UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF TENNESSEE

In re: No. 97-10709
Chapter 11

NOXSO CORPORATION

Debtor

MEMORANDUM

Appearances: Kyle R. Weems, Weems & House, Chattanooga, Tennessee, Attorney for Noxso Corporation

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HONORABLE R. THOMAS STINNETT
UNITED STATES BANKRUPTCY JUDGE

Noxso Corporation is the debtor in possession in a Chapter 11 reorganization case. Donald M. Marburger has filed a motion to compel Noxso to assume or reject an executory contract. 11 U.S.C. § 365(d)(2); *Fed. R. Bankr. P.* 6006. Noxso has filed a motion for judgment on the pleadings. Since parties have relied on matters other than the pleadings, the court must treat the motion as one for summary judgment. *Fed. R. Civ. P.* 12(c). The court can grant summary judgment to Noxso only if there is no genuine issue of material fact, and the law entitles Noxso to a judgment in its favor. *Fed. R. Bankr. P.* 7056; *Fed. R. Civ. P.* 56(c).

Noxso and Mr. Marburger both say that the relevant facts are undisputed. In June 1996 Mr. Marburger paid Noxso $500,000 for 145,773 shares of Noxso stock. The contract required Noxso to use its best efforts to register the stock so that it could be sold in public market. Noxso failed to complete the registration before its bankruptcy and still has not registered the stock. Mr. Marburger contends the contract is still executory, since the stock has not been registered, and seeks to compel Noxso to assume or reject the contract.

Noxso contends that assumption or rejection of the contract is not the ultimate point of Mr. Marburger's motion. According to Noxso, Mr. Marburger wants to establish a claim for damages caused by Noxso's failure to register the stock because he will supposedly be a creditor, not merely a stockholder, for the amount of the damages. The difference is important under two basic rules.

First, a stockholder's ownership of shares in a bankrupt corporation does not make him a creditor. A stockholder is an owner of the corporation to the extent of his shares. *Warren v.*

King, 108 U.S. 389, 2 S.Ct. 789, 27 L.Ed. 769 (1883); *In re Mansfield Ferrous Castings, Inc.*, 130 B.R. 243 (Bankr. N. D. Ohio 1991); *In re Medical Equities, Inc.*, 83 B.R. 954 (Bankr. S. D. Ohio 1987). 11 U.S.C. § 101(5), (10) & (12) (definitions of claim, creditor & debt). The stockholder is an equity security holder who can file a proof of interest, not a proof of claim. 11 U.S.C. § 101(16) & (17) (definitions of equity security & equity security holder); 11 U.S.C. § 501(a) (right to file a proof of interest).

Second, the claims of all creditors must be paid in full before any of the corporation's property is distributed to stockholders on account of their stock ownership. 11 U.S.C. § 726 & § 1129(b); *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 U.S. 963, 99 L.Ed.2d 169 (1988); *In re Homestead Partners, Ltd.*, 197 B.R. 706, (Bankr. N. D. Ga. 1996); *Brandt v. Hicks, Muse & Co. (In re Healthco International, Inc.)*, 195 B.R. 971 (Bankr. D. Mass. 1996).

In light of these rules, Mr. Marburger doubtlessly prefers to be a creditor owed a claim for damages instead of a stockholder seeking to recover his ownership interest. Noxso's main argument assumes that Mr. Marburger has a claim for damages and is a creditor to that extent. Noxso contends that any claim for damages based on its failure to register the stock must be subordinated to other creditors' claims and treated as an equity interest.

The court has confirmed a plan of reorganization for Noxso. Assuming the contract is executory, the plan has the effect of rejecting it. This renders the motion to compel assumption or rejection moot. Confirmation of the plan, however, was not intended to decide the issue of whether any resulting claim by Mr. Marburger for damages should be paid as a creditor's claim or subordinated to the level of equity interests. 11 U.S.C. §§ 365(g) & 502(g); *Fed. R. Bankr. P.* 3003(c)(3) & 3002(c)(4).

