UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF WISCONSIN

In re:

CONCRETE RAISING CORPORATION — Chapter 11

Debtor. — Case No. 95-26272-MDM

CONCRETE RAISING CORPORATION,

Plaintiff,

vs. — Adversary No. 96-2028

TONY ZIDAR, JR., and
AMERICAN CONCRETE RAISING AND
CONSTRUCTION, INC.,

Defendants.

MEMORANDUM DECISION

I. INTRODUCTION

Defendants filed a proof of claim in the debtor's chapter 11 bankruptcy case in the amount of $194,606.97. The debtor subsequently commenced this adversary proceeding seeking to subordinate defendants' claim pursuant to 11 U.S.C. § 510(c). The defendants' answer acknowledged defendant American Concrete Raising and Construction, Inc., (ACR) had no claim against the debtor. Thus, the debtor only seeks to equitably subordinate the claim of defendant Tony Zidar, Jr.

This court previously denied the debtor's motion for summary judgment. Upon a motion for reconsideration, the court reiterated that issue preclusion did not apply in this case. Two prior state court rulings did determine certain issues relevant to the inquiry at hand, such as the amount of the debtor's liability to the defendant and the debtor's damages caused by defendants' actions of unfair competition after the claim against the debtor arose. However, the state court did not determine the nature and origin of the claim at the time the debt was established, such that equitable subordination would follow as a matter of law. At a hearing on the motion for reconsideration, the parties were given the choice to either litigate the matter before the court or present stipulated facts and exhibits upon which the court could reach a decision. The parties chose the latter option.

This court has jurisdiction pursuant to 28 U.S.C. § 1334(b), and this matter is a core proceeding under 28 U.S.C. § 157(b)(2)(B). This decision constitutes the findings of fact and conclusions of law of this court pursuant to Fed. R. Bankr. P. 7052. For the reasons stated herein, the court will grant the debtor's request to subordinate Tony Zidar's claim.

II. STIPULATED FACTS

Concrete Raising Corporation (CRC) was incorporated in 1973. Between 1973 and October 1992, one-half of CRC's common stock was owned by Robert ("Bob") Zidar and the other half by Bob's brother, Tony Zidar. In 1992, a dispute arose between the Zidar brothers. The brothers having reached an irreparable parting of the ways, Bob filed an action in Milwaukee County Circuit Court against Tony and Tony's wife, Kathleen, to sever their business relationship. On October 5, 1992, this initial action was settled pursuant to a stipulation and,

shortly thereafter, the parties entered into a series of transactions to memorialize the settlement. On October 20, 1992, Tony resigned as an employee of CRC, effective September 30, 1995, and Tony and Kathleen resigned as officers and directors of CRC. Tony and Kathleen also transferred to Bob and his wife, Sandra, their one-half undivided interest as tenants in common in the Plaza West Development property in West Allis and the 5000-5116 West Lincoln Avenue property in Milwaukee, both of which had been owned by the four parties personally.

The parties also entered into a Guaranteed Consulting Agreement by which CRC agreed to pay Tony $300,000 over a three-year period ending September 30, 1995, for advisory and consulting services. Through a Stock Redemption Agreement, Tony and Kathleen sold 100 ½ shares of common stock of the corporation back to CRC for $50,000. An additional $150,000 in cash and secured notes was also paid to Bob and Sandra. The parties executed a Mutual Release and set forth various agreements in a Summary of Stipulated Terms.

On January 21, 1993, CRC filed another action in Milwaukee County Circuit Court against Tony and his newly-formed corporation, American Concrete Raising and Construction, Inc. The complaint alleged trademark infringement, unfair competition and breach of contract. The defendants denied all liability and filed a counterclaim alleging certain amounts due pursuant to the Guaranteed Consulting Agreement. By the time CRC stopped paying on the agreement, it had paid Tony $86,637.70.

