

UNITED STATES BANKRUPTCY COURT  
EASTERN DISTRICT OF WISCONSIN

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In re

ARROWHEAD SYSTEMS LLC,

Debtor.

Case No. 2002-20147

Chapter 11

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MEMORANDUM DECISION ON DEBTOR'S OBJECTION TO PROOF OF CLAIM NO. 331  
OF STATE OF MINNESOTA DEPARTMENT OF REVENUE

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This matter came before the court on the debtor's objection to part of the State of Minnesota's proof of claim number 331, which amended proof of claim number 249. This court has jurisdiction over the parties to this proceeding and has jurisdiction over the subject matter pursuant to 28 U.S.C. § 1334 and 28 U.S.C. § 157. This is a core proceeding as defined in 28 U.S.C. § 157(b)(2)(A) and (B). The following constitutes the court's findings of fact and conclusions of law in accordance with Fed. R. Bankr. P. 7052. For the reasons stated below, the debtor's objection to a portion of proof of claim number 331 is overruled.

BACKGROUND

The State of Minnesota Department of Revenue filed its amended proof of claim number 331 on December 26, 2002, in the amount of \$9,845.17. The proof of claim included unpaid state sales tax, interest on the unpaid tax, and a "penalty priority" in the amount of \$1,386. On January 21, 2003, the debtor objected to only that portion of the claim identified as the penalty in the amount of \$1,386. Both parties filed briefs stating their respective positions.

The parties agree the penalty is a non-pecuniary tax claim, assessed solely because the debtor taxpayer failed to file a sales tax return and pay the sales tax due within the time prescribed. The penalty is not compensation for an actual pecuniary tax loss.

#### ARGUMENTS

The debtor contends that while the penalty assessed by Minnesota is intended to penalize the debtor for its nonpayment of taxes, it actually punishes the debtor's innocent creditors for the debtor's wrongful conduct. Under the Seventh Circuit's analysis in *Matter of Virtual Network Servs. Corp.*, 902 F.2d 1246 (7<sup>th</sup> Cir. 1990), the equitable subordination doctrine no longer requires, in all circumstances, some inequitable conduct on the part of the creditor. According to the debtor, the punitive aspect of the claim should not take priority over the allowed claims of unsecured creditors.

The State of Minnesota, on the other hand, argues that pursuant to *United States v. Noland*, 517 U.S. 535, 116 S.Ct. 1524 (1996), and *United States v. Reorganized CF&I Fabricators of Utah*, 518 U.S. 213, 116 S.Ct. 2106 (1996), penalty claims may not be categorically subordinated. Furthermore, because the claimant has not engaged in inequitable conduct, as required by *Matter of Mobile Steel Co.*, 563 F.2d 692, 700 (5<sup>th</sup> Cir. 1977), it contends the bankruptcy court cannot subordinate its claim.

#### DISCUSSION

Section 501(c) of the Bankruptcy Code provides that "the court may ... 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...." 11 U.S.C. § 510(c).

In 1990, the Seventh Circuit addressed the treatment of noncompensatory tax penalties in *Matter of Virtual Network Servs. Corp.*, 902 F.2d 1246 (7<sup>th</sup> Cir. 1990). The court held that nonpecuniary tax penalties were subject to equitable subordination pursuant to 11 U.S.C. § 510(c), even without a showing of inequitable conduct on the part of the IRS.

The Seventh Circuit's rationale in *Virtual Network* centered largely on the intention of Congress when it passed § 510(c). In that regard, the court relied upon the comments of Representative Edwards found in the statute's legislative history:

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 ...

*Matter of Virtual Network Serv. Corp.*, 902 F.2d at 1248 (citing 124 Cong. Rec. H11,117 (daily ed. Sept. 28, 1978), reprinted in 1978 U.S. Code & Cong. Admin. News 5787, 6452). The court also noted that under the Bankruptcy Act of 1898, all noncompensatory tax penalties were expressly disallowed and that it would be "unfair to allow the IRS's tax penalty claims to come out of the 'pockets' of other general unsecured creditors who had not been paid their pecuniary losses.... We agree that the equities in this case favor the subordination of the IRS's claims to those of the other general unsecured creditors." *Id.* at 1250.

In *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8<sup>th</sup> Cir. 1990) (chapter 11 case), and *Burden v. United States*, 917 F.2d 115 (3d Cir. 1990) (chapter 13 case) the Eighth and Third Circuits reached the same conclusions.

