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U.S. BKCY. APP. PANEL
OF THE NINTH CIRCUIT

NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

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

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

v.)

MEMORANDUM¹

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

¹ This disposition is not appropriate for publication. Although it may be cited for whatever persuasive value it may have (see Fed. R. App. P. 32.1), it has no precedential value. See 9th Cir. BAP Rule 8013-1).

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

3 Honorable Linda B. Riegler, Bankruptcy Judge, Presiding
4

5 Before: RUSSELL,² BRANDT and SMITH, Bankruptcy Judges.
6

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

14 We REVERSE.

15 **I. FACTS**

16 USA Capital Diversified Trust Deed Fund, LLC ("Diversified" or
17 "Debtor") is a Nevada limited liability company organized as of
18 February 3, 2000. The apparent purpose of Diversified was to provide
19 a vehicle for Nevada investors to invest in loans originated by co-
20 Debtor USA Commercial Mortgage Company ("USACM"). Investors purchased
21 membership interests in Diversified, which then invested in various
22

23
24 ² Hon. Barry Russell, United States Bankruptcy Judge for the
Central District of California, sitting by designation.

25 ³ Unless otherwise indicated, all chapter, section and rule
26 references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1532, and to
27 the Federal Rules of Bankruptcy Procedure, Rules 1001-9036, as enacted
and promulgated as of October 17, 2005, the effective date of most of
28 the provisions of the Bankruptcy Abuse Prevention and Consumer
Protection Act of 2005 ("BAPCPA") (Pub.L. 109-8, 119 Stat. 23).

1 loans.⁴ Diversified's stated purpose was to make or purchase entire
2 or fractional interests in acquisition, development, construction,
3 bridge or interim loans that were secured by first deeds of trust on,
4 among other things, undeveloped land and residential commercial
5 developments. Although Diversified loans were supposed to be secured
6 by first deeds of trust and have other protections for Diversified
7 investors, these protections were not generally provided by USACM.

8 There was a continuous offering of membership interests (known as
9 "units") in Diversified from May 2000 to July 2004. In July 2004,
10 Diversified stopped offering the sale of membership units, and on
11 September 27, 2005, the investors were notified that Diversified would
12 be liquidating. Diversified, USACM, USA Capital Realty Advisors, USA
13 Capital First Trust Deed Fund, LLC ("FTDF"), and USA Securities, LLC
14 ("Debtors")⁵ all filed for bankruptcy protection on April 13, 2006
15

16 ⁴ According to its Prospectus, Diversified registered the sale
17 of its membership units with the Nevada Securities Division, and
18 strictly limited its offering to Nevada residents in order to avoid
having to register its securities with the SEC.

19 ⁵ 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
27 Diversified and FTDF. Finally, USA Securities, LLC, a registered
broker-dealer, sold membership interests in FTDF.

28 Diversified is the only Debtor relevant to this appeal.

1 ("Petition Date"). After the Petition Date, with a change in
2 management for the Debtors, the abject failure of Diversified's former
3 insiders to invest Diversified's monies properly became apparent. As
4 time wore on, the scope of the wrongs inflicted upon Diversified by
5 the insiders came sharply into focus. For example, the largest loan
6 in the Diversified portfolio was found to be a complete fiction and a
7 subterfuge employed by the insiders as part of a scheme to fund their
8 speculative real estate activities with Diversified's funds, rather
9 than utilizing those funds to make non-insider loans secured by first
10 trust deeds as promised in the prospectus.

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

20 On November 30, 2006, the Official Committee of Equity Security
21 Holders of Diversified ("Committee") filed its Omnibus Objection to
22 Claims on Equity Misfiled as Creditor Claims ("Objection"). The
23 Objection objected to 111 of the 137 proofs of claim filed against
24 Diversified at that time. Included in the Objection were the
25 Committee's objections to the proofs of claim filed by Appellants.⁶

26
27 ⁶ The Committee specifically objected to Claim Nos. 90-1,
28 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:

(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

15 ⁶(...continued)

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

1 the Committee, the bankruptcy court made the following comments:

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

6 "A claim for damages arising from the
7 purchase or sale of such security shall be
8 subordinated to all claims or interests that are
9 senior or equal to the claim or interest
10 represented of a said security, except if it's
11 common stock."

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

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

18 And the problem with this - a distinction
19 will be made. Let's assume that, coincidentally,
20 these people sold goods and services to the
21 debtor. Well, they'd have a creditors claim for
22 that because it's a different level.

23 I just can't fathom the concept that these
24 creditors could claim a creditors claim for the
25 exact same injury that everybody else has.

