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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**
IN RE:	§	
	§	**Chapter 11**
FALCON GAS STORAGE CO., INC.	§	
	§	**Case No. 12-11790-shl**
Debtor.	§	**(Jointly Administered under**
	§	**Case No. 12-11076)**

TIDE'S MEMORANDUM OF LAW IN OPPOSITION TO SUBORDINATION OF TIDE'S CLAIMS AS PROPOSED IN THE DEBTORS' JOINT PLAN

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TO THE HONORABLE SEAN H. LANE
UNITED STATES BANKRUPTCY JUDGE:

Tide Natural Gas Storage I, LP and Tide Natural Gas Storage II, LP (together, "Tide"),[1] by their undersigned counsel, hereby file this Memorandum of Law In Opposition to Subordination of Tide's Claims as Proposed in the Debtors' Joint Plan. In support thereof, Tide respectfully submits as follows:

I. SUMMARY OF ARGUMENT

1. The issue before the Court is the extent that Tide's Claims should be subordinated for the purposes of distribution of Falcon's interest, if any, in the $70 million currently held in escrow. That $70 million is the subject of the District Court Action pending before Judge Wood.

2. If confirmed, the Debtors' Joint Plan would disallow all of Tide's Claims by subordinating them to every claim and interest in each of the Debtors. The result: Tide Claims would be bypassed entirely—even if Judge Wood finds that the claims are valid—and the Escrow Funds would be upstreamed to Arcapita's creditors even though those funds were the fruits of fraud. That result is contrary to the plain reading of § 510(b), case law, and Congress's intent. Indeed, the Debtors' only support for their remarkable stance is *dicta* from a single case that is factually distinct from this case.

3. A correct reading of § 510(b), as supported by relevant case law, requires that Tide's Claims be subordinated **only** to "claims or interests senior to or equal the claim or interest represented by [the security bought]" by Tide. Because Tide bargained for the purchase of LLC interests in Falcon's wholly-owned subsidiary NorTex (as opposed to the equity in Falcon itself),

[1] Capitalized terms used herein and not otherwise defined shall have the meaning ascribed to them in the Joint Plan and Disclosure Statement.

Tide's general unsecured claims are subordinated in priority to other general unsecured claims against Falcon but are superior to the interests of Falcon's equity (and the upstream claims of Arcapita's creditors), if any, in the Escrow Funds. Further, because Tide purchased LLC interests (as opposed to common stock), the "common stock exception" does not require that Tide's claim be subordinated to the level of Falcon's common stock. Tide's claims are therefore subordinated to other general unsecured claims against Falcon (totaling approximately $390,000),[2] but are ahead of the Interests in Falcon, which ultimately are held by Arcapita.[3]

II. RELEVANT BACKGROUND[4]

4. Tide is the plaintiff in the District Court Action, which is civil action number 10-CIV-5821 (KMW), and is currently pending before Judge Wood in the United States District Court for the Southern District of New York. Falcon, Arcapita, and Arcapita, Inc. are defendants in the District Court Action. The escrow agent, HSBC Bank USA, N.A., is a nominal defendant.

5. The District Court Action arises out of Falcon and its controlling affiliates' misrepresentations to Tide in connection with a half-billion dollar transaction for the sale of a natural gas storage business called "NorTex Gas Storage Company, LLC" ("NorTex").

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[2] The other asserted claims against Falcon are either invalid (see Debtors' omnibus claim objections at Dkt. Nos. 1049 to 1053) and/or subject to subordination below Tide's claims (see Tide's Original Complaint to Subordinate Hopper Claims Pursuant to Bankruptcy Code Section 510(b), filed at Dkt. No. 1 in Adv. No. 13-01355). Falcon has ample assets to satisfy $390,000 in general unsecured claims based on a disclosed tax refund of $3.8 million.

[3] Although this brief focuses on Tide's claims against Falcon and Tide's right to participate in distributions of the $70 million in escrow (to the extent Judge Wood rules Falcon has an interest in the Escrow Funds), the subordination analysis for Tide's claims against Arcapita is the same. With respect to distributions of Arcapita's assets, Tide's claims would be subordinate to Arcapita's general unsecured creditors but ahead of any equity interests in Arcapita.

