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OF THE NINTH CIRCUIT

UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

In re:	)	BAP No.	NV-07-1067-RBS
)		
USA COMMERCIAL MORTGAGE COMPANY	)	Bk Nos.	06-10725 LBR
USA CAPITAL REALTY ADVISORS, LLC;	)		06-10726 LBR
USA CAPITAL DIVERSIFIED TRUST DEED	)		06-10727 LBR
FUND, LLC; USA CAPITAL FIRST TRUST	)		06-10728 LBR
DEED FUND, LLC; USA SECURITIES,	)		06-10729 LBR
LLC,)		
	)	Ref. No.	07-06
Debtors.)		

MARGARET B. MCGIMSEY TRUST; BRUCE
MCGIMSEY; JERRY MCGIMSEY; SHARON
MCGIMSEY; JOHNNY CLARK,

Appellants,

v.

O P I N I O N

USA CAPITAL DIVERSIFIED TRUST DEED)
FUND, LLC; OFFICIAL COMMITTEE OF)
EQUITY SECURITY HOLDERS OF USA)
CAPITAL DIVERSIFIED TRUST DEED)
FUND, LLC,)

Appellees.

Argued and Submitted on July 26, 2007
at Las Vegas, Nevada

Filed - August 15, 2007
Ordered Published - October 10, 2007

Appeal from the United States Bankruptcy Court
for the District of Nevada

Honorable Linda B. Riegler, Bankruptcy Judge, Presiding

Before: RUSSELL,¹ BRANDT and SMITH, Bankruptcy Judges.

¹ Hon. Barry Russell, United States Bankruptcy Judge for the
Central District of California, sitting by designation.

1 RUSSELL, Bankruptcy Judge:

2
3 The Official Committee of Equity Security Holders of USA Capital
4 Diversified Trust Deed Fund, LLC, filed objections to the proofs of
5 claim of appellants. The Committee asserted that appellants' proofs
6 of claim are duplicative of their respective proofs of interest, and
7 in any event, that the claims should be subordinated pursuant to 11
8 U.S.C. § 510(b)². After holding two separate hearings, the bankruptcy
9 court disallowed appellants' claims. The appellants appealed.

10 We REVERSE.

11 **I. FACTS**

12 USA Capital Diversified Trust Deed Fund, LLC ("Diversified" or
13 "Debtor") is a Nevada limited liability company organized as of
14 February 3, 2000. The apparent purpose of Diversified was to provide
15 a vehicle for Nevada investors to invest in loans originated by co-
16 Debtor USA Commercial Mortgage Company ("USACM"). Investors purchased
17 membership interests in Diversified, which then invested in various
18 loans.³ Diversified's stated purpose was to make or purchase entire
19 or fractional interests in acquisition, development, construction,
20 bridge or interim loans that were secured by first deeds of trust on,
21 among other things, undeveloped land and residential commercial

22 _____
23 ² Unless otherwise indicated, all chapter, section and rule
24 references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and to
25 the Federal Rules of Bankruptcy Procedure, Rules 1001-9036, as enacted
26 and promulgated as of October 17, 2005, the effective date of most of
the provisions of the Bankruptcy Abuse Prevention and Consumer
Protection Act of 2005 ("BAPCPA") (Pub.L. 109-8, 119 Stat. 23).

27 ³ According to its Prospectus, Diversified registered the sale
28 of its membership units with the Nevada Securities Division, and
strictly limited its offering to Nevada residents in order to avoid
having to register its securities with the SEC.

1 developments. Although Diversified loans were supposed to be secured
2 by first deeds of trust and have other protections for Diversified
3 investors, these protections were not generally provided by USACM.

4 There was a continuous offering of membership interests (known as
5 "units") in Diversified from May 2000 to July 2004. In July 2004,
6 Diversified stopped offering the sale of membership units, and on
7 September 27, 2005, the investors were notified that Diversified would
8 be liquidating. Diversified, USACM, USA Capital Realty Advisors, USA
9 Capital First Trust Deed Fund, LLC ("FTDF"), and USA Securities, LLC
10 ("Debtors")⁴ all filed for bankruptcy protection on April 13, 2006
11 ("Petition Date"). After the Petition Date, with a change in
12 management for the Debtors, the abject failure of Diversified's former
13 insiders to invest Diversified's monies properly became apparent. As
14 time wore on, the scope of the wrongs inflicted upon Diversified by
15 the insiders came sharply into focus. For example, the largest loan
16 in the Diversified portfolio was found to be a complete fiction and a
17 subterfuge employed by the insiders as part of a scheme to fund their

18
19 ⁴ Debtors are affiliated financial service entities that
20 operated out of the State of Nevada. USACM was in the business of
21 underwriting, originating, brokering, funding and servicing commercial
22 loans that were primarily secured by residential and commercial
developments. As of the Petition Date, the loan portfolio that USACM
was servicing consisted of approximately 115 loans having a combined
outstanding balance of approximately \$960 million.

