited by Tide in open court and in its Supplemental Brief actually support the subordination of Tide's claim below all interest in Falcon and Arcapita Bank. *See* ¶ 13 below.

4. Tide also misstates the nature of the District Court Action. Prior to Falcon's bankruptcy case, the District Court Action presented a two-party dispute. The issue of who held title to the Escrowed Money, and as of when, was not relevant to the claims alleged and, but for Falcon's bankruptcy filing, title issues would never have become relevant. In the District Court's rulings on the pleadings as to the immediate release of the Escrowed Money, the District Court found that, although all parties agreed that the Escrow Breakage Trigger had occurred,

[1] All capitalized terms not otherwise defined in this Supplemental Brief shall have the meanings set forth in the Motion to File Claims and Objection.

there was an issue of fact as to whether Tide was excused, by Falcon's alleged fraud, from taking the final ministerial step of instructing HSBC to release the Escrowed Money. This finding pertained only to the release of the Escrowed Money and not to what event(s) must occur under the controlling agreements to cause title to vest in Falcon. As New York law makes clear, vesting of title of funds in escrow and the release of those funds are two different issues. The mere fact that the funds remain in escrow does not mean the grantor holds title to those funds. *See* ¶ 9 below.

5. As quoted in the Reply, the District Court held that the "***conditions for the release of the escrowed funds contained in the agreement have been met*** . . . ." Rep. at 14. In the same opinion, however, the District Court determined that, accepting the facts plead as true, Tide's performance (*i.e.*, providing escrow release instructions) may have been excused based on Tide's allegations that Falcon committed fraud and, at that time, it would not be appropriate to release the Escrowed Money. *Tide v. Falcon*, 2011 U.S. Dist. LEXIS 111532, at *44 (S.D.N.Y. Sep. 28, 2011). The District Court did *not* hold that, assuming the facts plead are proven, Tide and not Falcon holds title to the Escrowed Money and, therefore, title would be decided based on the adjudication of the fraud claims.

6. The practical effect of the District Court's ruling was that the Escrowed Money would remain in escrow and, as between Tide and Falcon alone, the Escrowed Money would be available to satisfy any liability Falcon may owe Tide. As between Tide and Falcon, as long as the Escrowed Money was *available* to satisfy any liability of Falcon to Tide, it did not matter whether Falcon or Tide held title to the Escrowed Money or when Falcon may have acquired title. If the District Court were to find that Falcon's fraud excused Tide from instructing HSBC to release the Escrowed Money and Tide was not in breach of the Escrow Agreement, the District Court would then have no reason to decide if title to the Escrowed Money nevertheless vested in Falcon, or if so, when. Unless and until the claims of third parties to Falcon's assets intervened, whether Tide or Falcon held title to the Escrowed Money was not relevant to any "case or controversy" actually at stake in the District Court Action.

7. As of Falcon's bankruptcy filing, everything changed. Falcon now represents the interests of all constituents of its estate and their rights as to Falcon's assets. Although not previously relevant in a dispute solely between Tide and Falcon, the issues of whether Tide or the Falcon estate holds title to the Escrowed Money, and as of when, are new and important issues that have arisen solely because of Falcon's bankruptcy case. These new issues should be decided by the Bankruptcy Court and may be decided without the need to decide whether Falcon committed fraud.

8. Claimants have often attempted to use fraud allegations to avoid subordination by claiming that, due to fraud, the consideration paid did not become property of the estate or that the claimant held a lien on the property transferred. A damage claim relating to an equity purchase induced by fraud does not entitle the claimant to a priority recovery by recovering the consideration transferred to the debtor thereby avoiding section 510(b) and obtaining a preference over other creditors. *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 seeking a constructive trust over funds even when claims are based on fraud in the inducement); *In re WorldCom, Inc.*, 329 B.R. 10, 17 (Bankr. S.D.N.Y. 2005) (subordinated claim for fraud in the inducement in connection with purchase of debtor's stock); *Silliman v. Murla (In re United Funding Mortg. Corp.)*, 478 B.R. 492, 496 (Bankr. D. Ga. 2012) (subordinated claims of stockholders whose claims were based on fraud in the inducement). Liability for fraud is relevant only to the amount of the claim and not whether the claimant or the debtor holds title to the consideration transferred or the priority of the related claim.