[4] At the Disclosure Statement Hearing on April 26, 2013, the Court indicated that it would consider the Debtors' proposed subordination of Tide's claims on a Rule 12(b)/Motion to Dismiss basis, meaning that all facts asserted by Tide (including those asserted in the District Court Action) are admitted to be true for the purposes of the Court's analysis (see Transcript, April 26, 2013 Hearing, pp. 55-56).

6. NorTex, formerly a subsidiary of Falcon, is in the business of storing and processing natural gas in and from two underground gas storage facilities located in northern Texas.

7. In March 2010, Tide and Falcon entered into a Purchase Agreement whereby Tide agreed to purchase all of Falcon's interest in NorTex. Tide thereby acquired the entire gas storage business of NorTex. The transaction closed on April 1, 2010. Tide paid Falcon $445 million for the purchase of NorTex. Tide also deposited $70 million into escrow with HSBC Bank USA, N.A., where the funds remain today.

8. In the District Court Action, Tide alleges the following causes of action: (1) Fraud/Fraudulent Inducement; (2) Breach of Express Warranty; (3) Breach of Contract; (4) Violations of § 10 and Rule 10b-5 of the Securities and Exchange Act of 1934; and (5) Request for Injunctive Relief. Tide seeks damages in the District Court Action of approximately $120 million.

9. Arcapita and certain affiliates filed for chapter 11 protection on March 19, 2012.

10. Falcon filed for chapter 11 protection on April 30, 2012.

11. Tide has filed the following proofs of claim based on Tide's causes of action asserted in the District Court Action:

(a) Claim Number 295, filed August 29, 2012, by Tide Natural Gas Storage II LP in the amount of $120 million, against Arcapita Bank B.S.C.(c).

(b) Claim Number 296, filed August 29, 2012, by Tide Natural Gas Storage I LP in the amount of $120 million, against Arcapita Bank B.S.C.(c).

(c) Claim Number 297, filed August 29, 2012, by Tide Natural Gas Storage II LP in the amount of $120 million, against Falcon Gas Storage Company, Inc.

(d) Claim Number 298, filed August 29, 2012, by Tide Natural Gas Storage I LP in the amount of $120 million, against Falcon Gas Storage Company, Inc.

(together, "Tide's Claims").

12. On February 28, 2013, this Court entered an order lifting the automatic stay to allow Judge Wood to determine (1) the relevant rights of Tide, Falcon, and the Hopper Parties to the Escrow Funds, and (2) the merits of Tide's claims in the District Court Action; but the Court retained jurisdiction to determine whether Tide's Claims are subordinate under § 510.

13. On April 25, 2013, the Debtors filed their (i) Second Amended Disclosure Statement in Support of the Joint Plan of Reorganization of Arcapita Bank B.S.C.(c) and Related Debtors under Chapter 11 of the Bankruptcy Code ("Disclosure Statement"), and (ii) Second Amended Joint Plan of Reorganization of Arcapita Bank B.S.C.(c) and Related Debtors under Chapter 11 of the Bankruptcy Code ("Joint Plan"). The Joint Plan consists of several "subplans" including the subplan for Falcon.

14. The Disclosure Statement provides that "to the extent that the Tide Claims are Allowed in whole or in part, then the Tide Claims shall be treated as provided in Classes 10(a) and 10(g)." (Disclosure Statement Art. V(H)(5)). The Joint Plan provides that Classes 10(a) and 10(g) are "Super Subordinated Claims" situated below Interests in Arcapita and Falcon, respectively. Such claims "shall not receive any Distributions or retain any property on account of such Claims." (Joint Plan § 4.10).

