No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are at Risk

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NOTES

NO FAULT EQUITABLE SUBORDINATION: REASSURING INVESTORS THAT ONLY GOVERNMENT PENALTY CLAIMS ARE AT RISK

The bankruptcy courts have the power to subordinate claims on equitable grounds, which means that they may place an otherwise superior, valid claim behind other claims in the name of equity. Congress codified the judicially created doctrine of equitable subordination in the Bankruptcy Act of 1978 but did not provide guidelines for application of the doctrine. Instead, Congress left the development of the doctrine to the courts. The danger of judges' arbitrarily applying such a harsh remedy has caused the financial community to study carefully the developments of the law of equitable subordination. The fear of unpredictable subordination was, for the most part, alleviated by the requirement of the Bankruptcy Act of 1978 that subordination occur only if the claimant acted inequitably. This doctrine assured investors that, absent such inequitable conduct, their priority was secure. Recent cases that have defied existing precedent by subordinating valid

1. See, e.g., Pepper v. Litton, 308 U.S. 295 (1939); see also infra notes 28-101 and accompanying text (describing the common law development of equitable subordination).
2. 3 COLIER ON BANKRUPTCY § 510.01 (15th ed. 1992).
4. Id. ("It is intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle."); see La Grand Steel Prods. Co. v. Goldberg (In re Poole, McGomgle & Dick, Inc.), 796 F.2d 318, 322 (9th Cir.), modified, 804 F.2d 576 (9th Cir. 1988) ("Section 510(c), permitting a bankruptcy court equitably to subordinate claims is essentially a codification of case law."); see also COLIER, supra note 2, § 510.04; infra note 104 and accompanying text (presenting the testimony in Congress of Rep. Edwards, the bill's sponsor).
7. Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 699-700 (5th Cir. 1977); see also infra note 77 and accompanying text (describing the impact of Mobile Steel).
claims without a finding of creditor misconduct have shaken the financial community and called into question the future of bankruptcy priority.

During a 1991 meeting of the American Bar Association Business Law Section, Martin Bienenstock, an attorney with the law firm of Weil, Gotshal & Manges, noted "a new chill in the air" from recent federal circuit cases that could signal "a trend toward no fault subordination." Mr. Bienenstock warned that although the cases had involved Internal Revenue Service (IRS) claims, the courts had subordinated the government claims even though no IRS misconduct had taken place. He stated that "the potential consequences are enormous," and "[t]he message is that perhaps lenders can be subordinated without being guilty of anything whatsoever, but solely because the court thinks their claims should be treated on a lesser basis than other creditors' claims."

Mr. Bienenstock's concern was the result of recent cases that involved subordinated nonpecuniary tax claims without a finding of misconduct on the part of the claimant. In 1990, the Seventh Circuit decided *In re Virtual Network Services Corp.*, holding that a court could subordinate a claim without a finding of misconduct. The Eighth Circuit and the Third Circuit quickly adopted the reasoning of the *Virtual Network* decision.

Mr. Bienenstock's statements reflected practitioners' fears that the equitable powers of the courts, unrestrained by the common law's requirement of a finding of misconduct, will eclipse the structure of bankruptcy prioritization. The question of "which claims should be on a parity with which other claims will be a function of first impression with every judge."
Unbridled equitable power implies that lenders will be unable to assess risk. At the heart of the Bankruptcy Code lies the importance of predicting the order of claims when a company becomes bankrupt; Congress intended stability before, during, and after a bankruptcy. Existing precedent allows lenders to determine the scope of permissible conduct and avoid subordination by staying within these bounds. The recent trend of increased lender liability has helped create a distrust of the legal system within the financial community. Increasing the exposure of lenders by eroding the requirement of inequitable conduct will only increase lenders' distrust by threatening the security they currently have.

This Note analyzes the development of the doctrine of equitable subordination, first in common law, then in statutory law. The common law development of equitable subordination was rooted in cases that involved misconduct. As the principle evolved, courts adopted a three-part test to determine when subordination was proper; one part of the test was a requirement that misconduct exist before subordination could occur. The Bankruptcy Code codified the common law, including the requirement of misconduct. Unfortunately, some ambiguity in the legislative history of the Bankruptcy Code could be construed to allow subordination without a finding of misconduct. Virtual Network Services Corp. v. United States was the first case in which a court utilized the legislative ambiguity to subordinate in the absence of misconduct. The Note concludes that Virtual Network is an anathema that courts should confine to its precise facts.

18. See, e.g., Charles Seligson, Preferences Under the Bankruptcy Act, 15 VAND. L. REV. 115 (1961) (stating that the goal of bankruptcy law is that all creditors similarly situated should be treated alike). See generally COLLIER, supra note 2, § 501.01 (discussing the Bankruptcy Code's provisions).
19. See infra note 77 and accompanying text.
20. See infra note 234.
21. See infra notes 32-69 and accompanying text.
22. Id.
23. See infra note 37 and accompanying text.
24. See infra note 104 and accompanying text.
25. See infra note 107 and accompanying text.
27. See infra notes 114-71 and accompanying text.
The bankruptcy court traditionally has been described as a multifaceted court with legal and equitable power. The court's equity jurisdiction is rooted in the central theme of the bankruptcy laws—equality of distribution. When the substantive laws of bankruptcy fail to achieve just results, bankruptcy courts invoke equity to allow substance to prevail over form. The courts' desire to achieve just results, and the equitable powers that sanctioned this pursuit, led the courts to develop the doctrine of equitable subordination. The doctrine of equitable subordination first appeared as an equitable defense to the allowance of claims.

"Deep Rock"

The Supreme Court first validated the bankruptcy courts' equitable power to subordinate claims in Taylor v. Standard Gas & Electric Co., popularly known as the "Deep Rock" case. In Taylor, the preferred stockholders of the Deep Rock Oil Corporation protested a claim against Deep Rock by its parent company, Standard Gas & Electric, that resulted from loans Standard had made...
to Deep Rock.\textsuperscript{34} The stockholders attempted to subordinate Standard's claim pursuant to section 77B of the Bankruptcy Act of 1898, which allowed for reorganization "including provisions modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character or otherwise." \textsuperscript{35} The Court found that Standard had mismanaged and undercapitalized Deep Rock and had denied the preferred stockholders voting power to which they were entitled.\textsuperscript{36} Because of Standard's inequitable conduct, the Court subordinated Standard's claim,\textsuperscript{37} recognizing that returning the preferred shareholders to the position that they had occupied prior to Standard's mismanagement was impossible.\textsuperscript{38} Instead, the Court guaranteed that the preferred stockholders would receive a right in the company's equity superior to Standard's, as well as a voice in managerial decisions equal to or greater than Standard's.\textsuperscript{39} By demanding that these steps be taken if reorganization were to occur, the Court eliminated the preferred shareholders' subordinated status that had caused the mismanagement.

\textit{Pepper v. Litton}

The Supreme Court clarified the scope of Taylor in Pepper v. Litton,\textsuperscript{40} decided the same year. In Pepper, Litton, the dominant and controlling stockholder of the Dixie Splint Coal Company, caused Dixie to confess judgment for unpaid salary claims that Litton intended to use as a shield against debts that the corporation owed to a creditor, Pepper, for royalties due through a lease.\textsuperscript{41} When Pepper asserted his claim against Dixie, Litton forced the company to file a voluntary petition in bankruptcy \textsuperscript{42} Litton be-

\begin{itemize}
\item \textsuperscript{34} Taylor, 306 U.S. at 309-12.
\item \textsuperscript{35} Id. at 322-23 (quoting § 77B(b)(2) of the Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (codified at 11 U.S.C. § 77B(b)(2) (1934) (repealed 1978))).
\item \textsuperscript{36} Id. at 323.
\item \textsuperscript{37} Id. at 324.
\item \textsuperscript{38} Id. at 323 ("It is impossible to recast Deep Rock's history and experience so as even to approximate what would be its financial condition at this day had it been adequately capitalized and independently managed").
\item \textsuperscript{39} Id. at 324.
\item \textsuperscript{40} 308 U.S. 295 (1939).
\item \textsuperscript{41} Id. at 297.
\item \textsuperscript{42} Id. at 298.
\end{itemize}
lieved that the company's confessed judgment would consume its remaining assets, leaving nothing for Pepper.\footnote{Id.}

The Court clarified the basis of its decision in Taylor by stating that the holding in that case "was based on the equities of the case,\"\footnote{Id. at 308. The Court stated that the inequity was a result of "the history of spoliation, mismanagement and faithless stewardship by [the subordinated claimant]." Id.} thus eliminating claims that the "Deep Rock" doctrine derived statutorily from section 77B of the Bankruptcy Act of 1898, or that it was limited to enterprise liability.\footnote{DeNatale & Abrams, supra note 5, at 421.} The Court explained that a bankruptcy court has the power to examine claims in two ways. First, it can determine whether a claim is valid; if it decides that the claim is not valid, the court can disallow it.\footnote{See Pepper, 308 U.S. at 305-06.} Second, even if the claim is valid, the bankruptcy court can look behind the form of the claim because a "bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate."\footnote{Id. at 308.} Litton's claim passed the first test of validity because he had secured a judgment, but his claim failed the second test because he had acted inequitably in securing the judgment.\footnote{Id. at 310-12.} The Court viewed this abuse of Litton's insider status as a violation of his fiduciary duty and held that Litton's inequitable conduct not only allowed, but required, the bankruptcy court to exercise its equitable powers by subordinating the claim.\footnote{Id. at 312.}

\textit{Comstock v. Group of Institutional Investors}

Comstock v. Group of Institutional Investors,\footnote{335 U.S. 211 (1948).} the third in the trilogy of cases\footnote{The characterization of the cases as a trilogy or the "big three," and the use of the term "Taylor-Pepper-Comstock," appeared in Asa S. Herzog & Joel B. Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 Vand. L. Rev. 83, 108, 111 (1961).} forming the fundamental doctrine of equitable subordination, involved the reorganization of a railroad company Comstock, an investor, objected to a claim by Missouri Pacific Railway Company against one of its subsidiaries, the New Orleans...
Railway Company. Comstock argued that Missouri Pacific, the controlling shareholder of New Orleans Railway, had mismanaged the subsidiary and caused it to operate with unfair advantage to Missouri Pacific. Comstock did not question the facial validity of the debt—the first prong of the Pepper test; instead, he attacked Missouri Pacific’s claim on the grounds that the circumstances surrounding the claim warranted the subordination of the claim to Comstock’s capital stock—the second prong of the Pepper test.