26 And under that theory, they would get their
27 claim paid in full, and I don't know what the
28 amount of the claim would be. I guess the amount
of the claim would be everything they put in the
investment.

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

And if it were the other way, trust me, I
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
--

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

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

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

5 THE COURT: No. I said you have a claim as an
6 equity holder.

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

8 THE COURT: Well, no.

9 MR. McGIMSEY: I -

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

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

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

14 MR. McGIMSEY: So I'm being subordinated; is that
15 correct?

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

18 MR. McGIMSEY: So -

19 THE COURT: It's not subordinated.

20 MR. McGIMSEY: Well, then -

21 THE COURT: You're asking -

22 MR. McGIMSEY: You're -

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

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

26 THE COURT: You were.

27 MR. McGIMSEY: I'm not asking -

28 THE COURT: But you were saying -

1 MR. MCGIMSEY: - to be elevated.

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

8 Oh, and in the 7001, I think only a - it
9 says, "Except as provided in a Chapter 11 plan."
10 I think 7001 only applies when you're seeking
11 subordination, equitable subordination, the bad-
12 conduct kinds of equitable subordination, as
13 opposed to looking at what the nature has, so I
14 just disagree.

15 I mean, it's an interesting argument. I just
16 disagree so, you know, your claim will be treated
17 like everybody else's.

18 MR. MCGIMSEY: Well, I don't understand that. My
19 claim has been - they filed an objection to the
20 claim, and I would just like it clear, your Honor
21 -

22 THE COURT: Yeah.

23 MR. MCGIMSEY: - you were saying that 510(b) says I
24 don't have a claim.

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

28 MR. MCGIMSEY: No one's claimed these -

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

MR. MCGIMSEY: Exactly.

THE COURT: Okay.

MR. MCGIMSEY: That I haven't -

THE COURT: So why -

MR. MCGIMSEY: - gotten back.

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.

1 MR. MCGIMSEY: I'm asking that because we -

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

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

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

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

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

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

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

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

15 IT IS HEREBY ORDERED that the Objection is
16 sustained.

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

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

28 **II. ISSUES**

29 A. Whether the bankruptcy court correctly sustained the Committee's
30 Objection on the basis that the Appellants' proofs of claim were
31 duplicative of their proofs of interest.

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

1 Further, there was no real indication that there was anything
2 wrong with Appellants' claims. Although the bankruptcy court seemed
3 to think that the proofs of claim were duplicative of the proofs of
4 interest, they are not. A proof of interest is based on mere equity
5 ownership; a proof of claim is based on a right to payment.
6 Appellants have proofs of interest by virtue of their ownership of
7 membership interests in Diversified, and proofs of claim based on
8 their claims against Diversified for breach of contract and fraud. It
9 is clear that Appellants are entitled to assert both claims and
10 interests, even though they cannot be paid on both. The fact that the
11 bankruptcy court felt uncomfortable with the idea that Appellants
12 could potentially jump in line ahead of other Diversified investors
13 was not a basis for disallowing Appellants' claims.

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

21 A. Whether the Claims and Interests are Duplicative

22 The core of the Committee's objection to Appellants' claims is
23 that these claims are duplicative of Appellants' proofs of interest.
24 We disagree. The proofs of claim and the proofs of interest are not
25 duplicative. Although both Appellants' respective proofs of claim and
26 proofs of interest relate to their membership interests in Diversified
27 and are for the exact same amount, this does not make the proofs of
28 claim and proofs of interest duplicative. The Committee's arguments

1 relating to equity and fairness do not change this result. As they
2 themselves admit, Appellants are not entitled to a double recovery.
3 Further, the issue of relative priority relates to whether Appellants'
4 claims should be subordinated, not whether they should be allowed.

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

24
25 ⁷ 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 upon their membership interests in Diversified. Their proofs of
2 claim, by contrast, are based upon their potential causes of action
3 against Diversified for breach of contract and fraud relating to their
4 purchase of those membership interests. Hence, Appellants' proofs of
5 interest and proofs of claim are clearly not duplicative.

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

25 It is neither incorrect nor improper for an equity holder to
26 assert a proof of claim based on breach of contract and fraud relating
27 to the purchase of a security and also a proof of interest. The Code
28 specifically contemplates this. As discussed below, § 510(b)

1 subordinates certain claims that are necessarily held by equity
2 holders. Equity holders must *a fortiori* be entitled to assert proofs
3 of claim in addition to proofs of interest or there would be nothing
4 to subordinate under § 510(b). If, in fact, an equity holder could
5 not assert both a proof of claim and a proof of interest, then
6 § 510(b) in most cases would have little to no meaning. See Tabor v.
7 Ulloa, 323 F.2d 823, 824 (9th Cir. 1963) (“[A] legislature is presumed
8 to have used no superfluous words.”) (citation omitted).