15. As noted, the admitted purpose and intent of the proposed treatment[5] is to deny Tide any right to participate in any portion of the $70 million (to the extent Judge Wood rules that Falcon has an interest in the Escrow Funds) so that the Debtors may bypass Tide's Claims (even if allowed by Judge Wood) and distribute the Escrow Funds to Arcapita's creditors (even if Judge Wood rules that the Escrow Funds are the product of the Debtors' fraud).[6]

16. In support of this proposed subordination of Tide's Claims, the Debtors rely on an incorrect reading of § 510(b) and *dicta* from one case (which is, in any event, factually distinguishable from the facts of this case)—*USA Capital Realty Advisors, LLC v. USA Capital Diversified Trust Deed Fund, LLC (In re USA Commercial Mortgage Company)*, 377 B.R. 608 (BAP 9th Cir. 2007). A correct reading of § 510(b), which gives meaning to every word in the provision as written by Congress, and a careful reading of relevant case law, reveals that Tide's Claims are not subject to "super subordination" as suggested by the Debtors nor do they share *pari passu* with the Interests in Falcon.

III. ARGUMENT

A. Section 510(b) Does Not Support The Treatment of Tide's Claims As Proposed Under Debtors' Joint Plan

17. Section 510(b) provides that:

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the

[5] See Joinder of Official Committee of Unsecured Creditors in Support of the Debtors' Memorandum of Law Regarding Subordination of Tide's Claims (proposed treatment provides "potential recoveries that Falcon's equity holders (and consequently the other Debtors' unsecured creditors) stand to receive if and when Falcon recovers the Escrowed Money.")

[6] For the purpose of the Court's analysis, Tide's Claims are are admitted to be valid and the Escrow Funds are admitted to be the product of the Debtors' fraud.

> 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).

18. There is no question that when interpreting a statute, a court should "give effect, if possible, to every clause and word of a statute, avoiding, if it may be, any construction which implies that the legislature was ignorant of the meaning of the language it employed." *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883); *see also United States v. Colasuonno*, 697 F.3d 164, 173 (2d Cir. 2012). Stated another way, statutes, such as the Bankruptcy Code, should be construed "so as to avoid rendering superfluous" any statutory language. *Astoria Federal Savings and Loan Ass'n v. Solimino*, 501 U.S. 104, 112 (1991); *see also United States v. Martinez-Santos*, 184 F.3d 196, 204 (2d Cir. 1999).

19. By arguing that § 510(b) requires "super subordination" of all of Tide's Claims to all claims and interests, the Debtors fail to give effect to the phrase "that are senior to or equal the claim or interest represented by such security" and render that language completely superfluous as it relates to a security of debtor's affiliates. Falcon's proposed interpretation of § 510(b) would effectively rewrite the statute to read as follows:

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security . . . . 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.**

20. This interpretation is inconsistent with the rules of statutory construction promulgated by the United States Supreme Court because, under Debtors' interpretation, all claims and interests would always be senior to the interest represented by a security of an affiliate of the debtor.

21. Furthermore, because Falcon's misinterpretation of § 510(b) would place every claim arising from the sale of an affiliate's security (except those based on common stock) below the level of all claims and interests, "[s]uch a reading of the provision would convert the term 'subordinate', as used in § 510(b), into 'disallow.'" *In re Lernout & Hauspie Speech Products, N.V.*, 264 B.R. 336, 343 (Bankr. D. Del. 2001). But, Congress did not use the term "disallow" in § 510(b); it used the term "subordinated." Congress is familiar with the term "disallow," as Congress used that term throughout § 502 of the Bankruptcy Code. "[W]here Congress includes particular language in one section of a statute but omits it in another …, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Keene Corp. v. United States*, 508 U.S. 200, 208 (1993) (quoting *Russello v. United States*, 464 U.S. 16, 23 (1983)). If Congress wanted to disallow all claims and interests arising from the sale of an affiliate's security (except those based on common stock), Congress would have so provided. However, Congress did not and therefore, this Court should not interpret the section to say that it did.