23 FTDF is very similar to Diversified. Its apparent purpose
24 was to allow USACM to offer investors throughout the United States
(not just in Nevada, as was the case with Diversified) the opportunity
25 to invest in loans that USACM originated. Investors purchased
membership interests in FTDF, which then invested in various loans.

26 USA Capital Realty Advisors, LLC was the nominal manager of
Diversified and FTDF. Finally, USA Securities, LLC, a registered
27 broker-dealer, sold membership interests in FTDF.

28 Diversified is the only Debtor relevant to this appeal.

1 speculative real estate activities with Diversified's funds, rather
2 than utilizing those funds to make non-insider loans secured by first
3 trust deeds as promised in the prospectus.

4 Diversified had approximately 1,300 members as of the Petition
5 Date. Among these members were the Margaret B. McGimsey Trust, Bruce
6 McGimsey, Jerry McGimsey, Sharon McGimsey, and Johnny Clark
7 (collectively, the "Appellants"). Appellants filed proofs of
8 interest, in the aggregate amount of \$592,825.45 plus interest, for
9 their respective equity investments in Diversified. Appellants also
10 filed proofs of claim, in the very same aggregate amount, against
11 Diversified based on allegations of breach of contract and fraud
12 relating to their purchase of the membership interests in Diversified.

13 On November 30, 2006, the Official Committee of Equity Security
14 Holders of Diversified ("Committee") filed its Omnibus Objection to
15 Claims on Equity Misfiled as Creditor Claims ("Objection"). The
16 Objection objected to 111 of the 137 proofs of claim filed against
17 Diversified at that time. Included in the Objection were the
18 Committee's objections to the proofs of claim filed by Appellants.⁵

19
20
21 ⁵ The Committee specifically objected to Claim Nos. 90-1,
22 93-1, 94-1, 95-1, 129-1, 130-1, 131-1, and 136-1. The objections were
summarized in the table in Exhibit 1 to the Objection as follows:

Claim No.	Claimant	Claim Amount	Proposed Disposition
90-1	Margaret B. McGimsey Trust	\$96,094.75	Disallow as duplicative of proof of interest already on file
93-1	Sharon or Jerry McGimsey	\$311,091.58	Disallow as duplicative of proof of interest already on file
94-1	Johnny Clark	\$99,467.90	Disallow as duplicative of proof of interest already on file

(continued...)

1 The Committee contended that the Appellants' claims were
2 duplicative of the proofs of interest which Appellants had filed and
3 contended that, in any event, that the claims would necessarily be
4 subordinated pursuant to § 510(b).

5 An initial hearing was held on January 3, 2007. The bankruptcy
6 court continued the hearing, however, and ordered supplemental,
7 concurrently filed briefing from the Appellants and the Committee on
8 whether § 510(b) applied to Appellants' claims and, if so, whether the
9 statute required Appellants' claims to be subordinated only below
10 other unsecured creditor claims or subordinated such that Appellants'
11 claims are on par with all similarly situated holders of equity
12 interests in Diversified. The continued hearing was held on January
13 31, 2007. After hearing oral argument from counsel for Appellants and
14 the Committee, the bankruptcy court made the following comments:

15 THE COURT: Okay. Well, I'm going to sustain the
16 Funds' objections. 510(b) says, "For purpose of
17 distribution under this title, a claim arising
18 from" - let's see.

19 "A claim for damages arising from the
20 purchase or sale of such security shall be
21 subordinated to all claims or interests that are
22 senior or equal to the claim or interest

23 ⁵(...continued)

24 95-1	Bruce McGimsey	\$86,171.22	Disallow as duplicative of proof of interest already on file
25 129-1	Margaret B. McGimsey Trust	\$96,094.75	Disallow as duplicative of Claim no. 90-1
26 130-1	Sharon or Jerry McGimsey	\$311,091.58	Disallow as duplicative of Claim no. 93-1
27 131-1	Johnny Clark	\$99,467.90	Reclassify as proof of interest and duplicative of claim no. 94-1
28 136-1	Bruce McGimsey	\$86,171.22	Disallow as duplicative of Claim no. 95-1

1 represented of a said security, except if it's
2 common stock."

3 You know, there's no need to go to the
4 legislative history because it's clear. It says
5 arising from the purchase or sale.

6 The only reason they have a claim is because
7 they bought the security, and management didn't do
8 what it's supposed to do.

9 And the problem with this - a distinction
10 will be made. Let's assume that, coincidentally,
11 these people sold goods and services to the
12 debtor. Well, they'd have a creditors claim for
13 that because it's a different level.

14 I just can't fathom the concept that these
15 creditors could claim a creditors claim for the
16 exact same injury that everybody else has.

17 And under that theory, they would get their
18 claim paid in full, and I don't know what the
19 amount of the claim would be. I guess the amount
20 of the claim would be everything they put in the
21 investment.

22 And then everybody else who suffered the
23 exact same kind of injury and damage would then
24 have to share pro rata after what's left. That
25 just turns the concept of bankruptcy upside down.
26 I agree.