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

21 We also disagree with the argument that Appellants’ claims should
22 be disallowed because they are not distinguishable from the many other
23 potential, but unfiled claims against Diversified that other
24 Diversified members may hold against it based upon the same general
25 facts. This argument goes as follows: If the bankruptcy court
26 extends the claims bar date to allow all other Diversified members to
27 file proofs of claim, and then all other Diversified members do file
28 proofs of claim, then the Appellants would be in the same position

1 that they would have been in had they not filed proofs of claim in the
2 first place. *Ergo*, it makes sense to simply disallow the claims now
3 instead of having to proceed through these many procedural hoops in
4 order to get to the same inevitable result. This argument fails
5 because it puts the cart way before the horse. Even if the bankruptcy
6 court hypothetically extended the claims bar date, there is no
7 guarantee that even a significant number of Diversified members, if
8 any, would file proofs of claim. More significantly, punishing
9 creditors for diligently meeting claims bar dates because other
10 potential creditors have failed to do so is contrary to bankruptcy
11 policy and procedure. It is not uncommon in chapter 11 cases for a
12 handful of trade creditors to fail to file proofs of claim.
13 Penalizing the trade creditors who timely file proofs of claim because
14 others did not would be clearly erroneous. It is the same with this
15 case. Penalizing the Appellants for having filed proofs of claim when
16 other members of Diversified failed to do so, notwithstanding ample
17 notice, is erroneous.

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

22 B. Section 510(b)

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

1 the Appellants in order to subordinate their claims under § 510(b),
2 the applicability and effect of § 510(b) deserves discussion.

3 It is clear from the transcript of the January 31, 2007 hearing
4 and the language of the order sustaining the objections to Appellants'
5 claims that the court was disallowing Appellants' claims, not
6 subordinating them. Section 510(b) provides no basis for the
7 disallowance of claims. Disallowance and subordination are different.
8 "Disallowance of a claim is a legal determination that the claim under
9 consideration is not allowable by law. On the other hand,
10 subordination of a claim presupposes that the claim is allowed but for
11 equitable reasons must be subordinated to the other allowed claims."
12 Ford v. Feldman (In re Fla. Bay Trading Co.), 177 B.R. 374, 383
13 (Bankr. M.D. Fla. 1994). Although the bankruptcy court appears to
14 have been heading in the right direction inasmuch as the effect of
15 subordination under § 510(b), if established, may be functionally
16 equivalent to disallowance (*i.e.*, no distribution on the claims), the
17 bankruptcy court's ruling was nonetheless in error.

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

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

23 11 U.S.C. § 510(b) (emphasis added).⁸

24 ⁸ The text of the original subsection (b) provided as follows:

25 Any claim for rescission of a purchase
26 or sale of a security of the debtor or
27 of an affiliate or for damages arising
28 from the purchase or sale of such a
security shall be subordinated for

(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

24 ⁸(...continued)

25 purposes of distribution to all claims
26 and interests that are senior or equal
27 to the claim or interest represented by
28 such security.

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

1 holder of the debtor to share on a priority with general creditors.”
2 4 COLLIER ON BANKRUPTCY ¶ 510.LH[1], p. 510-32 (rev. 15th ed. 2006). “The
3 clear mandate of section 510(b) is that shareholder claimants will not
4 be allowed to elevate their interests from the level of equity to
5 general claims. . . . Rescission will lead to subordination below the
6 interest held before rescission.” 4 COLLIER ON BANKRUPTCY ¶ 510.04[1], p.
7 510-11 (rev. 15th ed. 2006). For example, suppose a preferred
8 stockholder holds a claim based upon the rescission of the purchase of
9 the preferred stock. In such a case, § 510(b) would clearly
10 subordinate its claim below the priority of the preferred stock.
11 Thus, it is clear that inasmuch as § 510(b) applies to Appellants’
12 claims, those claims may be subordinated below equity.

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

1 to the firm conclusion that, except where the Code directs otherwise,
2 Congress intended that claims subordinated under § 510(b) be
3 subordinated to a level below the priority of the securities upon
4 which the claims are based.⁹

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

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25 ⁹ But see In re Computer Devices, Inc., 51 B.R. 471, 478-80
26 (Bankr. D. Mass. 1985) (holding that, based on the language in the
27 House Report, the intention of Congress was not to subordinate claims
28 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.