9. When and whether the debtor acquired title to funds held in escrow is determined by the express terms of the contract between the parties. If the contract does not specify a transfer of title earlier, title will remain with the grantor until the occurrence of the condition specified in the escrow agreement. But "the deposit of property placed in escrow creates in the grantee such an equitable interest in the property that ***upon full performance of the conditions according to the escrow agreement, title will vest at once in*** **[*the grantee*]**. *Hassett v. Blue Cross and Blue Shield of Grater New York (In re O.P.M. Leasing Servs., Inc.)*, 46 B.R. 661, 667

(Bankr. S.D.N.Y. 1985) (emphasis added) (quoting 28 Am. Jur. 2d Escrow § 10 (1964)); *Musso v. N.Y. State Higher Educ. Servs. Corp. (In re Royal Business School, Inc.)*, 157 B.R. 932, 940 (Bankr. E.D.N.Y. 1993) (quoting *In re O.P.M. Leasing*). The mere fact that funds in escrow have not been released is not the determining fact as to title. *See In re Atlantic Gulf Cmtys. Corp.*, 369 B.R. 156, 169 (Bankr. D. Del. 2007) (applying New York law, title vested upon satisfaction of the escrow conditions notwithstanding the escrow term requiring the counterparty's instruction to escrow to release funds and its refusal to consent).

10. In this case, the title issues may be resolved based on the terms of plain agreements and undisputed facts. The agreements expressly state that title to the Escrowed Money passed to Falcon upon the closing of the NorTex Sale. *See* Rep. at 11. But if title did not pass at that point, it passed upon the occurrence of the Escrow Breakage Trigger. *See* Rep. at 10-11. Either way, even if not released from the escrow, Falcon holds title to Escrowed Money, and it is property of its estate. Importantly, if this Court were to rule in Falcon's favor, such a ruling would not contradict the District Court because the District Court never resolved any issue relating to title. Again, the District Court found only that the Escrowed Money should not be released; it did not resolve which entity has title to the Escrowed Money.

11. Falcon is not seeking to expend the Escrowed Money and Falcon is happy to leave the funds in escrow or in a "blocked account" subject to the further order of this Court until Tide's claims are liquidated. However the resolution of the threshold title and subordination issues will define what is at stake in liquidating Tide's claim, will focus the issues and will likely lead to an earlier and less expensive resolution.

12. Falcon seeks the opportunity to *quickly* place these issues before the Bankruptcy Court for determination, either in the Hopper Adversary Proceeding or in a separate adversary proceeding. If Falcon is correct as to title, then whether Tide was excused from giving the instruction to HSBC – the issue before the District Court – is no longer important and the District Court may determine if Falcon is liable for fraud or breach of contract subject to the damage limitations in the Purchase Amendment. However, if this Court determines that title to the Escrowed Money was held by Tide and would only be transferred to Falcon when Tide gave the

release instruction to HSBC, then whether Falcon committed fraud and whether Tide was excused from giving the escrow instruction may be decided by the District Court.

II. SUBORDINATION IS A GIVEN; ONLY THE LEVEL OF SUBORDINATION IS IN DISPUTE

A. A Claim Against a Parent/Debtor Based on the Purchase of an Interest in a Non-Debtor Subsidiary Does Not Alter the Application of Section 510(b)

13. The cases which Tide says are controlling support, rather than undermine, Falcon's position. A claim for damages arising from the "purchase or sale of a security . . . of an affiliate of the debtor . . . shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security . . . ." 11 U.S.C. § 510(b). As the cases cited by Tide hold, where the claim arose from the purchase of an equity interest in an affiliate of the debtor, a related claim *against the debtor* must be subordinated. *See In re VF Brands, Inc.*, 275 B.R. 725, 730 (Bankr. D. Del. 2002); *In re Wisconsin Barge Line, Inc.*, 76 B.R. 142, 144 (Bankr. E.D. Mo. 1987). Where, as here, the claim is based on the security of 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 estate. *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).