22. The correct reading of the statute, which gives meaning to each word and respects the fact that Congress "says in a statute what it means and means in a statute what it says there" is provided in *In re National Farm Financial Corp.*, 2008 WL 410236 (Bankr. N.D. Cal. Feb. 12, 2008). That court recognized that the phrase "shall be subordinated to all claims or interest that are senior to or equal the claim or interest represented by such security" is critical. "The 'such security' language in § 510(b) provides that the claim follows the security bought and has the same priority as the security that gave rise to the claim." *Nat'l Farm*, 2008 WL 410236, *4 (Bankr. N.D. Cal. Feb. 12, 2008). This "follow the security" interpretation gives meaning to every word in § 510(b) and is consistent with the "purpose of the statute … to prevent a party

that bargains for the risks and benefits of an equity position in a company from raising itself to parity with the company's creditors when the company becomes insolvent." *Id.* (internal citations omitted).

23. As noted by the court in *National Farm*,

> The subordination of fraud claims seeks to return the priority of sellers common stock to buyers of common stock, in part because they accept the risks inherent in common stock. **The buyers of subsidiary's stock, however, do not accept any of the risks associated with holding stock of its parent**.

Nat'l Farm, 2008 WL 410236 at *4 (quoting Nicholas L. Georgakopoulos, *Strange Subordinations*, 16 Bankr. Dev. J. 91 (1999)) (emphasis added).

24. In this instance, Tide bargained to purchase securities of NorTex, not securities of Falcon. Tide did not accept any risks associated with holding stock of Falcon. Arcapita and its creditors alone bear those risks. Yet, under Falcon's interpretation of § 510(b), Arcapita and its creditors would not only be allowed to bootstrap themselves to a *pari passu* position with Tide's Claims against Falcon, they would take priority over Tide's structurally superior claims. It is logical and consistent that a party with a general unsecured claim arising from an equity transaction should be relegated to the level of its equity. Falcon's position that such a party should be *per se* punished with disallowance is illogical and inconsistent with the text and purpose of the statute.

B. <u>Subordination of Tide's Claim As Proposed Under the Debtors' Joint Plan Is Contrary to Case Law</u>

25. Falcon's position also is contrary to well-established case law, notwithstanding Falcon's reliance on cherry-picked *dicta*. In *VF Brands, Inc.*, for example, the Bankruptcy Court for the District of Delaware considered a factually analogous situation and avoided the absurd result urged by Falcon. *See In re VF Brands, Inc.*, 275 B.R. 725 (Bankr. D. Del. 2002). In that

case, Vlasic Farms, Inc. was a wholly owned subsidiary of the chapter 11 debtor Vlasic Foods International ("VFI"). An investor asserted a proof of claim against VFI, asserting damages based on breaches of a stock purchase agreement between VFI and the investors related to the purchase of the subsidiary stock of Vlasic Farms, Inc.

26. In applying § 510(b), Judge Walrath first determined that the claims of the investors against VFI must be subordinated to claims that were equal to or greater than such claims. *VF Brands*, 275 B.R. at 727. In *VF Brands*, like this case, the asserted claims were general unsecured claims against the parent, and the court found that the asserted claims were equal to other general unsecured claims and therefore, subordinate to general unsecured creditors of the parent.

27. Specifically Judge Walrath noted:

> the subordination that section [510(b)] mandates is to claims that are "senior or equal to" the claims of [claimant]. … In the absence of section 510(b), such a claim would have the same priority as any other general unsecured claim against the parent. Therefore, such a claim is one which is "equal to" the claims of the general unsecured creditors of the parent …. Applying section 510(b) requires that the claim of [claimant] (which is based on damages from the purchase of stock of an affiliate of the Vlasic Debtors) must be subordinated to the claims of the general unsecured creditors of the Vlasic Debtors which in the absence of that section would be equal in priority to its claim.

VF Brands, Inc., 275 B.R. at 726.

28. Notably, however, Judge Walrath did not automatically hold that § 510(b) mandates the subordination of the investors' claims to the level of VFI's equity on the basis that VFI's equity was equal or senior to the securities of VFI's subsidiary. Instead, Judge Walrath ruled that the investors' claims had to share on par with VFI's equity because "section 510(b) provides that if the claim is common stock, it will be given the same priority as common stock." *VF Brands, Inc.*, 275 B.R. at 727.