27 And if it were the other way, trust me, I
28 would just allow everybody else to claim to be
treated as a creditors claim.

There's absolutely no reason for disparate
treatment, and that would, in essence, have
created an unequal classification, so it was an
interesting theory, but I don't agree with it, so
--

23 (Hr'g Tr. 22:5 - 23:6, January 31, 2007.)

24 An interesting colloquy followed between the court and counsel
25 for the Appellants regarding what exactly the court had ruled:

26 MR. McGIMSEY: Well, can I ask you exactly what
27 you've done, your Honor? Have you said I have no
claim?

28 THE COURT: No. I said you have a claim as an

1 equity holder.

2 MR. McGIMSEY: Well, do you say I have no -

3 THE COURT: Well, no.

4 MR. McGIMSEY: I -

5 THE COURT: You may have a claim, but it's going to
6 be treated equally.

7 MR. McGIMSEY: So you are subordinating my claim.

8 THE COURT: It's going to be treated equally to all
9 other claims, the equity claims, in the same
10 interest.

11 MR. McGIMSEY: So I'm being subordinated; is that
12 correct?

13 THE COURT: You're going to be treated like
14 everybody else. You're going to be treated
15 exactly in accordance with what everybody else is
16 being treated.

17 MR. McGIMSEY: So -

18 THE COURT: It's not subordinated.

19 MR. McGIMSEY: Well, then -

20 THE COURT: You're asking -

21 MR. McGIMSEY: You're -

22 THE COURT: - to be elevated. You're asking to be
23 elevated. That's what you were asking to do.

24 MR. McGIMSEY: I'm not asking to be elevated.

25 THE COURT: You were.

26 MR. McGIMSEY: I'm not asking -

27 THE COURT: But you were saying -

28 MR. McGIMSEY: - to be elevated.

THE COURT: - by filing that you were saying I'm
going to categorize my equity interest different
by filing a creditors claim; ergo, I am being
elevated, so it's not that you're being
subordinated. You're being treated exactly what
you're supposed to be.

1 Oh, and in [Rule] 7001, I think only a - it
2 says, "Except as provided in a Chapter 11 plan."
3 I think 7001 only applies when you're seeking
4 subordination, equitable subordination, the bad-
conduct kinds of equitable subordination, as
5 opposed to looking at what the nature has, so I
6 just disagree.

7 I mean, it's an interesting argument. I just
8 disagree so, you know, your claim will be treated
9 like everybody else's.

10 MR. McGIMSEY: Well, I don't understand that. My
11 claim has been - they filed an objection to the
12 claim, and I would just like it clear, your Honor
13 --

14 THE COURT: Yeah.

15 MR. McGIMSEY: - you were saying that 510(b) says I
16 don't have a claim.

17 THE COURT: No. It says that it's to be - well, it
18 says that it was subordinated, but I think in this
19 case it's senior to or equal, or equal.

20 MR. McGIMSEY: No one's claimed these -

21 THE COURT: What are your damages? Your damages
22 are exactly what you put in, right?

23 MR. McGIMSEY: Exactly.

24 THE COURT: Okay.

25 MR. McGIMSEY: That I haven't -

26 THE COURT: So why -

27 MR. McGIMSEY: - gotten back.

28 THE COURT: - should your clients be paid their
25,000, 50,000, whatever it is and in full before
everybody else gets their share or, more
importantly, they have to share it pro rata?
That's what you're asking.

MR. McGIMSEY: I'm asking that because we -

THE COURT: And I'm saying no. I'm saying that's
not the law.

MR. McGIMSEY: So these people - anybody can file a
late claim. We no longer have a -

1 THE COURT: That has nothing to do with it.

2 MR. MCGIMSEY: We no longer have a late claim -

3 THE COURT: It's not a creditors claim.

4 MR. MCGIMSEY: So that is what I wanted you to say,
5 your Honor.

6 (Hr'g Tr. 23:17 - 26:15, January 31, 2007).

7 On February 14, 2007, an order sustaining the objections to
8 Appellants' claims was entered. The order reads, in pertinent part,
9 as follows:

10 IT IS HEREBY ORDERED that the Objection is
11 sustained.

12 IT IS FURTHER ORDERED that the claims listed
13 on Exhibit A [including appellants'], attached
14 hereto and made a part hereof, shall be disallowed
15 in their entirety, as they are creditor claims
16 filed by holders of equity interests in USA
17 Capital Diversified Trust Deed Fund, LLC
18 ("Diversified Fund") who are not entitled to any
19 distribution from Diversified Fund on the basis of
20 such claims but who shall recover from Diversified
21 Fund on a pro rata basis according to their
22 respective equity interests.

23 Appellants timely filed a Notice of Appeal the same day.

24 **II. ISSUES**

25 A. Whether the bankruptcy court correctly sustained the Committee's
26 Objection on the basis that the Appellants' proofs of claim were
27 duplicative of their proofs of interest.