Although both Taylor and Comstock involved reorganization under section 77 of the Bankruptcy Act of 1898, and the plaintiffs in both cases made similar allegations, the Court distinguished Comstock on the grounds that Missouri Pacific had acted in good faith. The Court explained that the purpose of the rule in Taylor was to prevent a fiduciary in such a position from enriching itself by breach of its trust. It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong.

In a dissenting opinion, Justice Murphy argued that the Court should not confine the doctrine of equitable subordination to matters of bad faith. He read Pepper as allowing subordination when negligence and the “utmost subjective good faith” created inequity. The Court rejected Justice Murphy’s broad reading.

Where Pepper expanded Taylor by giving the bankruptcy courts broad use of their equitable powers, Comstock narrowed the use of these powers by imposing a requirement that courts find bad faith

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52. Comstock, 335 U.S. at 214.
53. Id. at 217.
54. See supra note 46 and accompanying text.
55. Comstock, 335 U.S. at 219.
56. See supra note 47 and accompanying text.
57. Comstock, 335 U.S. at 229.
58. Id. (emphasis added).
59. Id. at 238 (Murphy, J., dissenting).
60. Id.
61. Id. at 230-31 (“Disallowance of petitioner’s objections on such findings [of good faith] was not error of law.”).
before they order subordination. Commentators have construed *Comstock* as "a reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable."72

Despite the clarity of *Comstock*, some viewed the principles of the *Taylor-Pepper-Comstock* trilogy as ambiguous. An article written twelve years after *Comstock* pointed out some of the weaknesses of these cases.63 For example, the basis of the Court's decision in *Pepper* may have been fraudulent conduct.64 If this interpretation is accurate, then much of Justice Douglas' opinion was dicta. *Pepper* thus only exacerbated the ambiguity of the *Taylor* opinion's use of the word "injustice" by categorizing the breach of moral obligations of the fiduciary as "unjust."65 Finally, the fact that Justice Douglas, the author of *Pepper*, dissented in *Comstock* diminishes the importance of *Comstock*.66 Because of these weaknesses, commentators have argued that the *Taylor-Pepper-Comstock* trilogy merely gave the bankruptcy court three examples of how to define "injustice."67

Despite this criticism, a majority of courts seized the holdings in these three cases as basic guidelines for determining when subordination was proper.68 The focus of the litigation that followed the cases became the degree of offending conduct that was necessary to trigger the possibility of subordination.69 Apparently, the Supreme

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64. See id.
65. Id.
66. Id. at 108 (stating that the disagreement in *Comstock* reflected a different interpretation of facts, not principles of law).
67. Id.
68. See *infra* notes 71-78 and accompanying text (describing the adoption of the framework of Benjamin v. Diamond (*In re Mobile Steel Co.*), 563 F.2d 692 (5th Cir. 1977)).
69. See, e.g., Smith v. Associated Commercial Corp. (*In re Clark Pipe & Supply Co.*), 893 F.2d 693 (5th Cir. 1990) (holding equitable subordination improper when a creditor reduced funding and exercised powers pursuant to a loan agreement negotiated prior to insolvency).
The primary distinctions between subordinating the claims of insiders versus those of non-insiders lie in the severity of misconduct required to be shown, and the degree to which the court will scrutinize the claimant's actions toward the debtor or its creditors. Where the claimant is a non-insider, egregious conduct must be proven with particularity. It is insufficient for the objectant in such cases merely to establish sharp dealing; rather, he must prove that the claimant is guilty of gross misconduct tantamount to "fraud, overreaching or spoliation to the detriment of others." Where the claimant is an insider, his dealings with the debtor will be subjected to more exacting scrutiny. If the objectant comes forward with sufficient substantiations of misconduct on the part of the insider claimant, the burden will shift to the insider to establish that each of his challenged transactions with the debtor had all the earmarks of an arm's length bargain.


Section 101(31) of the Bankruptcy Code reads in part:

"insider" includes—

(B) if the debtor is a corporation—

(i) director of the debtor;

(ii) officer of the debtor;

(iii) person in control of the debtor;

(iv) partnership in which the debtor is a general partner;

(v) general partner of the debtor; or

(vi) relative of a general partner, director, officer, or person in control of the debtor;

(E) affiliate, or insider of an affiliate as if such affiliate were the debtor;

11 U.S.C. § 101(31)(1988). Section 102(3) provides that the use of the word "includes" is not limiting in its effect. *Id.* § 102(3). The categories of § 101(31), therefore, are not exhaustive and an entity that does not fit neatly into any of the categories may nonetheless be an insider if it exerts sufficient influence over the debtor. *See, e.g.*, Highway & City Freight Drivers v. Gordon, 576 F.2d 1285 (8th Cir. 1978).

Some writers argue that, on one hand, the equitable subordination remedy demands flexibility and the imprecision allows courts to fashion appropriate relief. DeNatale and Abram explain:

Inasmuch as the thrust of the doctrine is to correct the results of inequitable or fraudulent conduct not otherwise vouched by the express provisions of the bankruptcy laws, any attempt to establish precise criteria for the application of the doctrine would result in permitting certain inequitable or fraudulent conduct to escape its reach and would defeat the very purpose of the doctrine.

DeNatale & Abram, *supra* note 5, at 422. The uncertainties and risks of commercial financing, on the other hand, could be reduced if courts offered corporate creditors more concrete guidance. One definition of inequitable conduct has been lauded in the literature and quoted by the courts:

Inequitable conduct is that conduct which may be lawful, yet shocks one's good conscience. It means, *inter alia*, a secret or open fraud; lack of faith or guardianship by a fiduciary; an unjust enrichment, not enrichment by bon chance, astuteness, or business acumen, but enrichment through another's loss
Court had answered affirmatively the question of whether subordination required bad faith.70

For many years after the Comstock decision, courts continued to struggle to define the amorphous concepts that comprised the doctrine of equitable subordination. An overwhelming number of courts followed the Supreme Court and required that some type of inequitable conduct exist before subordinating a legitimate claim.71 The Supreme Court left each court to determine exactly what the phrase “good faith”72 meant. Markedly absent was a framework to assist courts in uniformly applying the principles of equitable subordination.

In re Mobile Steel Co.

In 1977, the Fifth Circuit, after a thorough review of prior decisions, distilled the requirements for equitable subordination into three criteria:

70. All but one case until 1978 explicitly required inequitable conduct for the subordination of a creditor’s claim. See In re Burden, 917 F.2d 115, 122 (3d Cir. 1990) (Alito, J., concurring in part and dissenting in part) (pointing out that opinions written in 1990 could find only one pre-1978 case, Jezarian v. Raichle (In re Stirling Homex Corp.), 579 F.2d 206 (2d Cir. 1978), cert. denied, 439 U.S. 1074 (1979), that permitted subordination without explicitly requiring inequitable conduct). See infra notes 80–100 and accompanying text for a discussion of Homex.

71. See, e.g., Heiser v. Woodruff, 327 U.S. 726 (1946) (holding a bankruptcy court has the authority to subordinate a creditor’s claim based on a showing of fraudulent or inequitable conduct); Wood v. Richmond (In re Branding Iron Steak House), 536 F.2d 299 (9th Cir. 1976) (holding that equitable subordination requires a showing of “suspicious” inequitable conduct of a corporate officer accused of undercapitalization of a bankrupt corporation); Stebbins v. Crocker Citizens Nat’l Bank (In re Ahlswede), 516 F.2d 784 (9th Cir.) (finding that a bankruptcy court lacked the authority to subordinate a claim without evidence of inequitable conduct by a trustee), cert. denied, 423 U.S. 913 (1976); In re Credit Indus. Corp., 366 F.2d 402 (2d Cir. 1966) (holding that equitable subordination is based on a showing of inequitable conduct); Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958) (finding that the evidence did not support a claim of inequitable conduct when corporate officers converted partnership contributions into loans that left the partnership undercapitalized); Luther v. United States (In re Garden Grain & Seed Co.), 225 F.2d 495 (10th Cir. 1954) (holding that subordination is inappropriate without a finding of inequitable conduct); In re Elkins-Dell Mfg. Co., 253 F. Supp. 864 (E.D. Pa. 1966) (holding that convincing proof of unconscionable conduct is necessary to warrant equitable subordination).

72. See Comstock v. Group of Investors, 335 U.S. 211, 228-29 (1948).
(1) The claimant must have engaged in some type of inequitable conduct.
(2) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant.
(3) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.\(^7\)

Although aware of the article by Herzog and Zweibel\(^7\) that deemphasized the importance of \textit{Comstock},\(^7\) the court cited \textit{Comstock} as authority for the first two conditions.\(^7\) Courts and commentators quickly seized upon the new framework as a pragmatic solution to the ambiguity that plagued the doctrine of equitable subordination.\(^7\) In 1985 the law seemed to be settled:

\(73.\) Benjamin v. Diamond (\textit{In re Mobile Steel Co.}), 563 F.2d 692, 700 (5th Cir. 1977). Courts have emphasized the danger posed by a judge's decision to deviate from these strict guidelines and instead act on personal opinions of justice and morality. See, e.g., Boyajarian v. Defuses (\textit{In re Giorgio}), 862 F.2d 933, 939 (1st Cir. 1988).

\(74.\) Herzog & Zweibel, \textit{supra} note 51.

\(75.\) Mobile Steel, 563 F.2d at 699 (citing Herzog & Zweibel, \textit{supra} note 51).

\(76.\) Id. at 699-700.