14. In *VF Brands*, the creditor's claim against the parent/debtor was based on damages resulting from the creditors' 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 like Tide, 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 and interests against the subsidiary. *Id.* at 727. But, the creditor argued that its claim against the debtor should be senior to equity interests in the debtor because the creditor never purchased any shares of the debtor. *Id*. The court rejected the argument and held, because the creditor's claim against the debtor was based on the purchase of the subsidiary's common stock, 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.

15. Similarly, in *Wisconsin Barge* the claimant purchased all of the common stock of the debtor's two subsidiaries and later asserted a claim for fraud against the parent/debtor based on alleged misrepresentations in connection with the sale. *In re Wisconsin Barge Line, Inc.*, 76 B.R. at 143. The claimant argued that its claim against the parent/debtor should not be subordinated because the subsidiary was no longer an "affiliate" of the debtor on the date of the parent/debtor's bankruptcy petition. *Id.* at 144. The court subordinated the claim to all other claims and to the same level as common stock in the debtor. *Id.* at 145. Again, *Wisconsin Bridge* did not address subordination of claims relating to the purchase of LLC membership interests.

16. 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 subordinated claims against the parent to the parent's creditors and the claim against the subsidiary to the subsidiary's creditors. *Id.* at 344.

17. All of the above cases make it clear that, if a claim derives from the purchase of a security of the debtor or an affiliate, a claim asserted against any debtor is controlled by the express language of section 510(b) and is fully subordinated in the same manner without regard as to whether the claim is based on the purchase of the security of the debtor or the debtor's affiliate. Hence, (i) the plain language of section 510(b) applies to Tide's claims against Arcapita Bank and Falcon even though Tide's claims are based on its purchase of membership interests in NorTex; and (ii) based on the plain language of section 510(b), the "common stock" exception does not apply, and Tide's claims should be subordinated below all equity interests in both Falcon and Arcapita Bank. *USA Capital Realty Advisors, LLC v. USA Capital Diversified Trust Deed Fund, LLC (In re USA Commercial Mortgage Company)*, 377 B.R. 608, 611 (9th Cir. BAP 2007).

B. Tide's Cases Support the Subordination of Tide's Claims Against Falcon and Arcapita Bank *Below* All Claims and Equity Interest

18. As the decision of the BAP in *USA Capital Realty Advisors* expressly recognized, a claim based on the purchase of an interest other than common stock, must be subordinated below equity of the debtor against whom the claim is asserted, even if that effectively disallows the claim. *Id.* at 620 (recognizing that "the effect of subordination under § 510(b), if established, may be functionally equivalent to disallowance"). Tide contends that the holding in *USA Capital Realty Advisors* "runs contrary to numerous other subordination cases," but cites only two cases—***neither of which supports its argument***. Indeed, one case that Tide admits is controlling strongly supports the Debtors' position.

19. Tide contends that *SeaQuest Diving, LP v. S&J Diving, Inc. (In re SeaQuest Diving, LP)*, 579 F.3d 411 (5th Cir. 2009), contradicts *USA Capital Realty Advisors*. However, like the BAP in *USA Capital Realty Advisors*, the Fifth Circuit applied the express language of section 510(b) and did not apply the "common stock exception" to a claim based on limited partnership interests. In *SeaQuest* the debtors initiated an action to subordinate the claim of a former limited partner of the debtor based on a prepetition judgment for rescission of its purchase of Class A limited partnership shares. *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, finding 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 (emphasis added). Therefore, the *SeaQuest* decision fully supports the analysis of the BAP in *USA Capital Realty Advisors*. The provisions of section 510(b) speak for themselves, the common stock exception at the end of section 510(b) simply has no application to claims based on limited partnership interests or LLC membership interests, like Tide's. In the several years since *USA Capital Realty Advisors* and *SeaQuest*, Congress has not acted to amend section 510(b).