28 B. Whether the bankruptcy court correctly sustained the Committee's
Objection on the basis that the Appellants' proofs of claim should be
statutorily subordinated pursuant to § 510(b).

III. STANDARD OF REVIEW

In reviewing a bankruptcy court's decision on appeal, an
appellate court reviews findings of fact under a clearly erroneous

1 standard. Conclusions of law, including a bankruptcy court's
2 interpretation of a statute, are reviewed de novo. See Lundell v.
3 Anchor Constr. Specialists, Inc. (In re Lundell), 223 F.3d 1035, 1039
4 (9th Cir. 2000).

5 IV. DISCUSSION

6 The bankruptcy court disallowed Appellants' claims because it
7 felt that allowing Appellants to assert their claims would be unfair.
8 According to the bankruptcy court, because all investors in
9 Diversified had been defrauded as a part of the same fraud, all
10 investors were equally wronged and had or should have the same rights.
11 The idea that Appellants could jump in line ahead of the other
12 investors seemed unacceptable. Although the bankruptcy court's
13 concern for the other Diversified investors was laudable and although
14 its approach has a certain appeal on the surface, for the reasons
15 discussed below the actions of the bankruptcy court were not proper
16 under the Bankruptcy Code or Federal Rules of Bankruptcy Procedure.

17 The bankruptcy court's analysis ignored the state of the record
18 as it existed at the time of the hearings on the Objection. The
19 Appellants were the only investors to timely file proofs of claim
20 based on their claims for breach of contract and fraud. Assuming
21 arguendo that all other interest holders could file proofs of claim,
22 they did not do so. Whether they would at some later point is pure
23 speculation. If the other Diversified investors were, instead, trade
24 creditors with equal rights, those trade creditors who did not file
25 proofs of claim would simply not have claims.

26 Further, there was no real indication that there was anything
27 wrong with Appellants' claims. Although the bankruptcy court seemed
28 to think that the proofs of claim were duplicative of the proofs of

1 interest, they are not. A proof of interest is based on mere equity
2 ownership; a proof of claim is based on a right to payment.
3 Appellants have proofs of interest by virtue of their ownership of
4 membership interests in Diversified, and proofs of claim based on
5 their claims against Diversified for breach of contract and fraud. It
6 is clear that Appellants are entitled to assert both claims and
7 interests, even though they cannot be paid on both. The fact that the
8 bankruptcy court felt uncomfortable with the idea that Appellants
9 could potentially jump in line ahead of other Diversified investors
10 was not a basis for disallowing Appellants' claims.

11 As to § 510(b), although there was extensive discussion by the
12 parties at the hearings and in the briefs at the trial level, as well
13 as in the briefs on appeal, as to whether Appellants' claims should be
14 subordinated, the bankruptcy court never subordinated Appellants'
15 claims. It merely disallowed them. In any event, it is clear that
16 subordination under § 510(b) would first require an adversary
17 proceeding pursuant to Rule 7001(8).

18 A. Whether the Claims and Interests are Duplicative

19 The core of the Committee's objection to Appellants' claims is
20 that these claims are duplicative of Appellants' proofs of interest.
21 We disagree. The proofs of claim and the proofs of interest are not
22 duplicative. Although both Appellants' respective proofs of claim and
23 proofs of interest relate to their membership interests in Diversified
24 and are for the exact same amount, this does not make the proofs of
25 claim and proofs of interest duplicative. The Committee's arguments
26 relating to equity and fairness do not change this result. As they
27 themselves admit, Appellants are not entitled to a double recovery.
28 Further, the issue of relative priority relates to whether Appellants'

1 claims should be subordinated, not whether they should be allowed.

2 A proof of claim asserted by an equity holder for breach of
3 contract and fraud relating to the purchase of a security is simply
4 not duplicative of the equity holder's proof of interest. Unlike most
5 of the other claims subject to the Objection, Appellants were not mere
6 equity holders who filed proofs of claim out of confusion. Had that
7 been the case, Appellants' claims could easily have been challenged
8 and properly disallowed.⁶ See § 502(b)(1) ("[I]f such objection to a
9 claim is made, the court . . . shall allow such claim in such amount,
10 except to the extent that -- (1) such claim is unenforceable against
11 the debtor and property of the debtor, under any agreement or
12 applicable law for a reason other than because such claim is
13 contingent or unmatured[.]"). It is axiomatic that an allowed proof
14 of claim requires something more than mere equity ownership. A proof
15 of claim for breach of contract and fraud relating to the purchase of
16 a security is clearly something more than mere ownership, and as such
17 cannot be considered duplicative of a proof of interest. See BLACK'S
18 LAW DICTIONARY 541 (8th ed. 2004) (defining "duplicative" as, inter
19 alia, "[h]aving or characterized by having overlapping content,
20 intentions, or effect"). Here, Appellants' proofs of interest are
21 based purely upon their membership interests in Diversified. Their
22 proofs of claim, by contrast, are based upon their potential causes of
23 action against Diversified for breach of contract and fraud relating

24
25 ⁶ It is true that the Committee argued that Appellants' claims
26 should be disallowed as they are derivative claims that belong to
27 Diversified and not to equity holders individually. Similarly, the
28 Committee argued that Appellants could not have a claim based on
breach of contract as a matter of law. However, as the bankruptcy
court did not rule on these arguments and instead based its entire
ruling on the argument that the proofs of claim and the proofs of
interest are duplicative, we decline to address them.