\(77.\) See Smith v. Associated Commercial Corp. (\textit{In re Clark Pipe & Supply Co.}), 893 F.2d 693, 699 (6th Cir. 1990) (holding that evidence of inequitable conduct by a lender was sufficient to justify equitable subordination); Spacek v. Thomen (\textit{In re Universal Farming Indus.}), 873 F.2d 1334 (9th Cir. 1989) (holding that subordination would be denied absent harm to other creditors); Bergquist v. Anderson-Greenwood Aviation Corp. (\textit{In re Bellanca Aircraft Corp.}), 850 F.2d 1275, 1282 (8th Cir. 1988) (applying \textit{Mobile Steel}'s three-part test); Estes v. N & D Properties, Inc. (\textit{In re N & D Properties, Inc.}), 799 F.2d 726, 731 (11th Cir. 1986) (explicitly adopting \textit{Mobile Steel}'s three-part test); La Grand Steel Prods. Co. v. Goldberg (\textit{In re Poole}, McGonigle & Dick, Inc.), 796 F.2d 318, 323 (9th Cir.) (holding that a stockholder's claim would be subordinated based on evidence that its repurchase agreement would harm the general creditors), \textit{modified}, 804 F.2d 576 (9th Cir. 1986); Unsecured Creditors Comm. of Pacific Express, Inc. v. Pioneer Commercial Funding Corp. (\textit{In re Pacific Express, Inc.}), 69 B.R. 112, 116 (Bankr. 9th Cir. 1986) (applying the \textit{Mobile Steel} test); Katz v. Department of Justice (\textit{In re Bellucci}), 29 B.R. 814, 815 (Bankr. 1st Cir. 1983) (holding that § 510(c)(1) will not subordinate an IRS claim to the claims of a debtor's defrauded clients); Wilson v. Huffman (\textit{In re Missionary Baptist Found.}), 712 F.2d 206, 211-12 (6th Cir. 1983) (holding that a bankruptcy judge must provide clear factual reasoning in order to subordinate a claim under \textit{Mobile Steel}); Trone v. Smith (\textit{In re Westgate-California Corp.}), 642 F.2d 1174, 1178 (9th Cir. 1981) (holding that actions by an individual against a bankrupt entity that would have been litigated would not have justified subordination because subordination would be punitive); \textit{In re Thomas}, 91 B.R. 731, 737 (N.D. Tex. 1988) (holding § 510 inapplicable because the IRS's failure to refer a dispute between government agencies to the U.S. Attorney's office did not constitute wrongful conduct); \textit{In re Powe}, 75 B.R. 387, 389-90 (Bankr. M.D. Fla. 1987) (holding § 510 inapplicable because no evidence showed that the IRS had engaged in inequitable conduct); \textit{In re Campton Corp.}, 40 B.R. 875, 877 (Bankr.
Although the doctrine appears to have been utilized with greater frequency recently, the doctrine of equitable subordination itself has not changed significantly in the last forty years. Indeed, the simple and well stated principles of equity jurisprudence set forth by the Supreme Court in Pepper v. Litton continue to be as relevant and valid today as they were over forty years ago. [The Mobile Steel] criteria are not new but are merely a restatement of the elements of the doctrine. It would appear that there has not in fact been any expansion of the doctrine by the courts.\(^7\)

\textit{In re Stirling Homex}

One other case, Jezarian v. Raichle (\textit{In re Stirling Homex Corp.}),\(^8\) sets the background for the current controversy that surrounds the doctrine of equitable subordination. \textit{Homex} is recognized as the lone case prior to the passage of the Bankruptcy Code

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N.D. Tex. 1984) (holding that a U.S. Department of Energy claim that was not based on pecuniary loss, and that was not likely to be returned to actual injured parties, was property subordinated); \textit{In re Graft Bros., Inc.}, 38 B.R. 237, 238 (Bankr. D. Me. 1984) (holding that Congress' failure to provide a highway use tax did not constitute inequitable conduct under § 510); \textit{In re Roamer Linen Supply, Inc.}, 30 B.R. 932, 937 (Bankr. S.D.N.Y. 1983) (holding that § 510(c)(1) does not provide a basis for subordinating pecuniary tax liens); Regro Crescent Corp. v. Tymon (\textit{In re Regro Crescent Corp.}), 7 C.B.C.2d 713, 717 (Bankr. E.D.N.Y. 1982) (holding that prepetition debts from shareholder loans to a debtor shall be subordinated only by proving that the corporation was undercapitalized prior to the loan or that shareholder conduct was inequitable); Allied Tech., Inc., v. R.B. Bruneman & Sons, Inc. (\textit{In re Allied Tech., Inc.}), 25 B.R. 482, 499 (Bankr. S.D. Ohio 1982) (holding that claims arising under an assumption of a lease would not be subordinated under § 510(c)(1) because the lease benefitted the deceased's estate and thus the other secured creditors); George Ashe, \textit{Subordination of Claims—Equitable Principles Applied in Bankruptcy}, 84 \textit{Banking L.J.} 778, 780 (1967); Helen D. Chaitman, \textit{The Equitable Subordination of Bank Claims}, 39 \textit{Bus. Law.} 1561, 1562 (1984) (discussing subordination of bank claims); DeNatale & Abram, supra note 5, at 418; Margaret H. Douglas-Hamilton, \textit{Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor}, 31 \textit{Bus. Law.} 343, 343 (1975); Herzog & Zweibel, supra note 51, at 108-11; Jeremy W Dickens, Note, \textit{Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of “Control,”} 66 Tex. L. Rev. 801 (1987) (analyzing lender liability and equitable subordination contexts); W Clark Watson, Note, \textit{Deep Rock in the Deep South—Equitable Subordination of Claims in Fifth Circuit Bankruptcy Proceedings}, 11 \textit{CumB. L. Rev.} 619, 620 (1980).

\(^7\) DeNatale & Abram, supra note 5, at 447.

\(^8\) 579 F.2d 206 (2d Cir. 1978), cert. denined, 439 U.S. 1074 (1979).
that subordinated creditors' claims without making an express finding of inequitable conduct.80

In Homex, key officials of the company seeking reorganization engaged in fraudulent conduct intended to mislead the public into believing that the company was financially stable when it was not.81 In distributing the company's assets, the bankruptcy judge subordinated the claims of the "allegedly defrauded stockholders"82 to those of the company's general unsecured creditors.83 The stockholders sought classification of their claims based not on their interest in the company, as evinced by stock certificates, but on their claims against the company that alleged fraud.84 The court gave the following logic for its decision to subordinate the claims:

If the claims of alleged defrauded stockholders are not subordinated to the claims of conventional general unsecured creditors, a wholly new element will have been created in the financial structure of business. No longer will creditors, whether banks, suppliers, or subcontractors, be free as they now are to extend credit to the ordinary course of business on their presumed right to be accorded priority over the claims of investors and speculators in securities. Such a fundamental change in the financial structure of the business community is unwarranted in the absence of legislation designed to overturn the long established rule of absolute priority.

Defrauded stockholder claimants in the purchase of stock are presumed to have been bargaining for equity type profits and assumed equity type risks.85

The bankruptcy court did not explicitly follow the Mobile Steel framework in reaching its decision, probably because of the large

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80. See supra note 70.
81. Homex, 579 F.2d at 208.
82. The court used this term throughout the opinion, perhaps because the shareholders had not proven that the fraud had an effect on their transactions. The fact that five of the officers of the company were convicted of securities fraud, mail fraud, and conspiracy, id. at 209 n.4, may indicate that the court believed that the shareholders could not have been completely oblivious and could not have had clean hands, and that they must have been involved somehow in the impropriety.
83. Id. at 209-10.
84. Id. at 212.
85. Id. at 210 (citing the opinion of the bankruptcy court).
body of existing case law that addressed the issue in *Homex* and the important policy concerns.\footnote{86}

The Second Circuit affirmed the decision of the bankruptcy judge,\footnote{87} citing *Pepper v. Litton*\footnote{88} as a justification for the bankruptcy court's application of equitable subordination.\footnote{89} The appellate court did not have to justify the *Homex* opinion on the basis of the equitable principles outlined in *Pepper* because a well-defined body of law was already available to deal with the *Homex* type of case.\footnote{90} In reorganization cases, courts take a suspicious view of stockholders who attempt to assume the role of creditors.\footnote{91} One can view the issue in these situations as one not of subordination, but of whether the courts should allow stockholders to recharacterize their interests “in such a way as to achieve parity with ordinary unsecured tort and contract claimants.”\footnote{92} The *Homex* opinion cited Collier's explanation that when the claims of one group of unsecured creditors deserve priority, the creditors “must be separately classified and accorded the priority to which they are entitled.”\footnote{93} The bankruptcy court engaged in this unique type of subordination.\footnote{94} Another view of the *Homex* opinion is that the decision was one in which the bankruptcy court applied the two-prong *Pepper* analysis, finding that the claims could possibly fit within the legal definition of claims that deserve parity but that

\footnote{86. See id. at 213-14 (“We will not allow stockholders whose claims are based solely on the alleged fraud that took place to deplete further the already meager pool of assets presently available to the general creditors.”).}
\footnote{87. Id. at 210.}
\footnote{88. 308 U.S. 295 (1939).}
\footnote{89. *Homex*, 579 F.2d at 212.}
\footnote{90. The reference to *Pepper* appears in *Homex* as a sanction of the lower court’s use of equitable principles to subordinate the claims of the shareholders. The appellate court used phrases from *Pepper* to establish the broad scope of the powers available to the bankruptcy court. Id. at 212; see supra notes 40-49 and accompanying text (discussing the broad language in *Pepper*).}
\footnote{91. See, e.g., *Homex*, 579 F.2d at 211.}
\footnote{92. Id.}
\footnote{93. Id. at 213 (citing 6 COLLIER ON BANKRUPTCY ¶ 9.13, at 1620-21).}
\footnote{94. Although the court’s action has been classified as subordination, a strong argument can be made that the court was engaged in determining proper classification. The opinion pointed to the fact that courts are beginning to use equity to determine whether claims belong together or whether claims belonging together should be shifted due to inequitable conduct. Id. at 212-13.}
equity mandated their subordination. In other words, the shareholders attempted to use a legal technicality, frowned on by the bankruptcy court, to gain a larger share in the liquidation. The court viewed this subtle attempt to override the system as inequitable conduct.