Mr. Marburger has not contended the transaction should be treated as a loan instead of a stock purchase. It is unlikely he can prove the transaction was really a loan. *Matthews v. Bradford*, 70 F.2d 77 (6th Cir. 1934); *Al Baraka Bancorp (Chicago), Inc. v. Hilweh*, 656 A.2d 197 (Vt. 1994); *Lincoln Theatres Corp. v. Fleming*, 66 F.2d 441 (4th Cir. 1933); *Thompson v. Leggett (In re Culbertson's)*, 54 F.2d 753 (9th Cir. 1932); *In re Desnoyers Shoe Co.*, 210 F. 533 (S. D. Ill. 1914) *aff'd sub nom. Dozier v. Sangamon Land & Trust Co. (In re Desnoyers Shoe Co.)*, 224 F. 372 (7th Cir. 1915).

Thus, the question for the court is whether Mr. Marburger's claim for damages can be subordinated to the level of equity interests. Again, the court is assuming for the purpose of argument that Mr. Marburger has a claim for damages and that he is a creditor to that extent.

Noxso relies on § 510(b) of the Bankruptcy Code for the proposition that Mr. Marburger's claim for damages must be subordinated to the claims of creditors. 11 U.S.C. § 510(b). The briefs and argument have focused on the issue of subordination under § 510(b).

A. The claim can be subordinated under § 510(b) because it arose out of the purchase or sale of the stock.

Section 510(b) deals with claims growing out of the sale or purchase of a security of the debtor or an affiliate. The Bankruptcy Code defines "security" to include stock in a corporation. 11 U.S.C. § 101(49)(A)(ii).

Section 510(b) provides for subordination of two kinds of claims:

> (1) a claim arising from rescission of the purchase or sale of a security of the debtor; or
>
> (2) a claim for damages arising from the purchase or sale of a security of the debtor.

Mr. Marburger contends his claim for damages can not be subordinated under § 510(b) because it does not fit within either of these categories. According to Mr. Marburger's argument, the claim did not arise from the sale or purchase of the stock; it arose afterward as a result of Noxso's failure to register the stock.

Some cases support the argument that a claim for damages will not be subordinated under § 510(b) if the injury resulted from an independent cause that occurred after the sale. *In re Amarex*, 78 B.R. 605 (Bankr. W. D. Okla. 1987); *In re Angeles Corp.*, 177 B.R. 920 (Bankr. C. D. Cal. 1995); *aff'd* 199 B.R. 220 (B.A.P. 9th Cir. 1996)(Table); *Audre Recognition Systems Inc. v. Casey (In re Audre, Inc.)*, 210 B.R. 360 (Bankr. S. D. Cal. 1997).

The court assumes § 510(b) was intended to apply to a damage claim only if it arose out of the sale transaction, not if it arose from a later, independent cause. The question is whether Mr. Marburger's claim for damages arose from the sale transaction or a later, independent cause.

Noxso's promise to register the stock was the key ingredient in the sale by Noxso and the purchase by Mr. Marburger. Mr. Marburger asserts a claim for damages essentially because Noxso breached its contract with him by failing to register the stock. This is the same contract under which Noxso sold and Mr. Marburger purchased the stock. The court sees Noxso's duty to register the stock as part of the sale transaction. The contract should not be dissected so that Noxso's failure to register the stock was an event that occurred outside the sale transaction. Therefore, any damages suffered by Mr. Marburger as a result of Noxso's failure to register the stock constitute a claim arising from the sale or purchase of the stock.

This result also follows from the risk analysis that some courts have used to decide whether a claim comes within the rule of § 510(b). *In re Granite Partners, L. P.*, 208 B.R. 332 (Bankr. S. D. N. Y. 1997); *Audre Recognition Systems Inc. v. Casey (In re Audre, Inc.)*, 210 B.R. 360 (Bankr. S. D. Cal. 1997); *see also Flynn v. Loewer Realty Co. (In re V. Loewer's Gambrinus Brewery Co.)*, 167 F.2d 318, 319-320 (2d Cir. 1948).