1 to their purchase of those membership interests. Hence, Appellants'
2 proofs of interest and proofs of claim are clearly not duplicative.

3 Rather than explain why Appellants' proofs of claim are
4 unenforceable under § 502(b), the Committee bases its argument on the
5 perceived unfairness in permitting Appellants to assert both proofs of
6 claim and proofs of interest. According to the Committee's brief,
7 "Appellants are using one pretense or another to attempt to assume the
8 role of unsecured creditors in addition to their role as equity
9 interest holders and to recover twice under both guises for the same
10 investment." The Committee asserts that Appellants' claims are not
11 distinguishable from the 1,300 potential (although unfiled) claims
12 held by every other member of Diversified, and that it is unfair to
13 allow Appellants to assert their claims to the prejudice of other
14 members of Diversified that hold the exact same claims but have not
15 filed proofs of claim. However, the perception of unfairness is an
16 insufficient basis for the disallowance of a proof of claim. See
17 Heath v. American Express Travel Related Servs. Co. (In re Heath), 331
18 B.R. 424, 426 (9th Cir. BAP 2005) ("Section 502(b) sets forth the
19 exclusive grounds for disallowance of claims, and Debtors have
20 introduced no evidence or arguments to establish any of those
21 grounds.").

22 It is neither incorrect nor improper for an equity holder to
23 assert a proof of claim based on breach of contract and fraud relating
24 to the purchase of a security and also a proof of interest. The Code
25 specifically contemplates this. As discussed below, § 510(b)
26 subordinates certain claims that are necessarily held by equity
27 holders. Equity holders must a fortiori be entitled to assert proofs
28 of claim in addition to proofs of interest or there would be nothing

1 to subordinate under § 510(b). If, in fact, an equity holder could
2 not assert both a proof of claim and a proof of interest, then
3 § 510(b) in most cases would have little to no meaning. See Tabor v.
4 Ulloa, 323 F.2d 823, 824 (9th Cir. 1963) (“[A] legislature is
5 presumed to have used no superfluous words.”) (citation omitted).

6 The Committee’s argument that it is inappropriate for Appellants
7 to be able to assert proofs of claim in addition to their proofs of
8 interest for policy reasons is similarly unfounded. The Committee
9 contends that allowing Appellants to assert both proofs of claim and
10 proofs of interest effectively would allow Appellants to enjoy a
11 double recovery. This is not so. As counsel for Appellants correctly
12 noted during oral argument at the initial hearing on January 3, 2007,
13 any amounts that Appellants receive on their proofs of claim would
14 serve to reduce the amount of their proof of interest (“MR. MCGIMSEY:
15 I filed proof[s] of interest because we have proof[s] of interest. I
16 believe that to the extent that we recovered under our unsecured
17 claim[s] that would go against our proof[s] of interest, you know.”).

18 We also disagree with the argument that Appellants’ claims should
19 be disallowed because they are not distinguishable from the many other
20 potential, but unfiled, claims against Diversified that other
21 Diversified members may hold against it based upon the same general
22 facts. This argument goes as follows: If the bankruptcy court
23 extends the claims bar date to allow all other Diversified members to
24 file proofs of claim, and then all other Diversified members do file
25 proofs of claim, then the Appellants would be in the same position
26 that they would have been in had they not filed proofs of claim in the
27 first place. Ergo, it makes sense to simply disallow the claims now
28 instead of having to proceed through these many procedural hoops in

1 order to get to the same inevitable result. This argument fails
2 because it puts the cart way before the horse. Even if the bankruptcy
3 court hypothetically extended the claims bar date, there is no
4 guarantee that even a significant number of Diversified members, if
5 any, would file proofs of claim. More significantly, punishing
6 creditors for diligently meeting claims bar dates because other
7 potential creditors have failed to do so is contrary to bankruptcy
8 policy and procedure. It is not uncommon in chapter 11 cases for a
9 handful of trade creditors to fail to file proofs of claim.

10 Penalizing the trade creditors who timely file proofs of claim because
11 others did not would be clearly erroneous. It is the same with this
12 case. Penalizing the Appellants for having filed proofs of claim when
13 other members of Diversified failed to do so, notwithstanding ample
14 notice, is erroneous.

15 In short, there is no basis for finding that Appellants' proofs
16 of claim and proofs of interest are duplicative. As the bankruptcy
17 court's decision rested on its finding that the proofs of claim and
18 proofs of interest are duplicative, we must reverse.