29. Thus, Judge Walrath used the "common stock" exception to *lower* the priority for subordinated claims based on common stock. The court engaged in a two-step process, first finding that the claims were equal in priority to general unsecured claims and therefore subordinated to general unsecured claims, then finding that the common stock exception forced the claims to be treated equal to common stock of the debtor. *VF Brands, Inc.*, 275 B.R. at 727 ("Further, section 510(b) provides that if the claim is common stock, it will be given the same priority as common stock. Thus we conclude that the [claimants'] claim against the Vlasic Debtors must be treated on the same level as the Vlasic Debtors' shareholder claims are treated."). If not for the common stock exception, the claims would have remained between general unsecured claims and VFI's interests. In this case, the Tide Claims are equal in priority to general unsecured claims and therefore subordinate to general unsecured claims against Falcon (to the extent such claims exist), but are not common stock, which means they are entitled to "follow the security" on which they are based, placing them above the equity interests in Falcon. This is the proper application of § 510(b) in cases involving securities of a debtor's subsidiaries when, as here, the subsidiary is solvent and the parent-debtor receives identifiable proceeds from its equity in the subsidiary.

30. *In re Nat'l Farm Fin. Corp.*, 2008 WL 410236 (Bankr. N.D. Cal. Feb. 12, 2008) further supports this proper application of § 510(b)—that the Tide Claims are entitled to "follow the security." In *Nat'l Farm*, the debtor was a holding company whose only asset was 100 percent of the shares of Business Alliance Insurance Company ("BAIC"), a non-debtor. PSM Holding Corp. ("PSM"), a non-affiliated third party contracted with the debtor to buy the debtor's interest in BAIC. The debtor failed to perform, and PSM was awarded a judgment for damages against the debtor. That judgment drove the debtor to file for chapter 11 protection.

The debtor asserted that the claims of PSM against it should be subordinated to the level of the debtor's common stock pursuant to § 510(b). Likewise, in this case, Falcon is a holding company, whose only asset was the 100% membership interests of NorTex. Tide, like PSM, has a claim against Falcon arising from the sale of equity in a subsidiary. Falcon, like the debtor in *Nat'l Farm*, now seeks to subordinate Tide's claims to the level of Falcon equity (or even beyond that level under the misapplication of "super subordination").

31. In denying debtor's assertion that PSM's claims must be subordinated to the level of equity, the court in *Nat'l Farm* held that § 510(b) requires that a claim arising from the sale of a security must "follow the security", *i.e.*, the claim "has the same priority as the security that gave rise to the claim." *Nat'l Farm*, 2008 WL 410236 at *4. Therefore, in the *Nat'l Farm* case, as in this case, "section 510(b) provides that a claim arising from the purchase of the common stock of Debtor's subsidiary has the same priority as the common stock of Debtor's subsidiary," which means that the Tide Claims can be satisfied from the proceeds of Falcon's equity in NorTex (*i.e.* the Escrow Funds) ahead of the equity interests in Falcon. *Nat'l Farm*, 2008 WL 410236 at *4.

32. Nevertheless, despite this clear case law and the Code's language regarding subordination, and *not* disallowance, Falcon misapplies the reasoning in *USA Commercial Mortgage* to support its spurious proposition that Tide's Claims should be subordinated below the interests of Falcon's common equity holders, and therefore, effectively disallowed. *USA Capital Realty Advisors, LLC v. USA Capital Diversified Trust Deed Fund, LLC (In re USA Commercial Mortgage Company)*, 377 B.R. 608 (BAP 9th Cir. 2007) ("*USA Commercial Mortgage*"). Specifically, a careful reading of the *USA Commercial Mortgage* case shows that critical facts distinguish the claims of the creditor in that case from the claims of Tide in this case

and that the portion of the opinion that the Debtors rely on is mere *dicta*. *See Vasquez v. Strack*, 228 F.3d 143, 150 (2d Cir. 2000) (declining to rely on statements in prior opinion because those statements were *dicta*); *United States v. Banki*, 685 F.3d 99, 107 (2d Cir. 2011) (noting that the court is not bound to follow *dicta*); *Chem One, Ltd. v. M/V Rickmers Genoa*, 660 F.3d 626, 640 (2d Cir. 2011) (*dicta* should not be treated as binding).

