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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 BRIEF ON SUBORDINATION ISSUES
(relates to Dkt. No. 279)

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"), by their undersigned counsel, in response to the Court's request at the January 16, 2013 hearing, hereby file this brief on subordination issues in further support of Tide's motion to lift stay (Dkt.

No. 279) and in opposition to Falcon's motion for leave to file counterclaim (Dkt. No. 11 in Adv. No. 12-1662).[1] In support thereof, Tide respectfully submits as follows:

Brief on Subordination Issues

Falcon has asserted that no court ever needs to consider Tide's fraud claims against it because Tide's claims can be "super subordinated" and thus, this Court should take up Falcon's subordination arguments prior to any court ruling on Tide's fraud claim. As discussed at the January 16th hearing and as set forth in greater detail below, Tide's fraud claims must be adjudicated in order to determine whether the Escrowed Funds are property of the estate and Falcon's claims for subordination under § 510(b) have no bearing on whether the Escrow Funds are property of the estate. Furthermore, even if Tide's claims were subject to subordination,[2] the claims would still not be subject to "super subordination" as argued by Falcon and there would still be few or no other claims against the Falcon estate to which to subordinate Tide's claims. Therefore, Tide's fraud claims must be adjudicated before any distributions can be made in this case, and for the reasons set forth in the Lift Stay Motion, such claims should be adjudicated in the District Court Action.

A. Tide's Fraud Claims Must Be Tried In Order to Determine Whether the Escrow Funds Are Property of the Estate

1. To the extent that the Escrow Funds are not property of the estate, § 510(b) does not apply to claims against the Escrow Funds. *See In re North American Cattle Co.*, 51 B.R. 822, 825 (Bankr. W.D. Mich. 1985) (section 510(b) is inapplicable where parties do not seek a distribution of property of the estate). It is well settled bankruptcy law that to determine whether

[1] Capitalized terms used but not otherwise defined herein shall have the meaning ascribed to them in Tide's Motion for an Order Lifting the Automatic Stay Pursuant to 11 U.S.C. § 362(d) to Allow Continuance of the District Court Action (Dkt. No. 279).

[2] Tide does not concede that its claims are subject to subordination and reserves all rights with respect thereto.

property in escrow constitutes property of the estate, courts look to state law and that "§ 541 provides the debtor's estate with 'no greater interest in property after filing for bankruptcy than the debtor had prior to filing.'" *See In re Royal Business School, Inc.*, 157 B.R. 932, 941 (Bankr. E.D.N.Y. 1993) (quoting *TTS*, 158 B.R. 583, 587 (D. Del. 1993)); *see also Nobelman v. Am. Sav. Bank*, 113 S. Ct. 2106, 2108 (1993); *Butner v. United States*, 440 U.S. 48, 55 (1979). Courts have also recognized that "[i]n New York, as in most other states, legal title to property placed in escrow remains with the grantor pending the fulfillment of the conditions agreed upon in the escrow agreement." *In re Royal Business School, Inc.*, 157 B.R. at 940 (citations omitted).

2. The questions of whether the escrow conditions between Falcon and Tide have been met and whether the Escrow Funds are Falcon's property are before Judge Wood. In the first of her two published opinions in the District Court Action, Judge Wood stated: "Falcon contends that … the money in the Escrow Account belonged to Falcon as soon as the escrow conditions were met." *Tide v. Falcon*, 2011 U.S. Dist. LEXIS 111532, *37 (S.D.N.Y. September 28, 2011). She further stated: "Falcon cites *Marriott Corp. v. Rogers & Wells* … for the proposition that the Escrowed Amount 'belonged to Falcon, subject only to the satisfaction of the escrow conditions.' **As the Court has noted, however, the escrow 'conditions' here have not been met**." *Id*. at *40, fn. 7 (emphasis added).