20. Tide also contends that the holing in *In re Alta+Cast, LLC*, 301 B.R. 150 (Bankr. D. Del. 2003), conflicts with *USA Capital Realty Advisors.* However, in *Alta+Cast*, the court's order simply stated, without any discussion, that a former employee's claim based on the debtor's failure to repurchase his ownership interest should be subordinated pursuant to sections

510(a) and (b) to a level equal to other equity interests *Id.* at 155. The court did not address whether the claim should be subordinated to a level below other ownership interests, and it was not raised by the parties. *See Memorandum of Law in Support of Debtor's Motion to Subordinate Claims*, 2003 WL 23964978 [Docket No. 176]; *Memorandum of law of Mark Hays in Support of Hays's Objections to Debtor's Motion*, 2003 WL 23964981 [Docket No. 180]. However, under the debtor's plan, holders of equity interests received no distribution and, hence, once subordinated, the level of subordination was irrelevant. *See Disclosure Statement with Respect to Second Amended Plan of Reorganization of Alta+Cast, LLC* at § 3.6.7, 2003 WL 2590992 [Docket No. 181]. The practical effect of the holding in *Alta+Cast* is entirely consistent with *USA Capital Realty Advisors*.

III. IF RELIEF FROM STAY IS GRANTED, THIS COURT SHOULD PROVIDE GUIDANCE TO THE DISTRICT COURT

21. The Debtors submit that the stay should remain in place until this Court can determine, based on the written agreements and undisputed facts and even assuming fraud is proven excusing Tide from giving the release instruction to HSBC, whether title to the Escrowed Money became vested in Falcon pursuant to the occurrence of the condition(s) set forth in the Purchase Agreement, Purchase Amendment and Escrow Agreement. This Court can also address subordination and the impact of the *USA Capital Realty Advisors* and *SeaQuest* cases, which raise purely an issue of law.

22. However, if this Court is still inclined to grant relief from stay, then the District Court will have to confront issues that were not relevant when the District Court Action represented only a two-party case. As explained above, since the filing of the Falcon bankruptcy case, the rights of all of Falcon's creditors to property of the Falcon estate are now involved. This Court recognized the changed circumstances now presented by the bankruptcy case when it advised the parties that, if relief from stay is granted and even if the District Court rules for Tide, the parties should return to the Bankruptcy Court before any further disposition of the Escrowed Money.

23. The District Court may not appreciate the issues that, although not important before, have become important upon the bankruptcy filing and, for example, the important

distinction between who holds title to the Escrowed Money as compared to, no matter who holds title, whether and when the Escrowed Money should be released. Therefore, if relief from stay is granted, the District Court is likely to need some guidance as to what is now needed to resolve the bankruptcy issues. Therefore, if this Court enters and order granting relief from stay, the Debtors respectfully request that the order include a request that the District Court make findings as to the following:

A. Under the terms of the First Amendment to Purchase Agreement and Escrow Agreement, did title to the Escrowed Money vest in Falcon at the closing of the NorTex Sale?

B. If the answer to the foregoing is "No," without regard to the release of the Escrowed Money, was the Escrow Breakage Trigger the condition specified in the First Amendment to Purchase Agreement and Escrow Agreement, the occurrence of which would cause title to the Escrowed Money to vest in Falcon?

C. If the answer to the foregoing is "No," what was the condition specified in the First Amendment to Purchase Agreement and Escrow Agreement, the occurrence of which would cause title to the Escrowed Money to vest in Falcon?

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February 1, 2013

Respectfully submitted,

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