Interestingly, the Second Circuit was aware of the ongoing legislative process involving the Bankruptcy Code at the time the decision in Homex was pending; the court cited two versions of the bill as they appeared at that time. The House version addressed the exact question confronted by the Homex opinion:

> The court’s power is broader than the general doctrine of equitable subordination, and encompasses subordination on any equitable grounds. The general creditors have not had the potential benefit of the proceeds of the enterprise deriving from ownership of securities and it is inequitable to permit shareholders that have had this potential benefit to shift the loss to general creditors.

These statements showed that the House believed that in cases involving shareholders who attempt to shift their status using tort theories, the courts needed powers broader than the “general doctrine of equitable subordination.” Congress later removed this passage from the bill.

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95. See supra notes 40-49 and accompanying text (discussing Pepper).
97. Id.
98. Id.
100. Id.
101. Virtual Network Servs. Corp. v. United States, 98 B.R. 343, 346 (Bankr. N.D. Ill. 1989), aff’d, 902 F.2d 1246 (7th Cir. 1990). It is possible that Congress did not want to make such a broad expansion of the equitable powers. Instead, Congress could have recognized that in the unique case of creditors attempting to shift the nature of their claims so as to be in parity with the unsecured creditors, an expanded definition of inequitable conduct was warranted. See In re Burden v. United States, 917 F.2d 115, 122-23 (3d Cir. 1990) (Alito, J., concurring in part and dissenting in part) (describing the suit by stockholders in Homex as an attempt to gain priority that might warrant an incremental change to the scope of misconduct). Because of the strong policies against upsetting the expectations of the general unsecured creditors, Congress may have felt that the extension of the doctrine of equitable subordination into this area was warranted.
Codification of Equitable Subordination

The controversy surrounding equitable subordination largely resulted from Congress' decision to codify the judicially created doctrine of equitable subordination.

Section 510 of the Bankruptcy Act of 1978 reads:

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

(2) order that any lien securing such a subordinated claim be transferred to the estate. 102

Although the language appeared very broad on its face, Congress attempted to clarify any ambiguity in the Code through its accompanying legislative statements.103


103. The weight that these statements deserve is unclear and this uncertainty only contributes to the difficulties surrounding the interpretation of legislative intent. Courts on both sides of the issue of whether inequitable conduct is required to subordinate a claim have referenced the statements and attacked their importance. See infra notes 118-65 and accompanying text.

Especially troubling is the heightened controversy surrounding the passage of the Bankruptcy Act of 1978. Some have pointed out that the passage of the Bankruptcy Code is unique. For example, Representative Edwards, the chairman of the subcommittee that introduced the House amendments, stated on September 28, 1978, "[T]his is the culmination of over 8 years' work by a congressional commission, two congressional committees, and numerous outside groups." 124 Cong. Rec. 32,392 (1978) (statement of Rep. Edwards), reprinted in 1978 U.S.C.C.A.N. 5787, 6452. The amendment substantially reformed the bankruptcy laws for the first time in 40 years; however, only a few members of Congress were involved in the final version of the bill, see Kenneth Klee, Legislative History of the New Bankruptcy Law, 28 DePaul L. Rev. 941, 941-57 (1979), as "eleventh-hour" hearings secured passage of the Code and resulted in a document with compromises that had previously gone unevaluated by Congress. See Frank R. Kennedy, Foreword: A Brief History of the Bankruptcy Reform Act, 58 N.C. L. Rev. 667, 676-77 (1980). Compounding the complexity of interpretation is the fact that no final report was ever issued on this section. See Patricia M. Wald, Justice in the Ninety-fifth Congress: An Overview, 64 A.B.A. J. 1854, 1855 (1978). Earlier committee reports therefore could not assess the language of § 510(c)(1) as ultimately enacted at that final congressional session, and members of Congress were forced to rely extensively on Representative Edwards and Senator DeConcini, the sponsor and co-sponsor of the House and Senate bills, respectively, to inform them of the numerous compromises recommended prior to final passage of the bill. Id.
The following statements represented the drafters’ attempts to clarify the meaning of section 510:

Section 510(c)(1) of the House amendment represents a compromise between similar provisions in the House bill and Senate amendment.

It is intended that the term “principles of equitable subordination” follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty or a claim for damages arising from the purchase or sale of a security of the debtor. The fact that such a claim may be secured is of no consequence to the issue of subordination. However, it is inconceivable that the status of a claim as a secured claim could ever be grounds for justifying equitable subordination.104

The drafters also stated:

Having completed a general description of the amendment the provisions of the House amendment which deal directly with, or affect, the payment or collection of taxes in cases under title 11 will be discussed in detail.

Since the House amendment authorizes subordination of claims only under principles of equitable subordination, and thus incorporates principles of existing case law, a tax claim would rarely be subordinated under this provision of the bill.105

These statements, identical in both the House and the Senate, provided the tinder that ignited the controversy now surrounding equitable subordination of nonpecuniary tax claims.


105. Id. at 32,412, 32,416 (statement of Rep. Edwards) (emphasis added), reprinted in 1978 U.S.C.C.A.N. at 6488, 6499. As originally introduced, the bill provided that a tax claim may not be subordinated on equitable grounds. See infra note 144 and accompanying text. The bill eventually deleted this expression but its sponsors indicated that the effect would be the same. 124 CONG. REC. 32,416 (statement of Rep. Edwards), reprinted in 1978 U.S.C.C.A.N. at 6498.
At first impression, Congress’ intent appears clear—the courts should follow existing case law, including the prerequisite of inequitable conduct. This impression is reinforced by Congress’ reiteration that under common law principles of equitable subordination, courts would rarely subordinate tax claims.\textsuperscript{106} Unfortunately, the drafters left an element of ambiguity in the statute by stating that along with claims tainted by inequitable conduct, penalty claims could be subordinated.\textsuperscript{107} For courts interpreting the statute in light of Congress’ apparent willingness to allow development by the courts,\textsuperscript{108} the ambiguity became an invitation to expand the definition of equitable subordination.

**Expansion of Equitable Subordination**

Under the Bankruptcy Act of 1898, the government could not collect penalty claims\textsuperscript{109} from bankrupt parties.\textsuperscript{110} The Bankruptcy Code, however, rejected the view that penalties should not play a part in the bankruptcy proceeding.\textsuperscript{111} Therefore, it was unsurpris-


\textsuperscript{107} Id. at 32,398 (statement of Rep. Edwards) (“a claim is generally subordinated if the claim itself is of a status susceptible to subordination, such as a penalty”), reprinted in 1978 U.S.C.C.A.N. at 6452.

\textsuperscript{108} See id. (statement of Rep. Edwards) (“It is intended that the term ‘principles of equitable subordination’ follow existing case law and leave to the courts development of this principle.”).

\textsuperscript{109} Penalty claims are claims by the IRS to collect additions to taxes from the debtor for failure to make a reasonable attempt to pay taxes or for delinquent payment of taxes. \textit{In re Burden}, 917 F.2d 115, 116 (3d Cir. 1990).

\textsuperscript{110} Section 57(j) of the 1898 Act prohibited the Government from collecting nonpecuniary loss penalties. 11 U.S.C. \S 93(j) (1976) (repealed 1978); see Simonson v. Granquist, 369 U.S. 38, 40-41 (1962) (explaining that Congress enacted section 57(j) to protect unsecured creditors from the debtor’s wrongful conduct, on the theory that innocent parties should not have to bear the burden of penalties that were intended to punish the bankrupt). Section 507(a)(7)(g) of 11 U.S.C. specifically includes penalties that are “in compensation for actual pecuniary loss.” 11 U.S.C. \S 507(a)(7)(g) (1988); see also \textit{In re Kline}, 403 F Supp. 974 (D. Md. 1975), aff’d, 547 F.2d 823 (4th Cir. 1977) (holding that \S 57(j) accomplished the congressional policy of protecting innocent creditors). In \textit{Simonson}, the Supreme Court interpreted this provision as applicable to secured or unsecured debt. Simonson, 369 U.S. at 82.

\textsuperscript{111} Section 726(a)(4) of 11 U.S.C. provides:

Except as provided in section 510 of this title, property of the estate shall be distributed—
ing that the courts sought to ensure that they could subordinate these penalty claims. If the courts did not subordinate or disallow penalty claims, creditors would be penalized for debtors' misconduct.

To avoid penalizing innocent creditors for debtor misconduct, courts began to subordinate penalty claims on equitable grounds. These courts crafted arguments utilizing their equitable powers to reach conclusions that proclaimed just results. The Seventh Circuit exceeded the existing common law, however, by announcing that inequitable conduct was not a prerequisite to subordination in IRS-asserted penalty claims.

In re Virtual Network Services Corp.