A stockholder can not anticipate or expect all the risks that may cause a decrease in the stock's value, but he necessarily assumes all those risks. Furthermore, all these risks of ownership arise out of the purchase of the stock in a general sense: the stockholder bears the risk only because he became the owner of the stock. But all the risks of stock ownership do not arise in the sale transaction. For example, a stockholder takes the risk of incompetent or crooked management at any time during his ownership of the stock. This is a risk of stock ownership but not necessarily a risk that occurs as part of the sale transaction.

Claims arising from the sale transaction should normally be based on risks arising in the sale transaction. The risk that Noxso would take too long to register the stock was a risk arising in the sale transaction, since registration was the key ingredient in the sale transaction. Based on a risk analysis, the court finds that any claim by Mr. Marburger for damages resulting from Noxso's failure to register the stock is a claim arising from the sale or purchase of the stock.

The sale contract supports the court on both conclusions. The contract provides:

> **2. RISK FACTORS. The undersigned understands and agrees that an investment in the Shares is not a liquid investment. In particular, the undersigned recognizes, acknowledges and agrees that:**
>
> 2.1 The undersigned must bear the economic risk of investment in the Shares for an indefinite period of time, since the Shares have not been registered . . . and, therefore, cannot be transferred or sold unless either they are subsequently registered . . . or an exemption from registration is available . . . .
>
> 2.2 The undersigned will have no right to require the Company to register the Shares . . . except as set forth in paragraph 5 hereof.
>
> 2.3 There is presently no established public market nor is there anticipated to be a public market for the Shares and there is no assurance that any registration statement will be declared effective or that a trading market will develop in such securities.

This section continues with warnings based on Noxso's status as a development stage company; in particular Noxso's success was said to depend on future financing and outstanding contracts.

Section 3 includes another series of representations, the first being a representation that Mr. Marburger has carefully reviewed and understands the risks relating to the purchase of the shares. Subsection 3.9 provides:

> **3.9 The undersigned understands the fundamental aspects of and risks involved in an investment in the Company, including (1) the speculative nature of the investment, (2) the financial hazards involved, including the risk of losing the entire investment, (3) the lack of liquidity and the restrictions on transferability of the Shares, (4) inherent risks relating to the business of the Company, and (5) the fact that the Company has a history of losses, limited capital resources and will require additional financing within the next twelve months.**

In subsection 5.1 Noxso agreed to use its best efforts to file a registration statement within 10 days after completion of Noxso's annual audit for the fiscal year ending June 30, 1996. Noxso also agreed to use its best efforts to cause the registration statement to be effective within 90 days after the filing.

The contract leaves little doubt that registration was a key part of the sale transaction and failure to register was a risk arising in the sale transaction. The court concludes that any claim by Mr. Marburger for damages resulting from Noxso's delay in registering the stock is a claim arising from the sale or purchase of the stock — a claim that must be subordinated under § 510(b).

The claim can be equitably subordinated under § 510(c) on the ground that it is a claim for recovery of Mr. Marburger's ownership interest.

Assume the court's decision with regard to § 510(b) is wrong: Mr. Marburger's claim for damages is *not* a claim arising from the sale or purchase of the stock; it is a claim arising from a later, independent event. The court has assumed that such a claim can not be subordinated under § 510(b). The question is whether it can be subordinated on other grounds as allowed by § 510(c). Section 510(c) does not deal with any particular kind of claim and does not set out any specific rules for subordination. It gives the court the power to subordinate a claim under "principles of equitable subordination." 11 U.S.C. § 510(c).

Before the enactment of § 510, the courts developed common law rules for the subordination of claims on equitable grounds. This doctrine or collection of rules made up the law of equitable subordination. *See generally* Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 21 Vand. L. Rev. 83, 94 (1961). Section 510(c) preserves the power of the courts to apply those rules.

Section 510(c) was not, however, intended to freeze the law as it was when § 510 was enacted; it allows the courts to develop new rules as needed to fit a variety of situations, especially in light of legal and commercial changes. 124 Cong. Rec. 32398 (1978) (Rep. Edwards); *United States v. Noland*, 517 U.S. 535, 116 S.Ct. 1524, 1526-27, 133 L.Ed.2d 748 (1996).

Since § 510(c) does not spell out any rules for subordination of claims, the court will refer to subordination under § 510(c) simply as "equitable subordination."