At trial in January 1995, the parties stipulated that under the Guaranteed Consulting Agreement CRC owed Tony $134,962.10 in unpaid principle, plus interest of $5,003.36, for a total of $139,965.46. Tony was due an additional $80,399.90 by September 30, 1995. After a bench trial, the state circuit court judge, Honorable Michael J. Barron, rendered a decision and

order, concluding that Tony confiscated certain corporate records of CRC and engaged in unfair competition. Accordingly, Judge Barron determined that, due to Tony's actions, CRC was entitled to an offset in the amount of $35,700 from the amounts due pursuant to the Guaranteed Consulting Agreement. The court entered judgment for Tony for $134.962.10, less $35,700, plus 5% interest. The remaining payments were not accelerated. By the time CRC filed its bankruptcy petition, the debt to Tony, now including all payments, grew to $194,606.97.

In order to determine whether Tony engaged in unfair competition in relation to CRC, Judge Barron analyzed the parties' prior agreement (Barron 3/23/95 Decision, p. 5-7). Judge Barron concluded that under the agreement Tony was not an employee of CRC; Tony was only employed on an advisory basis; he was not required to work beyond the Milwaukee area; he was not required to devote any significant amount of time for any duties; CRC was required to give Tony ten days' notice of any required assistance concerning litigation in which CRC may be involved; the payments due under the agreement would not cease even if Tony died; health insurance was the only fringe benefit for which Tony was eligible; Tony's participation in CRC's 401(k) program ceased as of September 30, 1992; and Tony was prohibited from coming on CRC's premises. Judge Barron then made the following finding:

> When you combine the above with the purchase of Tony's stock in CRC, the buyout of Tony's interest in the Lincoln Avenue and Plaza West properties, the absence of any noncompete agreement, the resignations by Tony as an employee, officer and director and Tony's testimony at the trial on valuation, it leads to the inescapable conclusion that the consulting agreement was actually part of a buyout of Tony's interest in the real estate owned by the brothers.

(Barron Decision, p. 5).

Judge Barron noted that Tony was paid in cash or notes, $200,000 in October 1992. Of that amount, $50,000 was allocated by agreement for Tony's stock in CRC. Evidence at the state court trial showed that there was about $700,000 equity in the Lincoln Avenue property and $500,000 in Plaza West. Dividing the $1.2 million equity in half between the brothers would leave each with $600,000. Tony testified that was negotiated down to $450,000. After deducting the $50,000 stock purchase from the $200,000 received at the time of the agreement, there was $150,000 left to allocate to Bob and Sandra's purchase of the equity in the two properties. Judge Barron pointed out that it was no coincidence that the $300,000 difference between $450,000 and $150,000 is the exact amount of the consulting agreement (Barron Decision, p. 6).

Judge Barron concluded that the consulting agreement was actually a tax savings device (Barron Decision, p. 6-7). It was to Robert's tax benefit that a portion of the buyout be allocated to paying off Tony on a weekly basis for three years as an ordinary and necessary business expense. Tony was never in fact contacted to provide any consulting services to CRC, which is not surprising, given the animosity between the brothers.

After Judge Barron's decision and order for judgment in Tony's favor against CRC, a supplementary receiver was appointed, who initiated efforts to seize CRC's assets. As a result of the actions of the receiver, CRC filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code on October 5, 1995. The receiver filed a proof of claim on behalf of Tony and ACR, as a secured claim, in the amount of $194,606.97. CRC's objection to the secured status of that claim was sustained by this court. The amount is not disputed. On June 14, 1996, an Order was entered confirming CRC's Amended Plan of Orderly Liquidation. Tony's claim is treated as an unsecured claim pursuant to the plan, and the debtor brought this proceeding to

subordinate Tony's claim to those of other unsecured creditors. Both parties agree that Tony is an insider of CRC as defined in 11 U.S.C. § 101(31).