In In re Virtual Network Services Corp., Virtual Network Services (VNS) filed a petition for relief under Chapter 11, to which the IRS responded by filing a claim for employment and withholding taxes pursuant to section 507(a)(4) of the Bankruptcy Code. Approximately ten percent of the amount claimed by the IRS represented tax penalties that the IRS had assessed against VNS prior to its petitioning the bankruptcy court for relief. The IRS characterized the penalty portion of its claim as a general un-
secured claim.\textsuperscript{120} VNS objected to the government's request that the court place the IRS claims in parity with those of the other general unsecured creditors, arguing that the court should subordinate penalty claims on equitable principles for two reasons: first, a delay would result from the IRS's collecting the penalties, and second, the effect of parity would be to shift the penalty from the debtor to the innocent creditors.\textsuperscript{121} The bankruptcy court ruled for the IRS, but the district court reversed.\textsuperscript{122} The Seventh Circuit affirmed the district court's decision to subordinate the IRS's penalty claim.\textsuperscript{123}

The main thrust of VNS's argument in the bankruptcy court was that 11 U.S.C. § 726(a), which provides for the automatic subordination of penalty claims in Chapter 7 liquidations,\textsuperscript{124} was applicable to Chapter 11 liquidations as well.\textsuperscript{125} The bankruptcy court quickly dispensed with this argument by pointing out that the Code states specifically that section 726(a) applies only to cases under Chapter 7.\textsuperscript{126} VNS made one final effort to prove that subordination was proper by adding that subordination was also possible under section 510(c)(1).\textsuperscript{127} To make this contention, VNS was forced to argue that the court could solve the ambiguity in section 510(c) by referring to the legislative history, which arguably demonstrated no prerequisite of inequitable conduct.\textsuperscript{128}

In addressing the legislative history argument, the district court was reluctant to look at legislative interpretation,\textsuperscript{129} but ultimately it recognized the necessity of turning to “the ashcans of the legislative process”\textsuperscript{130} to resolve the ambiguity in the phrase “under prin-

\textsuperscript{120} Id.
\textsuperscript{121} Id. at 344.
\textsuperscript{122} Id. at 353.
\textsuperscript{123} In re Virtual Network Servs. Corp., 902 F.2d 1246, 1250 (7th Cir. 1990), aff'g 98 B.R. 343 (Bankr. N.D. Ill. 1989).
\textsuperscript{125} Virtual Network, 98 B.R. at 344.
\textsuperscript{126} Id. “Subchapters I and II of chapter 7 of this title apply only in a case under such chapter.” 11 U.S.C. § 103(b).
\textsuperscript{127} Virtual Network, 98 B.R. at 345. The district court noted that the argument did not appear initially in VNS's brief; it appeared instead in the surreply to the government's supplemental response as well as in one footnote in the reply brief. Id. at 345.
\textsuperscript{128} Id. at 345-47.
\textsuperscript{129} Id. at 345-46.
\textsuperscript{130} Id. at 345 (quoting CHARLES P CURTIS, IT'S YOUR LAW 52 (1954)).
ciples of equitable subordination.”131 Foreshadowing the limited force of its holding, the district court cited ten sources that argued against the use of legislative history,132 leading the court to recognize “a growing restiveness with the judiciary’s readiness to consult extrinsic materials.”133 In the court’s opinion, the inherent problems of consulting legislative history—the danger that views of staff members or lobbyists, having been smuggled into the history, would override statutory text—made the use of such materials a dubious exercise to be avoided.134

The court nonetheless ended a lengthy recital of its concerns by acknowledging that the use of legislative history by the Supreme Court had increased and that in some cases, the use of legislative history had proved helpful in interpreting statutes.135 The district court’s reasoning was erroneous, though, given that the current Supreme Court has been reluctant to use legislative history as a source of statutory interpretation.136

The Legislative History

The district court considered the following arguments regarding the legislative history of section 510(c): first, in the initial version of the bill, the House judiciary committee had recognized that Congress intended section 510 to codify Pepper and Taylor but it had nonetheless included the statement, “[t]he court’s power is broader than the general doctrine of equitable subordination, and

131. Id.
132. Id. (citing Trustees v. Allied Prods. Corp., 872 F.2d 208 (7th Cir. 1989); In re Sinclair, 870 F.2d 1340 (7th Cir. 1989); Covolt v. Carey Canada Inc., 860 F.2d 1434 (7th Cir. 1988); In re Kelly, 841 F.2d 908 (9th Cir. 1988); IBEW v. NLRB, 814 F.2d 1434 (7th Cir. 1988); In re Kelly, 814 F.2d 697, 715-20 (D.C. Cir. 1987) (Buckley, J., concurring); FEC v. Rose, 806 F.2d 1081, 1089-90 (D.C. Cir. 1986); Wallace v. Christensen, 802 F.2d 1539, 1559-60 (9th Cir. 1986) (Kozinski, J., concurring); Hirschey v. FERC, 777 F.2d 1, 7-8 (D.C. Cir. 1985) (Scalia, J., concurring); see also Frank H. Easterbrook, The Role of Original Intent in Statutory Construction, 11 Harv. J.L. & Pub. Pol’y 59 (1987); Kenneth W. Starr, Observations About the Use of Legislative History, 1987 Duke L. J. 371, 375-79.
134. Id. at 345-46.
135. Id. at 346 (citing Jorge L. Carro & Andrew R. Brann, The U.S. Supreme Court and the Use of Legislative Histories: A Statistical Analysis, 22 Jurimetrics J. 294 (1982)).
encompasses subordination on any equitable grounds"; second, the committee had stated that courts "rarely" would subordinate tax claims, although in the initial version of the bill, the committee had provided that a court may not subordinate a tax claim on equitable grounds; and finally, the statements of the sponsors indicated that creditor misconduct was not a prerequisite for subordination.

The court rejected the argument that the House committee's change from "on equitable grounds" to "under principles of equitable subordination" indicated congressional intent to permit subordination even without a showing of inequity. Although VNS was the party that brought this language to the court's attention, the language appeared to indicate that the committee rejected a broad understanding of a bankruptcy court's power. This interpretation would favor the government's position that Congress did not intend subordination to include tax claims. The court, however, did not allow the argument to assist either side, stating that successive drafts provide little information about the final form of the legislation because drafts are not necessarily sequential.

The government then raised the argument that the initial version of the bill stated that a tax claim could never be subordinated, but the court pointed out that this ultimately changed to a tax claim would "rarely be subordinated." Unlike the argument advanced by VNS to assist its case, this change did not refute the government's position; it only created the possibility that a case might exist because the committee substituted the term "rarely" for "never." The government contended that the word "rarely" was a recognition by the drafters that, because of the requirement of creditor misconduct, the government usually would not be subject

139. Id. at 348.
140. Id. at 349-49.
141. Id. at 350.
142. See supra note 105 and accompanying text.
144. Id. at 347 (emphasis added).
to subordination. To support its position, the government offered the committee report regarding section 724(a), which stated:

Subsection (a) of section 724 permits the trustee to avoid a lien that secures a fine, penalty to the extent that the claim is not compensation for actual pecuniary loss. The subsection follows the policy found in section 57j of the Bankruptcy Act of protecting unsecured creditors from the debtor’s wrongdoing, but expands the protections afforded. The lien is made voidable rather than void in chapter 7, in order to permit the lien to be revived if the case is converted to chapter 11, under which penalty liens are not voidable. To make the lien voidable would be to permit the filing of a chapter 7, the voiding of the lien, and the conversion to a chapter 11, simply to avoid a penalty lien, which should be valid in a reorganization case.

The government argued that this language clearly indicated that the committee understood that under Chapter 11, a penalty claim would not be subordinated. The court refused to adopt the government’s position, holding that the word “rarely” did not refer to the requirement of misconduct because only “normally” is creditor misconduct required. As support, the court inferred that the Senate committee was aware of In re Stirling Homex Corp., a case that the court believed “illustrate[d] that creditor misconduct was not a necessary condition of equitable subordination.” The court explained the use of the word “rarely” by hypothesizing:

145. Id.
148. Id. at 348.
149. Id. at 347.
151. Virtual Network, 98 B.R. at 347. Although the court stated that the shareholders were not engaged in inequitable conduct, id., arguably this is not true. The court in Homex could have viewed the shareholders’ conduct as inequitable or could have applied priority principles to keep the shareholders from recharacterizing their claims by alleging fraud. See supra notes 80-102 and accompanying text (discussing Homex).
“rare” might also refer to the committee’s belief that Chapter 11 liquidations would be scarce. It might also reflect the belief that claims for non-compensatory tax penalties in Chapter 11 liquidations would be uncommon. Or, more likely yet, the staff (and Members) simply did not foresee the problem of subordination in the context of Chapter 11 liquidations.\footnote{Virtual Network, 98 B.R. at 347.}

The court dismissed the government’s supporting argument by distinguishing between Chapter 11 “reorganizations”—the language used in the committee report regarding section 724(a)—and Chapter 11 liquidations.\footnote{Id. at 348.} The court argued that without specific language concerning Congress’ knowledge of the differences between reorganizations and liquidations, giving any weight to this passage from the committee report would be erroneous.\footnote{Id.}

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The district court’s analysis was flawed; it stated that the Senate committee must have been aware of the Homex opinion, a case involving a reorganization that turned into a liquidation,\footnote{See supra notes 79-101 and accompanying text.} yet at the same time, the court asserted that the committee could not distinguish a reorganization from a liquidation. If, as the district court stated, the committee did not understand the principles involved in Homex, then it was illogical to infer that Congress, on the basis of that opinion, intended to expand the theory of equitable subordination. Distilled to its essence, the district court’s argument was that Congress did not understand the case that supplies the only explicit evidence that Congress may have intended to allow courts to subordinate equitably without a finding of misconduct; despite this incongruity, the court found that subordination without a showing of misconduct was proper.

As a result of this analysis, the court concluded that the committee reports could not add anything to the ambiguity in section 510 and turned to a second source of extrinsic evidence to assist in understanding the Code, the identical statements of the bill’s sponsors, Representative Donald Edwards and Senator Dennis DeConcini.\footnote{See supra notes 103-05 and accompanying text.} The district court believed that the statement, “[i]t is...
intended that the term ‘principles of equitable subordination’ follow existing case law and leave to the courts the development of this principle,”157 established that Congress favored expansion.158 Moreover, the statement, “[t]o date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination such as a penalty,”159 established that Congress intended to include “no fault” subordination of penalty cases.160

Although the district court indicated that the inquiry did not end simply because the legislative history demonstrated that Congress did not intend to limit subordination to cases involving inequitable conduct,161 for all practical purposes the question was resolved. The government could argue only that having VNS’s unsecured creditors pay for VNS’s wrongs was not unfair, but the court quickly dispensed with the notion that punishing individuals who were not guilty could be equitable.162 Once saddled with the burden of proving the claims nonpenal or demonstrating that the IRS stood on a par with other general unsecured creditors, the government faced an insurmountable obstacle.163

158. Id. at 349.
159. Id. at 348.
160. Id. at 349. The court addressed the unreliability of the statements of individual legislators and the dismissal of the usual preference for the official committee reports by arguing that because the committee reports had been held ambiguous, the reliance on the individual statements was necessary. Id. The court indicated a willingness to rely on these particular floor statements because they were the statements of the sponsors of the legislation and because the legislators possibly had relied on these statements in determining how to vote. Id. at 349-50.
161. Id. at 350-51.
162. Id. at 352.
163. The district court did not find that the claims made by the IRS were the type considered to be a “tax claim.” As the district court noted, however, the penalty provisions in the tax code are expressly meant to deter and punish: two goals in contravention of any equity or equitable considerations. The IRS’s attempt to recharacterize the tax penalty as a tax claim in order to avoid subordination is not new, but it has never succeeded nor do we conclude it should be successful here.