At this point, the court must emphasize that it is dealing with claims arising from stock ownership. A stockholder can bring a stockholder's derivative suit against the management, directors, or other stockholders for actions that have harmed the corporation and devalued his stock. The stockholder, however, does not recover for his personal benefit. Any recovery is for the benefit of the corporation. 19 *Am.Jur.2d* §§ 2246 & 2250-2252 (1986).

On the other hand, a stockholder may also have a personal claim against the management, officers, directors, or other stockholders for actions they have taken to devalue the stockholder's stock or otherwise deprive him of his investment. 19 *Am.Jur.2d* §§ 2249 (1986). The stockholder may also be able to collect this personal claim from the corporation itself. *Gibson v. Adams*, 946 S.W.2d 796 (Mo. Ct. App. 1997). Thus, a stockholder can be a creditor of the corporation for damages representing the decrease in the value of his stock.

The court assumes that Mr. Marburger has a similar claim against Noxso as a result of its failure to register the stock. This brings the court back to the question of whether such a claim can be equitably subordinated under Bankruptcy Code § 510(c).

The first problem involves the relationship between subsections (b) and (c) of § 510. Two decisions from the Ninth Circuit illustrate the problem. First is *THC Financial*, a case that was decided before the enactment of § 510. *Falcon Capital Corporation Shareholders v. Osborne (In re THC Financial Corp.)*, 679 F.2d 784 (9th Cir. 1982).

The case involved a corporate merger. The stockholders of Falcon Capital sold their stock to THC, the parent corporation of THC Financial, in return for $400,000 worth of THC stock. They immediately received $100,000 of the stock. They were to receive the other $300,000 when THC reached a certain level of performance. The corporation in bankruptcy was not THC but its subsidiary, THC Financial.

The THC stockholders (the former Falcon stockholders) asserted a claim for damages against THC Financial in its bankruptcy case. They alleged that THC and THC Financial fraudulently prevented them from obtaining the additional stock by intentionally preventing THC from reaching the required performance level. The stockholders sought to be treated as creditors of THC Financial on the basis that their claims were for damages caused by its fraud. The court concluded that the stockholders' claims were really claims to recover their lost investment, that is, their ownership interests in THC. The court subordinated the claims.

The second case is *Audre Recognition Systems Inc. v. Casey (In re Audre, Inc.)*, 210 B.R. 360 (Bankr. S. D. Cal. 1997). The court in *Audre* decided that a claim, such as those involved in *THC Financial,* can not be subordinated on the ground that it is really a claim for recovery of the claimant's investment. The court based this conclusion on the enactment § 510. The court reasoned as follows.

Before the enactment of § 510, equitable subordination required proof of inequitable conduct by the claimant. Congress enacted § 510(b) to allow subordination of certain claims based on their nature, without proof of inequitable conduct. It enacted § 510(c) to allow equitable subordination of other kinds of claims under the general principles that require proof of inequitable conduct. Therefore, the only claims that can be subordinated based on their nature, without proof of inequitable conduct, are those that come within § 510(b). Any other kind of claim can not be subordinated on the ground that it is, by nature, an attempt by a stockholder to recover his investment or ownership interest. *In re Audre,* 210 B.R. 360, 366-68. This court disagrees.

The court in *Audre* based its conclusion on a negative implication that is not required. In § 510(b) Congress provided for subordination of claims arising from the sale or purchase of securities without proof of inequitable conduct, because claims of this type had presented a difficult problem under prior law. The claims were clearly based on the stockholder's investment, but they were treated peculiarly as creditors' claim under American law:

> Not many doctrines have passed more fully into the collective consciousness of the legal and commercial communities than the absolute priority rule, which states this prohibition: in bankruptcy, stockholders seeking to recover their investments cannot be paid before provable creditor claims have been paid in full. Nevertheless, there is a class of cases not subject to this rule under current practice. In these cases a dissatisfied investor may rescind his purchase of stock . . . by proving that the transaction violated federal or state securities laws. Under such circumstances, it is currently held that the investor's claim either shares pari passu with, or is preferred to, claims of general creditors.