1 Judgeship Act of 1984,¹⁰ this does not change the fact that, under the
2 plain meaning of § 510(b), Appellants' claims would be subordinated
3 below the priority of the Diversified membership interests, not given
4 an equal priority with them. "If Congress enacted into law something
5 different from what it intended, then it should amend the statute to
6 conform it to its intent. It is beyond our province to rescue
7 Congress from its drafting errors, and to provide for what we might
8 think . . . is the preferred result." Lamie v. U.S. Trustee, 540 U.S.
9 526, 542 (2004) (quotes omitted).

10 Appellants take the position that notwithstanding the plain
11 language of § 510(b), "a claim should only be subordinated when it
12 will accomplish the purposes of section 510(b)." American Wagering,
13 Inc. v. Racusin (In re American Wagering, Inc.), __ F.3d. __, 2007 WL
14 1839681, at *3 (9th Cir. 2007).¹¹ Appellants specifically rely on our
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16 ¹⁰ "The limited liability company (LLC) is a new
17 type of entity organized under state law which
18 combines the pass-through attributes of the
19 partnership with the corporate characteristics of
20 limited liability. The first LLC to be given
partnership status for tax purposes was organized
under the Wyoming Limited Liability Company Act
[in 1977]."

21 Craig J. Langstraat & K. Dianne Jackson, Choice of Business Tax Entity
22 After the 1993 Tax Act, 11 AKRON TAX J. 1, 5 (1995). LLCs have "a
rather short history (the first IRS partnership status ruling was in
23 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).

24 ¹¹ The above-quoted language in American Wagering relates to
25 whether a particular claim falls within the ambit of § 510(b) in the
first place. This situation is distinguishable from the one we have
26 here. Here, Appellants' claims clearly would fall within the ambit of
§ 510(b). Given such a circumstance, there is no authority for the
27 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

(continued...)

1 dicta in American Wagering, Inc. v. Racusin (In re American Wagering,
2 Inc.), 326 B.R. 449 (9th Cir. BAP 2005)¹² for the proposition that
3 § 510(b) 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
10 of § 510(b) is to protect the rights of creditors,
11 not the rights of other shareholders.

12 Id. at 458. Based on this language, Appellants argue that § 510(b)
13 must not subordinate claims based on the purchase of equity interests
14 to a level equal to or below equity because that would go beyond the
15 purported purpose of § 510(b).¹³ To further bolster this argument,
16 Appellants additionally rely on the creditor protection rationales for
17 § 510(b) that are discussed in cases like American Broadcasting Sys.,
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19 ¹¹(...continued)

20 (In re Betacom of Phoenix, Inc.), 240 F.3d 823, 828-29 (9th Cir. 2001)
21 (describing subordination under § 510(b) as "mandatory
22 subordination").

23 ¹² Our opinion in American Wagering was originally reversed on
24 other grounds by American Wagering, Inc. v. Racusin (In re American
25 Wagering, Inc.), 465 F.3d 1048 (9th Cir. 2006). Recently, on June 28,
26 2007, the Ninth Circuit vacated its prior decision in American
27 Wagering and entered a new one. See ___ F.3d. ___, 2007 WL 1839681, at
28 *3 (9th Cir. 2007). The holding in this new opinion is the same.

29 ¹³ Note that had Appellants flipped back a few pages in
30 American Wagering, they would have seen how little that case actually
31 supports their position. See 326 B.R. at 452 ("[W]hen a claim for
32 damages arises from the purchase or sale of stock, that claim must be
33 subordinated to the claims of general unsecured creditors (as well as
34 to any claims of more senior shareholders)."); see also id. at 453
35 ("[T]he purpose of § 510(b) would be completely undermined were we to
36 allow Racusin to jump into line with the creditors and ahead of the
37 other shareholders merely by filing a lawsuit and limiting his claim
38 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 Inc. v. Nugent (In re Betacom of Phoenix, Inc.), 240 F.3d 823, 828-29
2 (9th Cir. 2001).

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

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

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19 ¹⁴ We disagree with the bankruptcy court's view, quoted above,
20 that Rule 7001(8) does not apply to § 510(b). By its own terms, Rule
21 7001(8) does not distinguish between types of subordination. Thus,
22 all types of subordination fall under this rule.

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

Arguably, however, the Committee's request that Appellants'
claims be subordinated was proper under Rule 3007, which provides in
(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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23 ¹⁴(...continued)

24 pertinent part that "[i]f an objection to a claim is joined with a
25 demand for relief of the kind specified in Rule 7001, it becomes an
26 adversary proceeding." Even if this were the case, however, the
27 adversary rules would apply. See Rules 7001-7087. However, since the
28 bankruptcy court did not rule on the subordination issue, we decline
to do so here. Of course, a plan can subordinate claims without the
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.