19 B. Section 510(b)

20 The bulk of the briefs relate to the applicability and effect of
21 § 510(b). Indeed, a great deal of the discussion at the trial level
22 also related to § 510(b), and yet the bankruptcy court never
23 subordinated Appellants' claims. As such, § 510(b) is of limited
24 importance for purposes of this appeal. Because it appears likely
25 that the Committee will promptly bring an adversary proceeding against
26 the Appellants in order to subordinate their claims under § 510(b),
27 the applicability and effect of § 510(b) deserves discussion.

28 It is clear from the transcript of the January 31, 2007 hearing

1 and the language of the order sustaining the objections to Appellants'
2 claims that the court was disallowing Appellants' claims, not
3 subordinating them. Section 510(b) provides no basis for the
4 disallowance of claims. Disallowance and subordination are different.
5 "Disallowance of a claim is a legal determination that the claim under
6 consideration is not allowable by law. On the other hand,
7 subordination of a claim presupposes that the claim is allowed but for
8 equitable reasons must be subordinated to the other allowed claims."
9 Ford v. Feldman (In re Fla. Bay Trading Co.), 177 B.R. 374, 383
10 (Bankr. M.D. Fla. 1994). Although the bankruptcy court appears to
11 have been heading in the right direction inasmuch as the effect of
12 subordination under § 510(b), if established, may be functionally
13 equivalent to disallowance (i.e., no distribution on the claims), the
14 bankruptcy court's ruling was nonetheless in error.

15 Section 510(b) provides, in pertinent part, that:

16 . . . a claim . . . for damages arising from the
17 purchase or sale of . . . a security [of the
18 debtor] . . . shall be subordinated to all claims
19 or interests that are senior to or equal the . . .
20 interest represented by such security, except that
if such security is common stock, such claim has
the same priority as common stock.

21 11 U.S.C. § 510(b) (emphasis added).⁷

22 ⁷ The text of the original subsection (b) provided as follows:

23 Any claim for rescission of a purchase
24 or sale of a security of the debtor or
of an affiliate or for damages arising
25 from the purchase or sale of such a
security shall be subordinated for
26 purposes of distribution to all claims
and interests that are senior or equal
27 to the claim or interest represented by
such security.

28 (continued...)

1 There appears to be no dispute between the parties that § 510(b)
2 could apply to subordinate Appellants' claims. The parties appear to
3 agree that the claims asserted by Appellants are based on damages
4 arising from the purchase or sale of a security of the debtor, as the
5 term "security" is defined under § 101(49). Instead, the dispute is
6 over what level these claims are to be subordinated to. Here, the
7 language of the statute is plain on its face. Appellants' claims
8 arising from the purchase or sale of the Diversified membership
9 interests are subordinated for purposes of distribution to all
10 Diversified membership interests. "The plain meaning of legislation
11 should be conclusive, except in the 'rare cases [in which] the literal
12 application of a statute will produce a result demonstrably at odds
13 with the intentions of its drafters.'" United States v. Ron Pair
14 Enterprises, Inc., 489 U.S. 235, 242 (1989) (citation omitted). As
15 such, to the extent that § 510(b) applies, Appellants' proofs of claim
16 are subordinated below all membership interests in Diversified. In
17 short, Appellants' claims may be subordinated below equity.

18 The history of § 510(b) supports this conclusion. Section 510(b)
19 was enacted as part of the Bankruptcy Reform Act of 1978. "The
20 principles announced in section 510(b) had no established forebear in
21 pre-Code practice. This section clarifies an unsettled area of law
22 under the Act, where some decisions permitted a rescinding security
23 holder of the debtor to share on a priority with general creditors."

24 4 COLLIER ON BANKRUPTCY ¶ 510.LH[1], p. 510-32 (rev. 15th ed. 2006). "The
25
26

27 ⁷(...continued)
28 11 U.S.C. § 510(b) (1978). Section 510(b) was modified into its
present form with the enactment of the Bankruptcy Amendments and
Federal Judgeship Act of 1984, Pub L. No. 98-353, 98 Stat. 333.

1 clear mandate of section 510(b) is that shareholder claimants will not
2 be allowed to elevate their interests from the level of equity to
3 general claims. . . . Rescission will lead to subordination below the
4 interest held before rescission." 4 COLLIER ON BANKRUPTCY ¶ 510.04[1], p.
5 510-11 (rev. 15th ed. 2006). For example, suppose a preferred
6 stockholder holds a claim based upon the rescission of the purchase of
7 the preferred stock. In such a case, § 510(b) would clearly
8 subordinate its claim below the priority of the preferred stock.
9 Thus, it is clear that inasmuch as § 510(b) applies to Appellants'
10 claims, those claims may be subordinated below equity.