John J. Slain & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy — Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N. Y. U. L. Rev. 261 (1973).

This law review article influenced Congress to enact § 510(b). H. R. Rep. 95-595, 95th Cong. 1st Sess. 194-196 (1977). Section 510(b) had a limited aim in dealing with this problem. It established a rule for a particular kind of claim for which there was a history of controversy. As a result, § 510(b) does not imply a general limit on the court's power to subordinate any other kind of claim by a stockholder based on its true nature as a claim for a return of the stockholder's investment. *See Field v. Mans*, 516 U.S. 59, 116 S.Ct. 437, 133 L.Ed.2d 351 (1995) (as to negative implications).

Furthermore, the inference that subordination without proof of inequitable conduct is allowed only under § 510(b) is based on a misunderstanding of the law before the enactment of § 510. The inference is much stronger if Congress understood that equitable subordination always required proof of inequitable conduct by the claimant. Equitable subordination, however, did not always require proof of inequitable conduct. Claims that did not arise out of the purchase or sale of securities were equitably subordinated without proof of inequitable conduct, as explained below.

As a general rule, the court will equitably subordinate a claim only when the claimant has engaged in inequitable conduct that harmed other creditors. Since the decision in *Mobile Steel*, this general rule has been repeated well past the three times required to make it true. *Benjamin v. Diamond (In re Mobile Steel Corp.)*, 563 F.2d 692, 701 (5th Cir. 1977); Lewis Carroll, *The Hunting of the Snark: An Agony in Eight Fits*, line 8. And it is true — as a general rule. But it was not an absolutely invariable rule when *Mobile Steel* was decided or when § 510 was enacted.

This is obvious from the capital contribution cases. They generally involve advances to the bankrupt corporation by a stockholder. The question is "whether the claim is, as a matter of substantial economic and legal reality, an indebtedness or . . . a proprietary interest." Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 21 Vand. L. Rev. 83, 94 (1961). The cases did not require proof of inequitable conduct. *Id.*

Of course, once the court determines that the loan was really a capital contribution, it may be said that it <u>sinks</u> to the level of an equity interest, instead of being pushed down or subordinated. *Id.* This theory has led some courts to say that re-characterizing a loan as a capital contribution does not involve equitable subordination. *Diasonics, Inc. v. Ingalls*, 121 B.R. 626 (Bankr. N. D. Fla. 1990); *Official Committee of Unsecured Creditors v. Bambu Sales, Inc. (In re Interstate Cigar Co.)*, 182 B.R. 675 (Bankr. E. D. N. Y. 1995); *Herzog v. Leighton Holdings, Ltd. (In re Kids Creek Partners)*, 200 B.R. 996 (Bankr. N. D. Ill. 1996). The court disagrees with the proposition that such cases do not involve equitable subordination.

First, when a court re-characterizes a loan as a capital contribution, it is exercising its equitable power to look through the form of a transaction to determine its substance. *See*, *e.g.*, *Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc.)*, 926 F.2d 1458 (5th Cir. 1991); *Clere Clothing Co. v. Union Trust & Savings Bank (In re Prager-Schlesinger Co.)*, 224 F. 363 (9th Cir. 1915); *Gelatt v. DeDakis*, 254 N.W.2d 171 (Wis. 1977); *S.G.V. Co. of Delaware v. S.G.V. Co. of Pennsylvania*, 107 A. 721 (Pa. 1919).

Second, the federal courts generally did not, and still do not, apply state law to decide the issue. They apply rules developed by the federal courts in bankruptcy cases, without mentioning state law that might allow the same result. *See, e.g., L & M Realty Co. v. Leo*, 249 F.2d 668 (4th Cir. 1957); *Arnold v. Phillips*, 117 F.2d 497 (5th Cir. 1941) *cert. den.* 313 U.S. 583, 61 S.Ct. 1102, 85 L.Ed. 1539 (1941); *Blasbalg v. Tarro (In re Hyperion Enterprises, Inc.)*, 158 B.R. 555 (D. R. I. 1993) (factors adapted from state law); *Official Creditors Committee v. Blades (In re New Madrid Nursing Homes, Inc.)*, 74 B.R. 240 (E. D. Mo. 1987); *but see Fruehauf Corp. v. Revitz (In re Transystems, Inc.)*, 569 F.2d 1364, 1366-67 (5th Cir. 1978).