The United States Supreme Court subsequently decided two cases that resolved this issue. See *United States v. Noland*, 517 U.S. 535, 116 S.Ct. 1524 (1996); *United States v. Reorganized*

*CF&I Fabricators of Utah*, 518 U.S. 213, 116 S.Ct. 2106 (1996). In *Noland*, the debtor filed a voluntary chapter 11 petition and converted to chapter 7 two years later. During the time the debtor operated its business under chapter 11, it did not pay the IRS any FICA or FUTA taxes. The IRS filed a “Request for Payment of Administrative Expenses,” which included penalties that had been assessed as a result of the debtor’s failure to pay its postpetition federal unemployment and social security taxes.

The chapter 7 trustee objected to the IRS’s position that the postpetition penalties were administrative expenses under § 503(b)(1). In the alternative, the trustee asserted the penalties should be equitably subordinated consistent with *Virtual Network* and *Schultz Broadway Inn*. The bankruptcy court ruled the postpetition penalties were entitled to administrative priority, but such penalties were subject to equitable subordination under § 510(c). The court concluded the equities of the case required subordination of the nonpecuniary tax penalties without a showing of wrongful conduct by the IRS because, absent subordination, the pecuniary claims of general unsecured creditors could go unsatisfied. The district court affirmed, and the IRS appealed.

The Sixth Circuit’s opinion essentially adopted the rationale set forth by the Seventh and Eighth Circuits in *Virtual Network* and *Schultz Broadway Inn*. The circuit court upheld the lower courts’ decisions that creditor misconduct was not a prerequisite to equitable subordination of postpetition nonpecuniary tax penalties. *In re First Truck Lines*, 48 F.3d 210, 214-18 (6<sup>th</sup> Cir. 1995).

In a unanimous decision, the Supreme Court reversed and remanded. The Court reasoned that the rationale employed by both the bankruptcy court and the Sixth Circuit would require equitable subordination of nonpecuniary tax penalties as a class in all chapter 11 cases, despite

the fact that the Bankruptcy Code contained no such directive. *Noland*, 517 U.S. at 541, 116 S.Ct. at 1527. In the Supreme Court’s opinion, the holdings of the lower courts were “inappropriately categorical in nature.” *Id.* at 543, 116 S.Ct. at 1528. Ultimately, the Court held that, although § 510(c) allowed for equitable subordination in certain situations, absent a specific statement by Congress in the statute that nonpecuniary tax penalties were to be subordinated by class, courts should not subordinate such claims in chapter 11 cases without a showing that the judicially-established elements of equitable subordination were satisfied.

In *United States v. Reorganized CF&I Fabricators*, the IRS filed a proof of claim in CF&I’s bankruptcy case asserting a priority claim based on a 10% “excise tax” imposed under I.R.C. § 4971(a) upon a pension plan sponsor for unpaid minimum funding contributions. The debtor contended the claim actually represented a nonpecuniary tax penalty and should be subordinated under § 510(c). The bankruptcy court and district court agreed. The Tenth Circuit relied heavily upon the opinions by the Courts of Appeal in *Noland*, *Virtual Network* and *Schultz Broadway Inn* to conclude that the nonpecuniary tax penalty could be equitably subordinated under § 510(c) without a finding of creditor misconduct. *United States v. CF&I Fabricators of Utah*, 53 F.3d 1155, 1158-59 (10<sup>th</sup> Cir. 1995).

Consistent with its opinion in *Noland*, the Supreme Court vacated the portion of the Tenth Circuit’s judgment which held the tax penalty was subject to equitable subordination under § 510(c) based solely on its classification as a nonpecuniary tax penalty. *United States v. Reorganized CF&I Fabricators of Utah*, 518 U.S. 213, 116 S.Ct. 2106 (1996). Referring to its decision in *Noland*, the Court stated “the subordination fell beyond the scope of a court’s authority under the doctrine of equitable subordination, because categorical subordination at the

same level of generality assumed by Congress in establishing relative priorities among creditors was tantamount to a legislative act.” *Id.* at 229, 116 S.Ct. at 2115.