3. Judge Wood also recognized the "settled law" that "[u]nder New York law, property in escrow should be released only after the conditions precedent are satisfied" and that "[p]ursuant to New York law, a party may not compel performance of an agreement that was induced by fraud." *See Tide v. Falcon*, 2011 U.S. Dist. LEXIS 111532, *38-40 (S.D.N.Y. September 28, 2011); *Tide v. Falcon*, 2012 U.S. Dist. LEXIS 63540, *10 (S.D.N.Y. May 4, 2012). Therefore, Judge Wood has now twice concluded that Tide's fraud claims must be

adjudicated before the Escrow Funds can be released. *Tide*, 2011 U.S. Dist. LEXIS 111532, *44 ("Because Tide has come forward with evidence that would allow a reasonable jury to find, by clear and convincing evidence, that each element of fraud has been satisfied, Falcon is not, at least at this juncture, entitled to the declaratory relief it seeks."); *Tide*, 2012 U.S. Dist. LEXIS 63540, *11 ("Thus, even considering the request for declaratory judgment on the merits, the Court comes to the same conclusion, that it must be denied pending adjudication of Tide's claims that the whole Amended Purchase Agreement was fraudulently induced.")

4. By now requesting that this Court order the turnover of the Escrow Funds without first adjudicating Tide's fraud claims, Falcon is requesting this Court to ignore Judge Wood's two prior rulings and well settled bankruptcy and New York law.

B. Tide Cannot Be "Super Subordinated" and Therefore, Tide's Fraud Claims Will Also Need to be Liquidated for Distribution Purposes

5. Tide contends that the Escrow Funds belong to Tide and, as noted, Falcon's claims for subordination can have no bearing on whether the Escrow Funds are property of Falcon's estate because § 510(b) applies only "[f]or the purpose of distribution" and therefore, presupposes that there is property to be distributed. *See* 11 U.S.C. § 510(b); s*ee also In re North American Cattle Co.*, 51 B.R. at 825. Whether Falcon has any significant assets to be distributed, however, will only be known *after* Tide's fraud claims are determined. Even assuming, *arguendo*, that the Escrow Funds belong to Falcon, however, Tide will still have a claim against the estate for the fraud perpetrated by Falcon, which will need to be adjudicated before any distributions can be made in Falcon's case.

6. Falcon mistakenly claims that any such claim will be "super-subordinated", i.e. subordinated to the equity of Falcon. In actuality, any Tide claim against the Falcon estate will

be treated, at worst, *pari passu* with the estate's other key creditors. Therefore, Tide's fraud claims must be adjudicated, regardless of Falcon's claims for subordination.

7. Falcon relies on one 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)—for the mistaken proposition that Tide is subject to the concept of "super subordination." Under Falcon's reading of that case, because Tide bought membership interests of a limited liability company, Tide's claims would somehow be "subordinated below *all* other equity interest in Falcon, *including* the common stock of Falcon." (Falcon Response p. 7). As the Court is aware, placing a claim behind the common stock of a debtor ensures no possible recovery on that claim. In short, Falcon argues that because it defrauded Tide in the sale of NorTex (a limited liability company rather than a corporation), Tide's claim for damages against Falcon will be automatically disallowed under § 510(b). This is an implausible and inequitable reading of the Code and case law. Moreover, such a reading runs contrary to numerous other subordination cases which have held that § 510(b) serves to subordinate certain claims to the claims of general unsecured creditors, but not to the interests of equity holders. *See, e.g., In re Alta+Cast, LLC,* 301 B.R. 150 (Bankr. D. Del. 2003); *In re SeaQuest Diving, LP*, 579 F.3d 411 (5th Cir. 2009).

8. The debtor in *In re Lernout & Hauspie Speech Products, N.V., et al.*, 264 B.R. 336 (Bankr. D. Del. 2001), attempted to make a similar argument to the Bankruptcy Court for the District of Delaware. That court correctly rejected the argument.

9. In *In re Lernout & Hauspie*, 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 stock in the parent. 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. Such a reading of the provision would convert the term 'subordinate', as used in § 510(b), into 'disallow.'" *Id*. at 343. Certainly, Congress understands the concept of disallowance of a claim, for "[i]n § 502 of the Bankruptcy Code, provisions are made for the disallowance of claims for various reasons. No such provision is made for claims based on securities fraud." *Id*. at 343-44. If Congress wanted fraud claims based on stock sales of a debtor subsidiary to be disallowed, it would have stated as much in § 502. It did not. "More consistent with the stated congressional intent is a conclusion that … [claimant's] claim against the debtor …, arising from the purchase of … [parent] securities, must be subordinated to general unsecured claimants in … [subsidiary], but may be treated *pari passu* for distribution purposes with other equity security holders of … [subsidiary]." *Id.* at 344.