III. ARGUMENTS

CRC seeks the equitable subordination of Tony's claim against the debtor pursuant to 11 U.S.C. § 510. Although inequitable conduct on the part of the creditor is a traditional element of equitable subordination, the Seventh Circuit has approved equitable subordination without fault. *Matter of Virtual Network Servs. Corp.*, 902 F.2d 1246, 1250 (7th Cir. 1990). CRC notes that Tony's claim arises from the Guaranteed Consulting Agreement, not a redemption agreement.

The debtor argues that the above transaction should be subordinated because it rendered the debtor insolvent on a balance sheet basis. As proof of this argument, the debtor points out that as of December 31, 1992, the debtor had retained earnings of $248,704. Deducting the $300,000 obligation to Tony from retained earnings leaves the debtor insolvent by approximately $52,000. The debtor argues that Tony used his fiduciary position as an insider for his own benefit and to the detriment of CRC's general creditors — conduct which § 510 was designed to prevent.

CRC also contends that Tony's unfair competition after the claim arose led to the debtor's inability to make payments pursuant to the Guaranteed Consulting Agreement. Upon receiving a judgment against CRC, Tony's efforts to collect on that judgment led to the filing of this chapter 11.

Finally, CRC argues that Tony provided no consideration to the debtor, either in the form

of assets transferred or services rendered, in connection with his claim. Judge Barron had held that the consulting agreement was actually a tax-savings vehicle resulting from the transfer of real estate to Bob and Sandra personally. The land transfer benefitted the stockholder, not the corporation, which agreed to pay for it.

The debtor's obligation under the consulting agreement arose as part of a package that included a stock redemption for $50,000, plus an additional unallocated payment in cash and secured notes totaling $150,000. The entire agreement was associated with Tony's withdrawal from the business. CRC points out that the principles of equitable subordination aim to redress the efforts of a corporate insider to convert his equity into debt. Those principles should be applied in this case. CRC derives support for its position from *Matter of Envirodyne Indus., Inc.*, 79 F.3d 579 (7th Cir. 1996), *cert. denied*, 117 S.Ct. 77 (1996):

> Because the stock redemption is a transaction by which a corporation acquires its own stock from stockholders, it is simply a method of distributing a proportion of the assets to stockholders. In substance, the former stockholders become equity holders rather than creditors on par with the corporation's other creditors. Thus subordination of claims in bankruptcy is equitable.

Id. at 582 (citation omitted); *see also In re Kids Creek Partners*, L.P., 200 B.R. 996 (Bankr. N. D. Ill. 1996). Because trade creditors will not be paid in full even if Tony's claim is subordinated, CRC contends that Tony is not entitled to any distribution from the debtor's estate.

Tony Zidar, on the other hand, believes that he should be treated as a general unsecured creditor. Tony notes that the Supreme Court cautioned bankruptcy courts against expanding the doctrine of equitable subordination:

> We do hold that (in the absence of a need to reconcile conflicting congressional choices) the circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the Bankruptcy

Code.

United States v. Noland, 116 S.Ct. 1524, 1528 (1996). Furthermore, the Seventh Circuit's holding in *Envirodyne* was limited to the facts of that case: the equitable subordination of "unsecured claims of non-tendering, cashed-out shareholders of a short-form merger under Delaware law to those of other general unsecured creditors." *Envirodyne*, 79 F.3d at 584. Tony points out that the Guaranteed Consulting Agreement is not a stock redemption agreement like that in *Envirodyne*. The substance of the Agreement constituted an exchange for value, namely payment for Tony's interest in property, and was not simply a redemption of Tony's interest in CRC. Tony claims that he became a traditional creditor of CRC, rather than an equity holder. Because this is not a stock redemption case, his argument continues, CRC must prove inequitable conduct on the part of Tony. Because CRC has not submitted any evidence of inequitable conduct in entering into the consultation agreement, Tony contends that it has not met its burden of proof to subordinate his claim.

IV. ANALYSIS

The doctrine of equitable subordination recognizes the bankruptcy court's fundamental role as a court of equity, permitting the court to disallow or subordinate claims which, if recognized, would produce unjust results. *Pepper v. Litton*, 308 U.S. 295, 304-06, 60 S.Ct. 238, 244-45 (1939).