In re Virtual Network Servs. Corp., 902 F.2d 1246, 1249 (7th Cir. 1990).

The IRS also attacked the district court’s findings that the tax penalty claims were punitive in nature by recharacterizing the nature of its claims as “unlike other nonpecuniary loss
The importance of the outcome of the legislative history argument is apparent from the fact that the court dedicated seven pages of its opinion to untangling this thorny mess. Once the court decided the argument in VNS's favor, though, it needed only two pages to conclude that a court may subordinate penalty claims consistent with the purpose of equitable subordination. The true controversy in these cases, therefore, is whether courts hold the power to subordinate claims in all instances, because if they do, they rarely will hesitate to exercise it to subordinate the government's penalty claims.

The Trend

The Seventh Circuit validated the district court's arguments, reiterating them and adding very little. To answer the government's argument that language in the committee report indicated that a court rarely would subordinate a tax claim, the court of appeals stated that IRS penalty claims are not "tax claims" but "tax penalties." By inferring that the committee was not referring to "tax penalties," the court held that this section of the committee report was inapplicable.

Once the Seventh Circuit crafted its no fault subordination position, the government began to lose the battle to achieve parity with general creditors for its nonpecuniary penalty claims in cases involving circumstances similar to those in Virtual Network. The first circuit to adopt the Virtual Network opinion was the Eighth Circuit in Schultz Broadway Inn v. United States. The Eighth Circuit reached the same conclusion as the Seventh Circuit, but for slightly different reasons. It emphasized Congress' rejection of the Senate version of section 510 that would have exempted government tax claims. The court believed that this rejection demonstrated the intent of the legislature to allow subordination in some penalty, [in that they] are designed not just to punish the debtor, but also serve to protect the integrity of the tax systems and to reimburse the Government for costs incurred as a result of certain taxpayer misconduct." Id. at 1250 (quoting Appellant's Brief at 9).

165. Virtual Network, 902 F.2d at 1249.
166. Id. at 1248.
167. 912 F.2d 230, 231 (8th Cir. 1990).
168. Id. at 232.
Otherwise, the opinion was remarkably similar to *Virtual Network*, resting on the statements of the sponsors and the inference that Congress was aware of the *Homex* opinion.\(^{170}\)

The Third Circuit also adopted *Virtual Network* and extended it to a case involving a Chapter 13 liquidation in *In re Burden*.\(^ {171}\) The court held that, unlike Chapter 7,\(^ {172}\) Chapters 11 and 13 shared the common characteristic that Congress had not explicitly provided for subordination of penalty claims.\(^ {173}\) Thus, the court found no reason to believe that Congress intended to apply section 510 to Chapter 11 cases and Chapter 13 cases differently.\(^ {174}\) Without a reason to treat the two differently, the court viewed *Virtual Network* as a logical precedent and expanded its reasoning to cover Chapter 13 reorganizations.\(^ {175}\) The court remanded the case because the district court had subordinated the claims as a matter of law.\(^ {176}\) The appellate court found no indication that Congress intended automatic subordination; because the district court was exercising its equitable jurisdiction, it had to weigh the equities on a case-by-case basis.\(^ {177}\)

*Burden* is enlightening not for its rank-and-file majority opinion, but for its dissenting opinion, which probes the reasoning of the court in *Virtual Network*. Judge Alito began his dissent by recognizing that “‘[t]he normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific.’”\(^ {178}\) He stated that “[t]his rule should be followed ‘with particular care in bankruptcy codifications,’”\(^ {179}\) and that section 510 is an instance in which courts particularly should follow this principle because

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169. *Id.*
170. *Id.* at 232-33; *see supra* notes 149-60 and accompanying text.
171. 917 F.2d 115 (3d Cir. 1990).
172. 11 U.S.C. § 726(a)(4) explicitly subordinates tax penalties to the fourth position. *See supra* note 111.
173. *Burden*, 917 F.2d at 118.
174. *Id.* at 118-19.
175. *Id.* at 117-18.
176. *Id.* at 119.
177. *Id.* at 120.
the sponsors intended for the codification of existing case law, including the requirement of inequitable conduct.\textsuperscript{180}

As for the ambiguity in the phrase "principles of equitable subordination," the dissent contended that the Fifth Circuit had summarized the case law as it existed in 1979, when the Bankruptcy Code codified the principles of equitable subordination as expressed in \textit{In re Mobile Steel}.\textsuperscript{181} To the dissent, the "paucity of contrary authority in the decisions addressing the subordination of nonpecuniary loss tax penalties [was] telling."\textsuperscript{182} Judge Alito's view of the one case that had not explicitly utilized the \textit{Mobile Steel} framework—\textit{In re Stirling Homex Corp}.\textsuperscript{183}—differed from the majority's:

Although the Second Circuit did not explicitly label [the shareholder's] conduct inequitable, its decision was clearly based on the view that their conduct was designed to achieve an inequitable result that should not be permitted. Thus, even if \textit{In re Stirling Homex Corp}. was a departure from prior precedent, it did not abandon the concept that equitable subordination must be based on the conduct of the individual claimant. At most, \textit{In re Stirling Homex Co}. represented an incremental change in the established doctrine.\textsuperscript{184}

The dissent went on to argue that the majority's holding in \textit{Burden} "represent[ed] a sharp break from established doctrine codified in Section 510(c)(1)."\textsuperscript{185} The dissent rejected the contention that the sequence of events that led to section 510's enactment was irrelevant.\textsuperscript{186} The congressional rejection of the initial proposal of the Bankruptcy Commission—that the Code subordinate all penalty claims—and the adoption instead of automatic subordination in Chapter 7 cases led Judge Alito to conclude that Congress did

\begin{itemize}
  \item \textsuperscript{180} \textit{Id.} at 121-22.
  \item \textsuperscript{181} \textit{Id.} at 122 (referring to \textit{Benjamin v. Diamond (In re Mobile Steel Co.)}, 563 F.2d 692, 700 (5th Cir. 1977)).
  \item \textsuperscript{182} \textit{Id.}
  \item \textsuperscript{183} \textit{Jezarian v. Raichle (In re Stirling Homex Corp.), 579 F.2d 206 (2d Cir. 1978), cert. denied, 439 U.S. 1074 (1979)}.
  \item \textsuperscript{184} \textit{Burden}, 917 F.2d at 122 (Alito, J., concurring in part and dissenting in part).
  \item \textsuperscript{185} \textit{Id.}
  \item \textsuperscript{186} \textit{Id.}
\end{itemize}
not want penalties subordinated in proceedings under other chapters.\textsuperscript{187}

He also rejected the majority's emphasis on the statements made on the House and Senate floor. Judge Alito posited that the development of the principle of equitable subordination mentioned in these statements was included to allow the incremental change represented by \textit{Homex}, not to allow courts radically to alter existing precedent.\textsuperscript{188} As for the reference to "a penalty," the dissent believed the meaning was ambiguous and

"under existing law," as previously noted, penalties were not "susceptible to subordination." Since it is impossible to determine what Representative Edwards and Senator DeConcini meant when they referred to "a penalty," that reference should not control the interpretation of the statute. Moreover, whatever Representative Edwards and Senator DeConcini had in mind, a single, ambiguous reference to "a penalty" in their floor statements could not have alerted the other members of Congress that the new code would fundamentally change the "principles of equitable subordination" recognized by the courts. A fleeting reference in floor statements—even authoritative floor statements by sponsors of the proposed legislation—should not be given controlling weight.\textsuperscript{189}

The dissent's arguments exemplify the difficulties of relying on legislative interpretation to justify a change in the law. The concerns of the district court in \textit{Virtual Network} regarding the complexities of interpreting legislative history\textsuperscript{190}—ambiguity and multiple interpretations—become all too clear. Courts, therefore, should not rely on this history as a justification for a major change in the law.

\textit{The Ramifications of Expansion}

That courts choose to subordinate nonpecuniary claims is not remarkable. It is based on sound logic—if penalties are not subordinated, the innocent creditor will be punished for the debtor’s mis-

\textsuperscript{187} \textit{Id.} at 122-23.
\textsuperscript{188} \textit{Id.}
\textsuperscript{190} See supra notes 156-64 and accompanying text.
conduct. The danger in expanding the scope of equitable subordination, however, beyond the immediate effect upon the government’s ability to obtain payment for the penalties it has assessed, lies in the broad language that the appellate court used in \textit{Virtual Network}:

We further conclude, as did the district court, that the principles of equitable subordination are broader than the doctrine which developed prior to § 510(c)(1)’s enactment. \textit{It is clear that in principle, equitable subordination no longer requires, in all circumstances, some inequitable conduct on the part of the creditor} \textsuperscript{191} The district court concluded that equitable subordination under § 510(c)(1) could be applied in this case, \textit{inter alia}, because 1) the goal of equitable subordination focuses not on the conduct of the creditor but on the fairness to creditors in a particular case, 2) punishing or deterring VNS’s innocent creditors because of VNS’s wrongful conduct serves no purpose, and 3) the IRS’s claims in this case are punitive in nature.\textsuperscript{191}

The district court in \textit{Virtual Network} recognized the implications of its actions. By deviating from \textit{Mobile Steel}’s empirical test\textsuperscript{192} and \textit{Comstock}’s restraints\textsuperscript{193} and venturing into the ambiguous area of “injustice” that had plagued courts attempting to apply \textit{Pepper v. Litton}’s analysis,\textsuperscript{194} courts may be returning the doctrine of equitable subordination to the problems that took the courts decades to remedy. The district court in \textit{Virtual Network} seized control and reluctantly attempted to accomplish the goal of reaching a just result in a unique case:

Framing the court’s power in these terms, however, seems to embrace the expansive notion of equitable power we disclaimed above: for it appears to invest the courts with the authority to arrange the claims of unsecured creditors in whatever manner they deem “fair.” We concede there is some danger in attempting to steer a straight course with only “fairness” as the rudder.