11 An argument could be made that instead of being subordinated
12 below equity, Appellants' claims should be on par with equity. (As a
13 practical matter, this would be of no benefit to Appellants because
14 the only way they prevail is if they are paid before similarly-
15 situated interest holders, and they'll get whatever interest holders
16 get on their proofs of interest.) This argument is based on the
17 language of the House Report to the Bankruptcy Reform Act of 1978,
18 which states that "[i]f the security is an equity security, the
19 damages or rescission claim is subordinated to all creditors and
20 treated the same as the equity security itself." H.R. REP. NO. 95-595,
21 at 359 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6315. The problem
22 with this argument, however, is that version of the bill being
23 described in the House Report diverged from "the statute that was
24 ultimately enacted." See NationsBank v. Commercial Fin. Servs., Inc.
25 (In re Commercial Fin. Servs., Inc.), 268 B.R. 579, 595 & n.23 (Bankr.
26 N.D. Okla. 2001). The Bankruptcy Reform Act of 1978, as enacted,
27 included the "equal to" language. This leads us to the firm
28 conclusion that, except where the Code directs otherwise, Congress

1 intended that claims subordinated under § 510(b) be subordinated to a
2 level below the priority of the securities upon which the claims are
3 based.⁸

4 The changes Congress made to § 510(b) through the enactment of
5 the Bankruptcy Amendments and Federal Judgeship Act of 1984 reinforces
6 our view. In 1984, § 510(b) was amended to provide that if the
7 applicable security is common stock, then the claims under § 510(b)
8 have the same priority as common stock. Based on the principle of
9 expressio unius est exclusio alterius (the express mention of one
10 thing excludes all others), it can be inferred that Congress did not
11 intend for § 510(b) to subordinate claims based on securities other
12 than common stock (i.e., limited partnership interests) to a level on
13 par with those securities. See Allen v. Geneva Steel Co. (In re
14 Geneva Steel Co.), 281 F.3d 1173, 1177 (10th Cir. 2002) ("In 1984,
15 Congress amended the statute to make clear that fraud claims springing
16 from the purchase or sale of common stock are treated on the same
17 level as common stock. All other claims are subordinated to their
18 underlying security."). While Congress likely did not specifically
19 have LLC membership interests in mind when enacting either the
20 Bankruptcy Reform Act of 1978 or the Bankruptcy Amendments and Federal
21 Judgeship Act of 1984,⁹ this does not change the fact that, under the

23 ⁸ But see In re Computer Devices, Inc., 51 B.R. 471, 478-80
24 (Bankr. D. Mass. 1985) (holding that, based on the language in the
25 House Report, the intention of Congress was not to subordinate claims
26 based on equity securities below equity securities). Computer Devices
is distinguishable because its discussion relates solely to common
stock, as opposed to other forms of equity securities. In any case,
Computer Devices is of no assistance to Appellants.

27 ⁹ "The limited liability company (LLC) is a new
28 type of entity organized under state law which

(continued...)

1 plain meaning of § 510(b), Appellants' claims would be subordinated
2 below the priority of the Diversified membership interests, not given
3 an equal priority with them. "If Congress enacted into law something
4 different from what it intended, then it should amend the statute to
5 conform it to its intent. It is beyond our province to rescue
6 Congress from its drafting errors, and to provide for what we might
7 think . . . is the preferred result." Lamie v. U.S. Trustee, 540 U.S.
8 526, 542 (2004) (quotation marks and citation omitted).

9 Appellants take the position that notwithstanding the plain
10 language of § 510(b), "a claim should only be subordinated when it
11 will accomplish the purposes of section 510(b)." Racusin v. American
12 Wagering, Inc. (In re American Wagering, Inc.), 493 F.3d 1067, 1072
13 (9th Cir. 2007).¹⁰ Appellants specifically rely on our dicta in

15 ⁹(...continued)

16 combines the pass-through attributes of the
17 partnership with the corporate characteristics of
18 limited liability. The first LLC to be given
19 partnership status for tax purposes was organized
under the Wyoming Limited Liability Company Act
[in 1977]."

20 Craig J. Langstraat & K. Dianne Jackson, Choice of Business Tax Entity
21 After the 1993 Tax Act, 11 AKRON TAX J. 1, 5 (1995). LLCs have "a
22 rather short history (the first IRS partnership status ruling was in
1988 and most of the state statutes were approved in 1992 and 1993)."
Id. at 6. LLCs did not appear in the State of Nevada until 1994. See
NEV. REV. STAT. ANN. § 86 (Michie 1994).

23 ¹⁰ The above-quoted language in American Wagering relates to
24 whether a particular claim falls within the ambit of § 510(b) in the
25 first place. This situation is distinguishable from the one we have
26 here. Here, Appellants' claims clearly would fall within the ambit of
27 § 510(b). Given such a circumstance, there is no authority for the
28 proposition that application of § 510(b) will depend upon whether the
particular facts fit the purported policy objectives of § 510(b).
Quite the opposite. See American Broadcasting Sys., Inc. v. Nugent
(In re Betacom of Phoenix, Inc.), 240 F.3d 823, 828-29 (9th Cir. 2001)
(describing subordination under § 510(b) as "mandatory
subordination").