Section 510(c)(1) 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)(1). The Seventh Circuit has established the following elements to be considered in a § 510(c)(1) equitable subordination claim: (1) whether the creditor claimant had engaged in some sort of inequitable conduct; (2) whether the misconduct has resulted in injury to other creditors or an unfair advantage to the miscreant; and (3) whether subordination of the debt is consistent with other provisions of the Bankruptcy Code. *Matter of Vitreous Steel Prods.*, 911 F.2d 1223, 1237 (7th Cir. 1990); *see also Matter of Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977). Once the elements have been established, the court is permitted, but not required, to equitably subordinate a claim. *Matter of Fabricators, Inc.*, 926 F.2d 1458, 1464 n. 9 (5th Cir. 1991). Misconduct by the creditor, however, is not necessarily required in every situation. *Matter of Envirodyne Indus., Inc.*, 79 F.3d 579 (7th Cir. 1996); *Matter of Virtual Network Servs. Corp.*, 902 F.2d 1246 (7th Cir. 1990).

The parties agree that Tony is an insider, and the transactions of an insider with a debtor are subject to a more rigorous level of scrutiny than the dealings of an outside party. *Pepper v. Litton*, 308 U.S. at 306, 60 S.Ct. at 245. However, in this case, inequitable conduct in the creation of the debt is not alleged, and there has been no indication that Tony engaged in any misconduct when the agreement was entered into. *See Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting,* 908 F.2d 1351, 1357 (7th Cir. 1990) ("'Inequitable conduct' in commercial life means breach *plus* some advantage-taking. . . .").[1]

[1]Other factors considered by courts to warrant equitable subordination are not present here: The transaction was not entered into on the eve of bankruptcy. *See Kham & Nate's Shoes*, 908 F.2d at 1356 (holding that equitable subordination is most frequently encountered where corporate insiders "convert their equity interests into secured debt in anticipation of bankruptcy"). Furthermore, the discord between the brothers leads to the conclusion that this was an arms-length transaction. *See Pepper v. Litton*, 308 U.S. at 306-07 ("The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's

In *United States v. Noland*, 116 S.Ct. 1524, 1528 (1996), the Supreme Court neither dispensed with nor endorsed the misconduct requirement: "[W]e need not decide today whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated." In *Noland*, the bankruptcy court attempted to ensure compensation of claims for actual loss by subordinating the tax penalty claims to general unsecured claims. *In re First Truck Lines, Inc.*, 141 B.R. 621 (Bankr. S.D. Ohio 1992) (bankruptcy court case in *Noland*). The district court and the Sixth Circuit Court of Appeals affirmed. The court of appeals concluded that the subordination of tax penalties was appropriate because tax penalties did not represent actual pecuniary loss and because the penalties no longer served a punitive purpose once the debtor was out of business Thus, tax penalties are "susceptible to subordination" by their very "nature." *In re First Truck Lines, Inc.*, 48 F.3d 210, 218 (6th Cir. 1995). The Supreme Court reversed. The Court pointed out that Congress intended to give the courts "some leeway to develop the doctrine" of equitable subordination when it enacted § 510(c). *Noland*, 116 S.Ct. at 1526-27. However, the court also cautioned that subordination should be consistent with developed doctrine. *Id*. Although the bankruptcy court 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.'" *Id*. at 1526 (citation omitted).

Because the issue of whether equitable subordination always requires a finding of misconduct has been left open by the Supreme Court, this court will base its decision on precedents set by the Seventh Circuit. The Seventh Circuit has taken the lead in recognizing subordination without fault. The court determined in *Virtual Network*:

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length bargain.").

> that Congress intended the courts to "develop" the "principles of equitable subordination." 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. It is clear that in principle, equitable subordination no longer requires, in all circumstances, some inequitable conduct on the part of the creditor.