\textsuperscript{191} In \textit{re Virtual Network Servs. Corp.}, 902 F.2d 1246, 1250 (7th Cir. 1990) (emphasis added).
\textsuperscript{192} Benjamin v. Diamond (\textit{In re Mobile Steel Co.}), 563 F.2d 692 (5th Cir. 1977); \textit{see supra} text accompanying note 73.
\textsuperscript{193} Comstock v. Group of Institutional Investors, 335 U.S. 211 (1948); \textit{see supra} notes 50-70 and accompanying text.
\textsuperscript{194} 308 U.S. 295 (1939); \textit{see supra} notes 40-49 and accompanying text.
NO FAULT EQUITABLE SUBORDINATION

We are not convinced, however, that this danger is sufficient to justify applying the doctrine of equitable subordination by reference to one of its grounds rather than its goal. While it is true that “faiures” is an open-ended concept, and therefore may someday become a talismanic phrase which courts use as an excuse rather than as a justification for subordinating a claim, “fear of the future, of what’s at the bottom of a long, slippery slope, is not a good reason for today’s decision.”

In In re Vitreous Steel Products Co., the Seventh Circuit provided dramatic evidence of the possible impact of its decision in Virtual Network. Vitreous Steel involved an institutional investor’s attempt to find a new owner for a company that was in financial difficulty. The company alleged that the conduct between the bank and the prospective owner was collusive. The bankruptcy court did not reach the issue of whether the bank’s conduct required subordinating its claims against the troubled company because it granted summary judgment to the bank on other grounds. On appeal, the circuit court reversed the grant of summary judgment and specifically instructed the bankruptcy court that on remand

the bankruptcy court is obligated to make findings of fact as to whether the bank’s actions call for subordination of its debt under the balancing test of Matter of Mobile Steel Co. The court should consider [Mobile Steel’s three factors] We recently held in Matter of Virtual Network Servces Corp. that it is not necessarily required that the creditor be found to have engaged in misconduct. We stated that the inquiry is to be made on a case-by-case basis focussing [sic] on fairness to the other creditors.

The Seventh Circuit’s extension of Virtual Network to a case involving a pecuniary claim by an institutional investor demon-
strates the dangerous ramifications of that opinion's broad language. Noticeably absent from Vitreous Steel are the two factors discussed in Virtual Network—punishing the creditor for the debtor's misconduct, and a punitive claim.\textsuperscript{201} The court in Vitreous Steel transformed the holding in Virtual Network into a simple evisceration of the misconduct requirement, unconstrained by the finding of a nonpecuniary claim and a penal claim.

The willingness of courts to return the law to a position in which "fairness" is the only guideline for application of the devastating principle of equitable subordination could undermine the Bankruptcy Code. The courts that have chosen to expand their equitable powers deserve no commendation for their cavalier willingness to throw the doctrine of equitable subordination back to the unformulated principles of fairness; rather, they should be criticized for endangering the security of creditors.

\textbf{The Retreat from Virtual Network}

\textit{The Seventh Circuit}

Two months after the Seventh Circuit decided Virtual Network, a different panel decided \textit{Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting.}\textsuperscript{202} Kham & Nate's Shoes (KNS) applied for, and received, the right to reorganize under Chapter 11 of the Bankruptcy Code.\textsuperscript{203} Pursuant to a judicial order, all postpetition loans were to receive "super-priority."\textsuperscript{204} One of KNS's existing creditors, a bank, loaned KNS money after the bankruptcy court issued a reorganization order granting new creditors additional protection.\textsuperscript{205} At one point during the reorganization process, the bank terminated the line of credit that induced KNS's suppliers to draw on letters of credit.\textsuperscript{206} This action created debt that the bank could claim deserved super-priority under the judicial order.\textsuperscript{207} By giving

\textsuperscript{201} See supra text accompanying note 142.
\textsuperscript{202} 908 F.2d 1351 (7th Cir. 1990).
\textsuperscript{203} Id. at 1353.
\textsuperscript{204} Id.
\textsuperscript{205} Id.
\textsuperscript{206} Id. at 1354.
\textsuperscript{207} Id.
KNS a line of credit, the bank, while still a creditor of some unsecured debt, became a creditor of first-priority debt as well.\textsuperscript{208}

KNS successfully argued to the bankruptcy and district courts that the bank’s action, designed to change its position in the reorganization, warranted subordination of its claim under section 510(c).\textsuperscript{209} Judge Easterbrook’s majority opinion refused to expand the doctrine of equitable subordination, noting that section 510(c) does not provide criteria for the exercise of the court’s equitable power.\textsuperscript{210} Instead of analyzing legislative history, he deferred to the common law.\textsuperscript{211} Judge Easterbrook did not ignore the \textit{Virtual Network} decision; he simply narrowly construed that case to mean that subordination is possible when a penalty is created by operation of law and the creditor has delayed in collecting the penalty to the detriment of other creditors.\textsuperscript{212} Because the bank in \textit{Kham & Nate’s Shoes} was not attempting to collect a penalty, Easterbrook held that the \textit{Virtual Network} line of cases was inapplicable.\textsuperscript{213} After dispensing with the argument that the court should apply no

\begin{itemize}
\item \textsuperscript{208} \textit{Id.}
\item \textsuperscript{209} \textit{Id.}
\item \textsuperscript{210} \textit{Id. at 1356.}
\item \textsuperscript{211} \textit{Id.}
\item \textsuperscript{212} \textit{Id.}
\end{itemize}

The district and circuit court opinions mentioned the IRS’s delay as a basis for their reasoning. The fact that Judge Easterbrook seized on this single fact indicated his desire to root § 510 in some type of injurious behavior or, more likely, to limit the \textit{Virtual Network} holding as much as possible.

Even this decision may not be much of a victory for the government because courts have shown a willingness to construe the term “penalty” very broadly. See \textit{In re Schultz Broadway Inn, Ltd.}, 89 B.R. 43 (Bankr. W.D. Mo. 1988) (subordinating a negligence penalty assessed by the IRS), aff’d, 912 F.2d 230, 231 (8th Cir. 1990); United States v. Mansfield Tire & Rubber Co. (\textit{In re Mansfield Tire & Rubber Co.}), 80 B.R. 395 (Bankr. N.D. Ohio 1987) (finding excise taxes to be penalties requiring subordination in Chapter 11 cases). But see Compton Corp. v. United States Dep’t of Energy (\textit{In re Compton Corp.}), 40 B.R. 875 (Bankr. N.D. Tex. 1984) (holding that a restitution claim did not constitute a penalty); \textit{In re Graf Bros., Inc.}, 38 B.R. 237 (Bankr. D. Me. 1984) (ruling that a highway use tax was not a penalty but a means of allocating construction costs).

Punitive damage claims, because of their penal nature, also have been found to be subject to subordination under § 510(c)(1). See \textit{In re Colin}, 44 B.R. 806 (Bankr. S.D.N.Y. 1984) (stating that punitive damage claims are penalty claims imposed not to afford redress, but to deter wrongful conduct). On the other hand, courts also have disallowed punitive damage claims under Chapter 11. See \textit{In re A.H. Robins Co.}, 89 B.R. 555, 563 (E.D. Va. 1988) (refusing to subordinate a punitive damage claim because such action would merely postpone inequitable treatment of creditors).

\textsuperscript{213} \textit{Kham & Nate’s Shoes}, 908 F.2d at 1356.
fault subordination, Judge Easterbrook utilized the framework established in Mobile Steel\textsuperscript{214} and defined inequitable conduct as a high hurdle that the bank had failed to clear.\textsuperscript{215}

\textit{Kham & Nate's Shoes} represents a breath of fresh air in an environment polluted by legislative interpretation. The Seventh Circuit avoided returning to the questionable endeavor of interpreting legislative history and in the process limited \textit{Virtual Network} to the narrowest construction possible.

\textit{Other Circuits}

The Fifth and Sixth Circuits have also rejected invitations to erode the doctrine of equitable subordination, limiting \textit{Virtual Network} to its precise facts. In \textit{In re Fabricators, Inc.},\textsuperscript{216} the Fifth Circuit had the option of rejecting the inequitable conduct requirement in a case involving a lender who had assumed control of a corporation.\textsuperscript{217} The court held that it would continue to apply the \textit{Mobile Steel} framework, including the requirement that the creditor act inequitably, before subordinating the creditor's claim.\textsuperscript{218}

In \textit{In re Mansfield Tire & Rubber Co.},\textsuperscript{219} the Sixth Circuit decided a case with facts similar to \textit{Virtual Network} but required only a small extension to the existing no fault subordination precedent.\textsuperscript{220} In \textit{Mansfield Tire}, a bankruptcy trustee attempted equita-

\textsuperscript{214} See supra notes 71-77 and accompanying text.

\textsuperscript{215} \textit{Kham & Nate's Shoes}, 908 F.2d at 1357. Judge Easterbrook defined inequitable conduct in the commercial context as "breach plus some advantage-taking." \textit{Id.} at 1357. The majority found that although KNS was in a difficult position, the bank did not create the difficulty and only acted in conformity with its contract. \textit{Id.} The fact that the contract had the possibility of creating hardship did not make the conduct of the bank inequitable. \textit{Id.} at 1358; \textit{cf.} Comstock v. Group of Institutional Investors, 335 U.S. 211 (1947) (holding that inequitable conduct did not occur due to a finding of good faith).