33. In *USA Commercial Mortgage*, investors purchased membership interests in USA Capital Diversified Trust Deed Fund LLC ("Diversified"). Diversified was pilfered by its insiders and eventually filed for chapter 11 protection. Certain investors filed proofs of claim against Diversified "based on allegations of breach of contract and fraud relating to their purchase of the membership interests in Diversified." *USA Commercial Mortgage*, 377 B.R. at 608. These same investors also filed proofs of interest in the same aggregate amount of their proofs of claim. *Id.* at 611. The unsecured creditors committee sought to disallow the proofs of claims as duplicative of the proofs of interest. The committee also sought to subordinate the investors' claims "below all membership interests in Diversified." The bankruptcy court disallowed the claims as duplicative and therefore, there was no need to subordinate the claims. *Id*. at 617-18. On appeal, after reversing the bankruptcy court's order disallowing the claims as duplicative and after stating that "§ 510(b) is of limited importance for the purposes of this appeal" because the bankruptcy court disallowed the claims and did not subordinate the claims, the 9th Cir. BAP analyzed the application of § 510(b) in *dicta*. After reviewing the legislative history of § 510(b) and relying on § 510(b)'s "clear language," the 9th Circuit BAP found that the investors' claims should be subordinated "to a level below the priority of the securities upon which the claims are based." *Id*. Consequently, the 9th Circuit BAP found that the investors' claims should be subordinated below Diversified's equity, essentially disallowing the claims. In

so holding, the court acknowledged that subordinating the investors' claims below the Debtors' equity (as opposed to allowing the claims to share on par with equity) had no practical effect on the investors' recovery in the case because their proofs of interest (filed in the same amount as their proofs of claims) already entitled the claimants to "get whatever interest holders get on their proofs of interest." *Id*. at 619. Thus, in using § 510(b), the *USA Commercial Mortgage* Court (and the committee in that case) did so to prevent the investors from receiving a double recovery and not to prevent the investors from obtaining any recovery at all.

34. In addition, unlike the investors in *USA Commercial Mortgage* whose claims were super subordinated because they were based on equity interests of the debtor Diversified, Tide's Claims are *not* based on equity interests of the debtor Falcon. Rather, Tide's Claims are based on the equity interests of NorTex, a non-debtor subsidiary of Falcon. Thus, the *USA Commercial Mortgage* rationale that § 510(b) requires subordination "to a level below the priority of the securities upon which the claims are based" would not serve to move Tide's Claims below Falcon's equity, because that equity is not the basis of Tide's Claims. Tide's claims must "follow the security" and that is *not* the security in Falcon; it is the security of NorTex, which, as an asset of Falcon, is structurally superior to the equity interests in Falcon. Accordingly, this Court should refuse Falcon's invitation to benefit Arcapita's creditors, whose claims are structurally subordinate to Tide's Claims by virtue of the fact that they are claims against a corporate parent.

35. Moreover, Falcon's citation to *In re Lernout & Hauspie Speech Products, N.V., et al.,* 264 B.R. 336 (Bankr. D. Del. 2001) is similarly unpersuasive. Contrary to Falcon's suggestions, that case does not stand for the proposition that claims against a parent-debtor and subsidiary-debtor resulting from the purchase of a security in the parent-debtor must be

subordinated below the equity of the parent-debtor.[7] Indeed, *Lernout* undermines the Debtors' proposed interpretation of § 510(b) by rejecting "super subordination" and any reading of §510(b) that would convert the term "subordinate" to "disallow." *Lernout*, 264 B.R. at 343-44.