Id. at 1249-50. Applying a fairness standard, the *Virtual Network* court upheld equitable subordination of IRS tax penalty claims to those of other unsecured creditors on the grounds that punitive, nonpecuniary claims of the IRS should be subordinated to actual loss claims. In determining whether the tax penalty should be subordinated to other claims that were not punitive, the court focused on the nature of the claim as a penalty. In other words, the unsecured creditors should not pay for the debtor's misdeeds. While the defendant's claim in this case differs significantly from a tax penalty claim, the principles developed in this cases provide guidance in analyzing what constitutes fair treatment of former insiders vis-a-vis other creditors of the same priority.

CRC suggests that the defendant's claim should be treated like a stock redemption claim because it arose in connection with Tony's withdrawal from the business. Various courts, including the Seventh Circuit, have determined that the origin and nature of stock redemption debt justifies its equitable subordination. *Envirodyne*, 79 F.3d at 582-84; *see also Liebowitz v. Columbia Packing Co.*, 56 B.R. 222 (D. Mass. 1985), *aff'd*, 802 F.2d 439 (1st Cir. 1986). In *Envirodyne*, the Seventh Circuit affirmed the equitable subordination of creditors' claims without finding that the creditors committed inequitable conduct. The creditors held canceled shares of stock in a corporation entering a short-form merger. Their equity interest was thus converted into debt and they retained the right to redeem their canceled shares for a specified amount without interest. They failed to do so, however, before the newly formed corporation filed for chapter 11.

The court examined the origin and nature of their claims and determined that the claims were properly subordinated based on the creditors' equity interest in the former corporation.

The Seventh Circuit examined other stock redemption cases and noted that stock redemption is a transaction by which a corporation acquires its own stock from stockholders.[2] It is simply a method of distributing a proportion of the assets to stockholders. *Envirodyne*, 79 F.3d at 582 (citing *Robinson v. Wangemann*, 75 F.2d 756 (5th Cir. 1935). In essence, the former stockholders become equity holders rather than creditors on par with the corporation's other creditors. The court reasoned that "'[t]he assets of a corporation are the common pledge of its creditors, and stockholders are not entitled to receive any part of them unless creditors are paid in full.'" *Id*. at 582-83 (quoting *Robinson*, 75 F.2d at 757).

The court considered fairness to other creditors when it concluded that the claims of the stock redeemers were "far weaker than other general unsecured creditors." *Id*. at 583; *see also Matter of Vitreous Steel Prods. Co.*, 911 F.2d 1223, 1237 (7th Cir. 1990). The court also pointed out that the subordinated creditors assumed the risk of the corporation's insolvency when they failed to tender their shares during the merger or anytime thereafter. *Id*.

Another court, *In re New Era Packaging, Inc.*, 186 B.R. 329 (Bankr. D. Mass. 1995), rationalized equitable subordination of stock redemption claimants:

> [I]n certain cases, some unfairness may result to the stockholder who redeems stock at a time of a company's substantial solvency and finds at the time for deferred payment that the company is insolvent through no fault of the stockholder. But juxtaposed against that unfortunate result is the recognition that, at the outset of the redemption transaction, the company became obligated to the stockholder, but received nothing in return. The burden

[2]Likewise, a stock redemption, for tax purposes, occurs if a corporation acquires its stock from a shareholder in exchange for property, regardless of whether the stock so acquired is canceled, retired or held as treasury stock. I.R.C. § 317(b).

> of payment should not, therefore, fall on the shoulders of the company's creditors who parted with value for the company's benefit.

Id. at 336.

CRC maintains that subordination is appropriate in this case because the transaction at issue is, in fact, a stock redemption, although Tony's withdrawal from the business contains other elements. The debtor points to the entry on the balance sheet described as "retained earnings" and argues that a division of the retained earnings would have netted much more than $50,000 had the corporation been divided in 1992. Therefore, the argument goes, much of the remaining claim is related to the stock buy-out. However, the debtor's concentration on the retained earnings figure does not advance its argument. Retained earnings is an accounting term relating to historical income, and it has nothing to do with current value. Book value, assets minus liabilities, is a better indicator, but even book value may be far away from what a third person might pay for one-half of the stock or assets of a company. At the end of 1992, the balance sheet shows a book value of $91,873, half of which is close to the amount determined by the arm's length agreement of the parties. Therefore, the agreed allocation was reasonable, and none of the defendant's claim is for stock redemption. The stock redemption portion of Tony's original claim, $50,000, was completely paid back on 1992, and the remaining amount due on the consulting agreement has nothing to do with it.