At least one commentator has criticized Judge Easterbrook's approach. See Dennis M. Patterson, \textit{A Fable from the Seventh Circuit: Frank Easterbrook on Good Faith}, 76 Iowa L. Rev. 503, 504 (1991) (stating that the "\textit{Kham} opinion does not represent a judicious rendering of substantive commercial law, but instead is a fable bearing only faint relation to the legal issues that should have been addressed in that case").

\textsuperscript{216} Fabricators Inc. v. Technical Fabricators, Inc. (\textit{In re Fabricators, Inc.}), 926 F.2d 1458 (5th Cir. 1991).

\textsuperscript{217} \textit{Id.} at 1467.

\textsuperscript{218} \textit{Id.} at 1465.

\textsuperscript{219} United States v. Mansfield Tire & Rubber Co. (\textit{In re Mansfield Tire & Rubber Co.}), 942 F.2d 1055 (6th Cir. 1991).

\textsuperscript{220} \textit{Id.} at 1061.
bly to subordinate what the court determined was a nonpenalty IRS tax claim.\textsuperscript{221} The trustee relied on the holding in \textit{Virtual Net-
work} and did not allege any inequitable conduct on the part of the IRS.\textsuperscript{222} The Sixth Circuit refused to expand the reach of \textit{Virtual
Network}, preferring to confine it at best to tax penalty cases.\textsuperscript{223} “We continue to recognize that equitable subordination in bankrupt-
cy may be appropriate if the claimholder is guilty of inequita-
ble conduct.” We decline [the trustee’s] invitation to extend equitable subordination of federal tax claims in the absence of some inequitable conduct \textsuperscript{224}

\section*{Policy Recommendations}

\textit{A Framework}

Courts following Judge Easterbrook have rejected invitations to extend the doctrine of no fault subordination. Courts should limit the holding in \textit{Virtual Network} to cases with similar facts, applying it only when a penalty is created by operation of law and when the delay in collecting the penalty has injured other creditors. Sub-
ordination is justified in cases in which these factors are present because some misconduct exists—the delay—and the penalty will not shift to innocent creditors. Absent these factors, courts should continue to apply the \textit{Mobile Steel} framework;\textsuperscript{225} otherwise they risk damaging the security of creditors and undermining the Bank-
ruptcy Code.\textsuperscript{226}

Allowing subordination only when these factors exist recognizes the type of “subtle” inequitable conduct that the court in \textit{In re Stirling Homex}\textsuperscript{227} determined justified subordination and repre-

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{221} Id. at 1056.
\item \textsuperscript{222} Id.
\item \textsuperscript{223} Id. at 1061.
\item \textsuperscript{224} Id. at 1062.
\item \textsuperscript{225} See supra note 73 and accompanying text.
\item \textsuperscript{226} See First Nat’l Bank v. Rafoth (\textit{In re Baker & Getty Fin. Servs., Inc.}), 974 F.2d 712 (6th Cir. 1992) (refusing to extend the \textit{Virtual Network} reasoning to cases not involving punitive damages).
\item \textsuperscript{227} Jezarian v. Raichle (\textit{In re Stirling Homex Corp.}), 579 F.2d 206 (1978); see supra notes 82–99 and accompanying text.
\end{enumerate}
\end{footnotesize}
sents only “an incremental change to established doctrine.”228 If the legislative history permits any expansion, it is this small incremental change, not a fundamental break with the existing precedent embodied in the Mobile Steel framework. To dismiss the requirement of inequitable conduct is to reject the entire body of law that Congress intended to codify; Pepper v. Litton,229 Taylor v. Standard Gas & Electric Co.,230 and Comstock v. Group of Institutional Investors231 all involved creditor misconduct.

Identifying Underlying Motivations

The courts in Virtual Network and its progeny could have grounded their opinions in the more logical and equitable argument that penalty claims unjustly transfer punishment from the debtor to the innocent creditor.232 Instead, these courts used analysis that was rooted in ambiguous legislative interpretation.233 Understanding why these courts went to such lengths only to reach the same results that they would have achieved under the existing framework is important.

One underlying reason for the courts’ tactics was the desire for increased lender liability. The increase in lender liability is a trend that was recognized long before Virtual Network.234 To the financial community, Virtual Network represents yet another attempt

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229. 308 U.S. 295 (1939).
231. 335 U.S. 211 (1948).
232. See supra note 212 and accompanying text (explaining courts’ willingness to subordinate penalty and punitive claims and describing how Judge Easterbrook interpreted Virtual Network to stand for the proposition that creditors should not be penalized for debtors’ misconduct).
233. See supra notes 118-64 and accompanying text.
234. See William H. Lawrence, Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing, 62 S. Cal. L. Rev. 1387, 1387-88 (1989). Professor Lawrence states: Recent claims of lender liability have captured the attention of the practicing bar and potentially affected clients as few other topics ever have. Either as a response to difficult economic times or as a reaction to the immense success enjoyed by several plaintiffs, lender liability has attracted extensive national attention. Over the years, an impressive array of nearly a dozen legal theories have developed. Although application of these theories to lenders is not new, plaintiffs’ lawyers have begun pressing these claims with renewed enthusi-
to expand the exposure of lenders in bankruptcy proceedings. The danger of judicial action against lenders comes in many forms, including equitable subordination. Helen Chaitman, in her work *The Ten Commandments for Avoiding Lender Liability*, provides some excellent examples of the types of “improper” lender behavior that could make a judge want to punish a lender.

Some of these pitfalls are classic reasons for equitable subordination and would meet the requirements for subordination as outlined in *Mobile Steel*. Some of the requirements, however, such as “making a sudden move,” or “arrogance,” would not meet the test of inequitable conduct. If a court wants to penalize for this type of misbehavior, or any type that does not fall within the present scope of inequitable conduct, then the court must find an alternative theory of liability. The answer for some courts came in the form of no-fault equitable subordination.

asm causing a considerable increase in concern among lenders about exposure to liability.


236. The commandments are:

I. Thou Shalt Not Make A Sudden Move
II. Thou Shalt Not Tell A Lie
III. Thou Shalt Honor Thy Commitments
IV. Thou Shalt Not Run Thy Borrower's Business
V. Thou Shalt Not Bail Thyself Out on Thy Brother's Money
VI. Thou Shalt Keep Thine Own Files Clean
VII. Thou Shalt Transfer A Troubled Loan to a Workout Officer
VIII. Thou Shalt Confer With Workout Counsel
IX. Thou Shalt Think Carefully Before Suing on a Deficiency
X. Thou Shalt Not Be Arrogant

Id. at 11.

Helen Chaitman has also provided avoidance techniques to assist lenders in avoiding equitable subordination. See generally Chaitman, supra note 235. The value of this guidance, rooted in avoiding control or participating in misconduct, will be dismissed if “fairness” becomes grounds for subordination. Chaitman has recognized that the possible impact of *Virtual Network* is uncertain.
The danger of undefined power is that lenders cannot determine what the court considers "proper conduct" until the court acts. When the court acts adversely to a lender's reasonable expectations, the results can be devastating. Lenders have the right to know what is required of them in order to maintain the priority that is crucial to their business.\textsuperscript{237}

The courts have sufficient options under the \textit{Mobile Steel} framework without resorting to unprincipled, unpredictable jurisprudence.\textsuperscript{238} If the judiciary's goal is to demand specific types of actions and conduct from lenders, it can explicitly label certain types of conduct as "improper." Lenders would then know prospectively what the law required of them. By lowering the threshold of inequitable conduct to the level that would encompass "arrogance," obviously the courts would throw the financial community into turmoil. The reality, of course, is that judges will not explicitly label this conduct "inequitable."

\textbf{CONCLUSION}

Courts should provide the financial community with specific definitions and guidelines to establish the necessary stability. Allowing courts to subordinate claims without adhering to principled methods for determining inequitable conduct opens the door for subordination for reasons that do not warrant the use of this drastic remedy. Lenders need stability to eliminate the risks of bankruptcy; this is the precise reason that bankruptcy legislation exists. It has taken four decades to establish practical guidelines that will assist creditors in assessing the risk of entering into a venture.

\textit{Virtual Network} opens a door that will allow chaos into this fragile world. The Seventh Circuit's results-oriented jurisprudence, based upon ambiguous legislative history, provides courts with near plenary discretion to subordinate on personal notions of jus-

\begin{itemize}
\item \textsuperscript{237} See Pearson, \textit{supra} note 234, at 300 ("The highly unpredictable nature of lender liability law interferes with the lenders' important economic role. Without lending, [economic] growth would be impossible.").
\item \textsuperscript{238} Under \textit{Mobile Steel}, a court cannot subordinate a claim unless the claimant has acted inequitably, the misconduct has injured other creditors or given the claimant an unfair advantage, and the subordination is not inconsistent with the Bankruptcy Code. Benjamin v. Diamond (\textit{In re Mobile Steel Co.}), 563 F.2d 692, 700 (5th Cir. 1977); \textit{see supra} notes 73-78 and accompanying text.
\end{itemize}
The return to the nebulous concept of "justice" that pervaded bankruptcy law before *Mobile Steel* is a dangerous course for the courts to take. Other circuits adjudicating cases involving reorganizations under Chapters 9, 11, and 13 should reject any continuation of this haphazard trend. If *Virtual Network* is limited to its precise facts, the impact of its holding may be restricted. Even if the policy of protecting innocent creditors justifies subordination of government claims in which no misconduct exists, the same policy does not justify the use of no fault subordination when a nonpenalty claim is at issue. As Judge Easterbrook stated, "Risk must be assessed *ex ante* by lenders, rather than *ex post* by judges."\(^{239}\)

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\(^{239}\) Kham & Nate's Shoes No. 2, Inc., v. First Bank of Whiting, 908 F.2d 1351, 1358 (7th Cir. 1990).