36. In *Lernout*, a parent and subsidiary company ran into financial difficulties allegedly due to misstated financial statements, prompting both companies to file for bankruptcy protection. Janet and James Baker filed proofs of claim against both debtors for, among other things, fraudulent conduct associated with the Bakers' acquisition of *common stock in the parent-debtor*. Both debtors then initiated an adversary proceeding to subordinate the Bakers' claims against parent and subsidiary under § 510(b). Importantly, the debtors sought to subordinate the Bakers' claims against the subsidiary to the level of the parent stock, which "would effectively disallow the claim in the [subsidiary] case." *Lernout*, 264 B.R. at 343. The Lernout court rejected such a reading of § 510(b) because it "would convert the term 'subordinate', as used in § 510(b), into 'disallow.'" *Id*. The Debtors' position to the contrary, therefore, has no basis in case law.

C. <u>The Debtors' Proposed Interpretation of § 510(b) is Contrary to Congress' Intent</u>

37. Finally, the interpretation argued for by the Debtors produces absurd results that are inequitable and far beyond the intent of Congress. Under the Debtors' interpretation, every party that has been defrauded by a debtor on account of the sale of a security of an affiliate (except a sale of common stock) would automatically be disallowed and barred from any recovery even where, as here, the debtor's primary asset consists of the debtor's equity in that affiliate (and is the product of debtor's fraud).

[7] As noted, Tide agrees that Tide's Claims against Arcapita should be subordinated to a level below Arcapita's general unsecured claims and above Interests in Arcapita for the same reasons discussed herein with regard to Tide's Claims against Falcon.

38. As noted, Congress' intent for § 510(b) was to prevent a party that bargains for risks and rewards of equity from bootstrapping itself ahead of that equity to a *pari passu* position with general unsecured creditors. *See* H.R. Rep. No. 95-595, p. 186-188 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6156; *see also*, Slain, John J. and Homer Kripke, *The Interface between Securities Regulation and Bankruptcy*, 48 N.Y.U. L. Rev. 261 (1973). The intent of § 510(b) is not to allow parent-debtors to profit from their fraud and the breaches/fraud of their subsidiaries. Yet that is the outcome that the Debtors propose.

39. Because Tide bargained to purchase securities of NorTex and not the securities of Falcon, Tide did not accept any risks associated with holding stock of Falcon. Arcapita and its creditors bear the risk. Accordingly, § 510(b) should not be interpreted to allow Arcapita (and its creditors) to bootstrap themselves to a *pari passu* position with Tide's Claims against Falcon, much less take priority over those structurally superior claims, especially as it relates to proceeds which represent the product of their own fraud. *See, e.g., United States v. Granderson*, 511 U.S. 39, 47 n.5 (1994) (dismissing an interpretation said to lead to an absurd result); *Dewsnup v. Timm*, 502 U.S. 410, 427 (1992) (Justice Scalia, dissenting) ("[i]f possible, we should avoid construing the statute in a way that produces such absurd results"); *Public Citizen v. Department of Justice*, 491 U.S. 440, 454 (1989) ("[w]here the literal reading of a statutory term would compel 'an odd result,' . . . we must search for other evidence of congressional intent to lend the term its proper scope").

IV. CONCLUSION

40. There is no basis in the Bankruptcy Code or case law for "super subordination"/ disallowance of Tide's Claims as they relate to the $70 million Escrow Funds. Tide's Claims are general unsecured claims against Falcon based on damages arising from the sale of securities of

Falcon's subsidiary. Under a textual reading of § 510(b), after giving meaning to every word, and as adopted by Judge Walrath in *VF Brands, Inc.*, such claims may be subordinated only to claims that are "senior to or equal" such claims, *i.e.* other general unsecured claims and all claims superior to general unsecured claims. This places the Tide Claims below Falcon's general unsecured claims (to the limited extent there are any), *but above* Interests in Falcon (*i.e*. Arcapita and its creditors). The next inquiry is whether the subordinated Tide Claims should share *pari passu* with Interests in Falcon. Since the Tide Claims are not based on common stock, they should remain superior to the Interests in Falcon.

PRAYER

WHEREFORE, Tide requests that the Court deny the subordination of the Tide Claims as sought by the Debtors in the Joint Plan. Tide further requests that the Court grant Tide such other and further relief as the Court deems just.

Respectfully submitted,

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