The debtor has a much more compelling argument for subordination of Tony's claim. According to the debtor, Tony provided no consideration to the debtor in connection with his claim against the corporation. Instead, consideration passed to Robert and Sandra Zidar, individually, not to the corporation which agreed to pay for it. Tony argues that value was given

the corporation by the agreement because he was available for consultation, and the agreement put an end to litigation. Also, Tony was obligated to assist in litigation in which the corporation was involved.

As Judge Barron observed, the total due under the consulting agreement would equalize the division of the equity in the real estate that the brothers and their wives owned together. The corporate debtor did not own the real estate. Tony and his wife gave up their half of the real estate and received a contract to be paid $300,000 over three years. The real estate went to Bob and Sandra, but CRC assumed the liability for the transfer. While Bob became the sole shareholder, he and the corporation are nevertheless separate legal entities. CRC is not just another pocket from which funds to pay individual debts can be withdrawn. Thus, the corporation received no consideration for its liability on the consulting agreement. This makes Tony's claim fundamentally different from those of creditors who did supply value for the corporation. It is only fair that his claim be subordinated to theirs. If consideration to the corporation can be found in such factors as Tony's availability for consultation or the cessation of tension, such consideration is too ephemeral to be weighed against the equities of trade creditors.

Perhaps it seems unfair to Tony that Bob received the real estate, but only $86,637 has been paid by the corporation so far on that $300,000 liability. Because of the general release, Tony may have no recourse. But the issue here is not fairness between Tony and Bob; it is between Tony and CRC creditors. The other creditors have greater right to the assets of the debtor.

Another bankruptcy court also distinguished between various claims made by shareholders against the corporate debtor by considering the benefit to the corporation. *In re*

Bentley-Russell, Inc., 201 B.R. 354 (Bankr. W.D. N.Y. 1996). The shareholders received two notes for loans used to finance the redemption of stock from the former owners. Because the corporation retained no benefit for the redemption of stock, the court determined that equitable subordination of those claims was appropriate. *Id*. at 356. The court did not equitably subordinate the shareholders' claims for money loaned to the corporation as working capital, nor did it subordinate claims for moneys actually expended for the debtor's benefit, thus highlighting the difference between the transfer of consideration to the corporate debtor and the lack thereof. *Id*. at 356-57. *See also Liebowitz v. Columbia Packing Co.*, 56 B.R. 222, 224 (D. Mass 1985), *aff'd*, 802 F.2d 439 (1st Cir. 1986) ("A stockholder who accepts a note in payment for his stock assumes the risk that the corporation will be solvent when the note becomes due.").

V. CONCLUSION

CRC received no benefit in entering into the Guaranteed Consulting Agreement with Tony. All of the consideration went to Bob and Sandra personally. Tony's claim relates entirely to amounts due under that agreement. Therefore, Tony's claim must be subordinated to the other general unsecured creditors who provided consideration to the debtor.

An order consistent with this decision will be entered.

Dated at Milwaukee, Wisconsin, April 4, 1997.

BY THE COURT:

___/s/______________________________
Honorable Margaret Dee McGarity
United States Bankruptcy Judge

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Defendants.

ORDER

For the reasons stated in the court's memorandum decision on this date, IT IS ORDERED that Tony Zidar's claim be equitably subordinated to the claims of other general unsecured creditors.

Dated at Milwaukee, Wisconsin, April 4, 1997.

BY THE COURT:

___/s/______________________________
Honorable Margaret Dee McGarity
United States Bankruptcy Judge

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