For these reasons, re-characterizing a loan as a capital contribution is equitable subordination. Such cases have traditionally been treated as "within the general sphere of equitable subordination of claims." Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 93 (1961); *Pepper v. Litton*, 308 U.S. 295, 60 S.Ct. 238, 246-47, 84 L.Ed. 281 (1939). The court is justified in saying that these cases involved equitable subordination without proof of inequitable conduct.[1]

The instrumentality and alter ego cases also cast doubt on the proposition that equitable subordination always required proof of inequitable conduct. They generally involved a claim by a related corporation or a stockholder. The courts would subordinate the claim without proof the claimant intended to harm the debtor's creditors or to gain an unfair advantage over their claims. The courts ordered subordination if the claimant's actions resulted in unfair treatment of the debtor's creditors and the result was foreseeable. This is not inequitable conduct in the usual sense. Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 102-112 (1961); *Gannett Co. v. Larry*, 221 F.2d 269 (2d Cir. 1955); *International Telephone & Telegraph Corp. v. Holton*, 247 F.2d 178 (4th Cir. 1957).

Of course, *THC Financial* and similar cases did not require inequitable conduct. They subordinated the claims on the basis of their true nature as attempts to recover ownership interests. *Kelce v. U. S. Financial Inc. (In re U. S. Financial Inc.)*, 648 F.2d 515 (9th Cir. 1980) *cert.*

[1] *Mobile Steel* apparently tried to force these cases into the inequitable conduct class by treating undercapitalization as a form of inequitable conduct. *Benjamin v. Diamond (In re Mobile Steel Corp.)*, 563 F.2d 692, 702-704 (5th Cir. 1977).

den. 451 U.S. 970, 101 S.Ct. 2046, 68 L.Ed.2d 348 (1981); *Jezarian v. Raichle (In re Stirling Homex Corp.)*, 579 F.2d 206 (2d Cir. 1978) *cert. den.* 439 U.S. 1074, 99 S.Ct. 847, 59 L.Ed. 2d 40 (1979).

Likewise, the courts have not required proof of inequitable conduct in order to subordinate a claim based on a corporate debtor's agreement to purchase a stockholder's stock. *See*, *e.g.*, *In re Hawaii Corp.*, 694 F.2d 179 (9th Cir. 1982); *Liebowitz v. Columbia Packing Co.*, 56 B.R. 222 (D. Mass. 1985) *aff'd* 802 F.2d 439 (1st Cir. 1986) (table); *Ferrari v. Family Mutual Savings Bank (In re New Era Packaging, Inc.)*, 186 B.R. 329 (Bankr. D. Mass. 1995); *In re Micro-Acoustics Corp.*, 34 B.R. 279 (Bankr. S. D. N. Y. 1983); *Keith v. Kilmer*, 261 F. 733 (1st Cir. 1919) *cert. den.* 252 U.S. 578, 40 S.Ct. 344, 64 L.Ed. 725 (1920), and *amended* 265 F.268 (1st Cir. 1920); *see generally* Dennis F. Dunne, *Stock Repurchase Agreements in Bankruptcy: A Tale of State Law Rights Discarded*, 12 Bankr. Dev. J. 355 (1996).[2]

The leading Supreme Court cases, taken together, do not say that equitable subordination always requires proof of inequitable conduct by the claimant. They state somewhat broader grounds. *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307, 59 S.Ct. 543, 83 L.Ed. 669 (1939); *Pepper v. Litton*, 308 S.Ct. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939); *Comstock v. Group of Institutional Investors*, 335 U.S. 211, 68 S.Ct. 1454, 92 L.Ed. 1911 (1948); Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 104-107 (1961) (discussing instrumentality & alter ego cases).

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2 The author argues that such claims should not be subordinated if state law treats the seller as a creditor. Of course, the point of subordination in bankruptcy cases has often been to treat the claimant as an owner attempting to recover his ownership interest even though he is a creditor under state law or other federal law.