This is not to say that a particular tax claim cannot be equitably subordinated under § 510(c), since the Code’s requirement that a chapter 7 trustee must distribute assets “in the order specified in ... section 507” (which gives a first priority to administrative expense tax penalties) is subject to the qualification, “[e]xcept as provided in section 510 of this title....” 11 U.S.C. § 726(a). Thus, “principles of equitable subordination” may allow a bankruptcy court to reorder a tax penalty in a given case. Also, it is clear that inequitable conduct need not be present for equitable subordination to occur. In the *Noland* case, the Supreme Court specifically declined to decide whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated. *Noland*, 517 U.S. at 543, 116 S.Ct. at 1528. Nevertheless, the Court did note that the district courts and courts of appeal have generally followed the *Mobile Steel* formulation. *Id.* at 539, 116 S.Ct. at 1526. Those factors are that: (i) the claimant must have engaged in inequitable conduct; (ii) the misconduct must have resulted in injury to the debtor’s creditors or conferred an unfair advantage on the claimant; and (iii) the equitable subordination of the claim must not be contrary to the provisions of bankruptcy law. *Matter of Mobile Steel Co.*, 563 F.2d 692, 700 (5<sup>th</sup> Cir. 1977); *see also Matter of Vitreous Steel Prods. Co.*, 911 F.2d 1223, 1237 (7<sup>th</sup> Cir. 1990).

After *Noland* was decided, the Seventh Circuit upheld a bankruptcy court order under § 510(c) subordinating claims of nontendering, cashed-out shareholders of a short-from merger under Delaware law to the claims of general unsecured creditors, despite the absence of misconduct, in *Matter of Envirodyne Indus., Inc.*, 79 F.3d 579, 583 (7<sup>th</sup> Cir. 1996); *see also In*

*re Johnson Rehab. Nursing Home, Inc.*, 239 B.R. 168 (Bankr. N.D. Ill. 1999) (holding requirement that claimant must have engaged in some sort of inequitable conduct in order to permit equitable subordination of claim is only the general rule, which is subject to exception upon facts of particular case). Nevertheless, the Seventh Circuit later emphasized that, notwithstanding its decision in *Envirodyne*, “inequitable conduct is still the general rule for equitable subordination.” *Matter of Lifschultz Fast Freight*, 132 F.3d 339, 349 (7<sup>th</sup> Cir. 1997).

In *Gordon Sel-Way, Inc. v. United States*, 217 B.R. 221 (E.D. Mich. 1997), the district court affirmed the bankruptcy court’s decision not to subordinate the IRS’s nonpecuniary tax penalties. The court found the bankruptcy court had properly analyzed the *Noland* decision and concluded the inequities allegedly resulting from the Bankruptcy Code’s priority schedule, pursuant to which the claim asserted for noncompensatory tax penalties would be paid before there was any payment to general unsecured creditors, was not a sufficient basis for the bankruptcy court to equitably subordinate the IRS’s claim to that of the unsecured creditors, where the government acted in good faith and without misconduct. *Id.* at 223. The district court further noted, absent creditor misconduct, it was difficult to apply equitable subordination. *Id.*

Clearly then, equitable subordination does not always require that the creditor be found to have engaged in misconduct; however, where there is no misconduct, some other factor must be present which would warrant imposition of equitable subordination, such as excessive delay by the creditor or the general equities of the case. *In re Kids Creek Partners, L.P.*, 212 B.R. 898, 928 (Bankr. N.D. Ill. 1997), *aff’d*, 233 B.R. 409 (N.D. Ill. 1999), *aff’d*, 200 F.3d 1070 (7<sup>th</sup> Cir. 2000). No such factor has been alleged here. This court can only conclude that the debtor

wishes to impose a categorical subordination of the tax penalty, which result is contrary to the principles set forth in *Noland*.

In the final analysis, equitable subordination must be based on the equities of a particular claim, rather than on the court's, the debtor's, or other creditors' general desire to rearrange statutory priority levels. In this case it is undisputed the State of Minnesota acted in good faith and without misconduct. Because no reason is offered to apply the doctrine of equitable subordination to proof of claim number 331, the debtor's objection is overruled.

The court will enter a separate order consistent with this decision.

Dated at Milwaukee, Wisconsin, April 17, 2003.

BY THE COURT:

\_\_\_\_\_/s/\_\_\_\_\_  
Honorable Margaret Dee McGarity  
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT  
EASTERN DISTRICT OF WISCONSIN

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In re

ARROWHEAD SYSTEMS LLC,

Debtor.

Case No. 2002-20147

Chapter 11

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ORDER OVERRULING DEBTOR'S OBJECTION TO PROOF OF CLAIM NO. 331 OF  
STATE OF MINNESOTA DEPARTMENT OF REVENUE

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For the reasons stated in the court's memorandum decision entered on this date,  
IT IS ORDERED the debtor's partial objection to proof of claim no. 331 is overruled.  
IT IS FURTHER ORDERED proof of claim no. 331 is allowed as filed.

Dated at Milwaukee, Wisconsin, April 17, 2003.

BY THE COURT:

      /s/        
Honorable Margaret Dee McGarity  
United States Bankruptcy Judge