10. Despite the Code's clear language regarding subordination, and *not* disallowance, Falcon points to the *USA Capital Realty Advisors* case for the spurious proposition that any Tide claim should be subordinated below claims of Falcon's common equity holders, or effectively disallowed. A detailed reading of the *USA Capital Realty Advisors* case shows that critical facts distinguish the claims of the creditor in that case from the claims of Tide in this case. Furthermore, taking those critical facts into account, it appears that if *USA Capital Realty Advisors* applies at all in this case, it applies to super subordinate the claims of the Hopper Parties and others, but not Tide, resulting in Tide having a senior (not subordinated) right to distributions vis-à-vis these other parties in interest.

11. In *USA Capital Realty Advisors*, 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 Capital Realty Investors*, 377 B.R. at 611. The unsecured creditors committee sought to subordinate the investors' claims "below all membership interests in Diversified." *Id*. at 618. After reviewing the legislative history of § 510(b) and relying on § 510(b)'s "clear language", the 9th Cir. BAP found that investors' claims should be subordinated "to a level below the priority of the securities upon which the claims are based." *Id*. Consequently, the 9th Cir. BAP subordinated the investors' claims below Diversified's equity, essentially disallowing the claims.

12. Unlike the investors in *USA Capital Realty Advisors*, 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 Capital Realty Advisors*' 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. The distinction between a claim arising from equity of a debtor's subsidiary and equity of a debtor itself is critical for the analysis of *USA Capital Realty Advisors*.

13. More analogous to the facts in our case are those in *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"). Investors asserted a proof of claim

against VFI, asserting damages based on breaches of a stock purchase agreement between VFI and investors related to the purchase of stock of Vlasic Farms, Inc. The court concluded that investors' claim should be subordinated and share *pari passu* with the equity interests of VFI. There was no super subordination. A similar fact pattern and conclusion were reached in *In re Wisconsin Barge Line, Inc. et al.*, 76 B.R. 142 (Bankr. E.D. Mo. 1987). Based on these cases, there is no basis to super subordinate Tide's claims against Falcon.

14. To the extent that *USA Capital Realty Advisors* applies in this case, its holding would super subordinate claims arising from the rescission of a purchase or sale of security of Falcon, or for damages arising from the purchase of or sale of Falcon's securities (i.e. not NorTex's securities). For example, the claims of employees based on Falcon's breach of its equity incentive plan, which claims total approximately $1.745 million, are damage claims arising from a purchase or sale of securities of Falcon, subject to super subordination under *USA Capital Realty Advisors*. *See In re U.S. Wireless Corp., Inc.*, 384 B.R. 713, 718-19 (Bankr. D. Del. 2008) (employee stock option plans constitutes a purchase and sale of securities for the purposes of section 510(b)). Investor claims filed as proofs of claim in this case, which claims total approximately $27 million, are damage claims arising from a purchase or sale of securities of Falcon's ultimate parent (Arcapita), subject to super subordination under *USA Capital Realty Advisors* (to the extent that they are not disallowed in their entirety). Finally, the $8.25 million claim of the Hopper Parties arises from a damage claim from the sale of Falcon securities[3] and is therefore also subject to super subordination.

[3] *See* Settlement Agreement and General Release attached to Hopper Parties' proofs of claim, stating that settlement payments, including the $8.25 million payment sought by the proof of claim is made "in consideration of the abandonment, forfeiture, and transfer for cancellation of Plaintiffs' stock, stock options, and stock appreciation rights in Falcon…."

15. However, this Court does not have to decide whether these other groups of creditors/equity interest holders are subject to "super subordination" in order to resolve the issues currently before the Court. Because Tide's claims are not subject to "super subordination" and, at worst, would share *pari passu* with the claims of these other creditor/equity groups, and because Falcon's schedules reveal that there are little or no general unsecured creditors to which to subordinate Tide's claims,[4] Tide's fraud claims, currently pending before Judge Wood, should be adjudicated before any distributions can be made in Falcon's case.

PRAYER

WHEREFORE, Tide requests that the Court lift the automatic stay to allow Tide to proceed with the District Court Action, deny the request of Falcon for permission to assert third party claims and counterclaims in the Hopper Adversary, and grant Tide such other and further relief as the Court deems just.

Respectfully submitted,

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[4] *See* Falcon's Schedules admitted as Tide's Exhibit 17. Tide does not concede that its claims are subject to subordination to general unsecured claims against Falcon, and Tide reserves all rights with respect thereto.

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