In summary, equitable subordination before the enactment of § 510 did not always require proof of inequitable conduct by the claimant. Furthermore, equitable subordination without proof of inequitable conduct was not limited to claims of the kind now dealt with by § 510(b).

The legislative history of § 510(c) also does not suggest that Congress meant to limit equitable subordination to cases involving inequitable conduct by the claimant. Section 510(c) tracks the wording of S. 2266. S. 2266, 95th Cong., 2d Sess. § 510(b). The report by the Senate Judiciary Committee did not say that proof of misconduct was always required for equitable subordination. It said it was "generally" and "normally" required. S. Rep. 95-989, Cong., 2d Sess. 74 (1978). One of the legislators who was most involved in the passage of the law said:

> 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.

124 Cong. Rec. H32398 (Sept. 28, 1978) (remarks of Rep. Edwards) (emphasis added).

In this statement, Representative Edwards recognized that prior law did not always require inequitable conduct — it allowed the court to subordinate a claim on the basis of its true nature as an attempt to recover an ownership interest. His statement does not suggest that subordination based on the status or nature of a claim would apply only to a penalty or a claim for damages arising from the purchase or sale of a security. They were used only as examples.

Thus, neither the legislative history of § 510 nor the prior law support the conclusion that equitable subordination, without proof of inequitable conduct, is allowed only under § 510(b).

Section 510(b) was <u>not</u> intended to cover the field as to the kinds of claims that can be subordinated without proof of inequitable conduct. Therefore, § 510 does not prevent a court from equitably subordinating a claim under § 510(c), without proof of inequitable conduct, on the ground that the claim actually seeks recovery of the claimant's ownership interest.

The law in this circuit does not always require proof of inequitable conduct. The court of appeals reached this conclusion in *United States v. Noland (In re First Truck Lines, Inc.)*, 48 F.3d 210 (6th Cir. 1995). The Supreme Court reversed the decision but not on the ground that inequitable conduct is always required. The Supreme Court explicitly refused to answer that question. *United States v. Noland*, 517 U.S. 535, 116 S.Ct. 1524, 1528, 133 L.Ed.2d 748 (1996).

Since the Supreme Court's decision, at least one district court has held that the law in this circuit does not always require proof of inequitable conduct in order to equitably subordinate a claim. *Gordon Sel-Way Inc. v. United States*, 217 B.R. 221 (E. D. Mich. 1997).

In summary, Mr. Marburger's claim may be subordinated under § 510(c), without proof of inequitable conduct, on the ground that it is a claim for recovery of his ownership interest. The court turns to the ultimate question of whether Mr. Marburger's claim should be subordinated on that ground.

The court has assumed that Mr. Marburger can recover damages from Noxso for his own benefit. Though all stockholders probably have suffered a decrease in the value of their stock, Mr. Marburger can assert his loss was distinct because it resulted from Noxso's failure to carry out a contract with him. The fundamental question is why Mr. Marburger's claim as a creditor to the extent of the damages should be treated differently from the claims of other creditors. There is no evidence that Mr. Marburger intentionally did anything to harm Noxso's creditors. Indeed, the infusion of his money may have helped them. Nevertheless, it may still be unfair to other creditors to pay damages to Mr. Marburger as a creditor

The situation is similar to a capital contribution case that does not involve inequitable conduct by the lender. In a capital contribution case, the court concludes the money was not a loan but an investment. This makes the claim really an attempt to recover an investment. It follows that it would be unfair to pay the claim along with the claims of creditors because it is unfair to return an investment to an investor before all creditors have been paid in full. Unfairness to creditors is the conclusion. The claim is not subordinated because the claimant's actions were unfair to creditors.[3]

Perhaps the leading modern case is *In re Envirodyne Industries, Inc.*, 79 F.3d 579 (7th Cir. 1996) *cert. den.*117 S.Ct. 77, 136 L.Ed.2d 36 (1996). The claimants had been stockholders of old Envirodyne which became new Envirodyne as the result of a merger. They failed to tender their old Envirodyne shares for new Envirodyne shares. Under Delaware law they were "cashed out" as a result. They ended up as creditors of new Envirodyne instead of stockholders. The court of appeals applied a risk analysis to compare their claims with the claims of other creditors of new Envirodyne. The court subordinated the claims because "[n]o amount of legal maneuvering" could obscure their "true nature" as equity interests. *Envirodyne*, 79 F.3d 579, 583.