1 American Wagering, Inc. v. Racusin (In re American Wagering, Inc.),
2 326 B.R. 449 (9th Cir. BAP 2005)¹¹ for the proposition that § 510(b)
3 was not enacted to protect other equity holders. In American
4 Wagering, we stated in dicta as follows:

5 It is not the other equity holders whose interests
6 § 510(b) protects. . . . Section 510(b) has much
7 more important work to do--to protect creditors
8 from dilution of their claims by equity holders
9 trying to claim creditor status. The purpose of
10 § 510(b) is to protect the rights of creditors,
11 not the rights of other shareholders.

12 Id. at 458 (citations omitted). Based on this language, Appellants
13 argue that § 510(b) must not subordinate claims based on the purchase
14 of equity interests to a level equal to or below equity because that
15 would go beyond the purported purpose of § 510(b).¹² To further
16 bolster this argument, Appellants additionally rely on the creditor
17 protection rationales for § 510(b) that are discussed in cases like
18 American Broadcasting Sys., Inc. v. Nugent (In re Betacom of Phoenix,
19 Inc.), 240 F.3d 823, 828-29 (9th Cir. 2001).

20 Appellants confuse the oft-stated rationales for § 510(b) for

21 ¹¹ Our opinion in American Wagering was originally reversed on
22 other grounds by Racusin v. American Wagering, Inc. (In re American
23 Wagering, Inc.), 465 F.3d 1048 (9th Cir. 2006). Recently, on June 28,
24 2007, the Ninth Circuit vacated its prior decision in American
25 Wagering and entered a new one. See 493 F.3d 1067. The holding in
26 this new opinion is the same.

27 ¹² Note that had Appellants flipped back a few pages in
28 American Wagering, they would have seen how little that case actually
supports their position. See 326 B.R. at 452 ("[W]hen a claim for
damages arises from the purchase or sale of stock, that claim must be
subordinated to the claims of general unsecured creditors (as well as
to any claims of more senior shareholders)."); see also id. at 453
("[T]he purpose of § 510(b) would be completely undermined were we to
allow Racusin to jump into line with the creditors and ahead of the
other shareholders merely by filing a lawsuit and limiting his claim
to damages rather than stock."). American Wagering made absolutely
clear that claims subordinated pursuant to § 510(b) are not merely
subordinated immediately beneath general unsecured creditors.

1 what the statute actually says. Here, the statute is clear. Section
2 510(b) would subordinate Appellants' claims in priority to a level
3 beneath all membership interests. We note that Appellants' argument
4 principally rests on our observation in a case which the Ninth Circuit
5 has since reversed.

6 In light of the foregoing, it is clear that § 510(b) would
7 subordinate Appellants' claims to a level below the Diversified
8 membership interests. As noted above, the bankruptcy court appears to
9 have been heading in the right direction inasmuch as the effect of
10 subordination may be functionally equivalent to disallowance (*i.e.*, no
11 distribution on the claims). However, this is only the case if first
12 there is an adversary proceeding, and then judgment is entered against
13 Appellants. See Rule 7001(8) (requiring an adversary proceeding for
14 the subordination of an "allowed claim or interest").¹³

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16 ¹³ We disagree with the bankruptcy court's view, quoted above,
17 that Rule 7001(8) does not apply to § 510(b). By its own terms, Rule
18 7001(8) does not distinguish between types of subordination. Thus,
all types of subordination fall under this rule.

19 While by its own terms Rule 7001(8) only applies to the
20 subordination of "allowed claim[s]," and, pursuant to § 502(a), a
21 claim is no longer deemed allowed if there is an objection, the
22 argument that an adversary proceeding was not required in this
23 instance due to the filing of the Objection is uncomfortably circular.
24 After all, the nanosecond before the Committee filed its objection,
Appellants held allowed claims, and an adversary proceeding would have
25 been required to subordinate those claims. It is true that Rule 7001
26 only deals with allowed claims, but that is because there is no
27 purpose served in subordinating disallowed claims. Rule 7001 would
28 have little meaning if you could avoid it by filing an objection.

29 Arguably, however, the Committee's request that Appellants'
30 claims be subordinated was proper under Rule 3007, which provides in
31 pertinent part that "[i]f an objection to a claim is joined with a
32 demand for relief of the kind specified in Rule 7001, it becomes an
33 adversary proceeding." Even if this were the case, however, the
34 adversary rules would apply. See Rules 7001-7087. However, since the
35 bankruptcy court did not rule on the subordination issue, we decline
36 (continued...)

1 **V. CONCLUSION**

2 For the reasons stated herein, we conclude that the bankruptcy
3 court erred in disallowing Appellants' claims.

4 Accordingly, we REVERSE.
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26 ¹³(...continued)
27 to do so here. Of course, a plan can subordinate claims without the
28 need for an adversary proceeding. See Rule 7001(8). This exception
has little relevance here, since the confirmed plan in this case did
not purport to subordinate Appellants' claims.