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3 Section 510(b) takes the same approach.

This result is similar to the result in two old cases. In one case, the preferred stockholders had the right to convert their shares into bonds. Not all of them had been converted before the corporation's bankruptcy. The question was whether the preferred stockholders could convert to bondholders and become creditors in the bankruptcy case. The court did not allow it:

> It is a fundamental rule of corporation law that one cannot be at the same time both a stockholder and a creditor of a corporation in respect of the same funds hazarded in the corporate enterprise.

Security Trust Co. v. Baker (In re Phoenix Hotel Co.), 83 F.2d 724, 726 (6th Cir. 1936) *cert. den.* 299 U.S. 568, 57 S.Ct. 31, 81 L.Ed. 418 (1936).

In the other case, a person put $6,000 into the corporation. In return he received the corporation's note for $6,000 and 60 shares of its stock at a par value of $100 per share. The agreement allowed him to choose at a later date whether to keep the stock and be a stockholder or return it and rely on the note as a creditor. He had not chosen before the corporation's bankruptcy. The court "in fairness and justice to the other creditors" did not allow him to choose to become a creditor afterward. *In re W. A. Silvernail Co.*, 218 F. 977, 978 (D. Kan. 1914).

How does Mr. Marburger's claim for damages compare? The alleged injury was to the value of Mr. Marburger's stock. Damages would be measured by the loss of the stock's value as a result of Noxso's delay in registering the stock. *Wulfiing v. Kansas City Southern Industries, Inc.*, 842 S.W.2d 133 (Mo. Ct. App. W. D. 1992); *Riskin v. National Computer Analysts, Inc.*, 326

N.Y.S.2d 419 (App. Div. 1971). Thus, the damages would be a replacement for Mr. Marburger's investment.

Other stockholders will not be creditors for the decrease in value of their stock as a result of Noxso's business problems. Mr. Marburger may argue that he should be a creditor because his loss was distinct and personal; it was not just the result of business failure. From the viewpoint of other creditors, there is no difference. Paying the damages to Mr. Marburger as a creditor would amount to returning his ownership interest to him before full payment of creditors. Mr. Marburger would be treated as both a stockholder and a creditor with respect to the same funds hazarded in the corporate enterprise.

A final question concerns the degree of subordination. In dealing with a similar problem, Professors Slain and Kripke proposed a distinction between creditors' claims arising before and after the investment. They proposed subordination only to creditors' claims that arose after the investment. They reasoned that the earlier investors could not have relied on the investment. John J. Slain & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy — Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N. Y. U. L. Rev. 261, 294-98 (1973).

Creditors may see no sense in this distinction. It is possible that creditors rely on all investments, both prior and subsequent to their dealings with the debtor. It seems more likely, however, that creditors rely on the priority of their claims over the stockholders' ownership interests. This thinking agrees with a risk analysis from the creditors' viewpoint. Both stockholders and creditors take the risk of business failure. Creditors, however, take the risk with the knowledge that the corporation's assets must be used to pay their claims before any distribution to stockholders on account of their stock ownership. From the creditors' point of view, a stockholder knowingly takes the risk that all the corporation's assets will be used to pay *all* creditors, prior and subsequent, ahead of any return on his investment. There should be no distinction between creditors' claims according to whether they arose before or after Mr. Marburger's investment.

Conclusion

There is no genuine issue of material fact regarding the nature of any claim by Mr. Marburger for damages resulting from Noxso's failure to register the stock. As a matter of law, any such claim must be subordinated to the level of an equity interest under either § 510(b) or § 510(c).

This Memorandum constitutes findings of fact and conclusions of law as required by *Fed. R. Bankr. P.* 7052.

BY THE COURT

R. THOMAS STINNETT
UNITED STATES BANKRUPTCY JUDGE

entered Jan. 29, 1999