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Beyond the Limits of Equity Jurisprudence: No-Fault Equitable Subordination

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BEYOND THE LIMITS OF EQUITY JURISPRUDENCE: NO-FAULT EQUITABLE SUBORDINATION

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In two 1996 decisions involving equitable subordination of claims in bankruptcy cases, United States v. Noland *and* United States v. Reorganized CF&I Fabricators of Utah, Inc.*, the Supreme Court did not answer the question of whether a bankruptcy court must find creditor misconduct before it equitably subordinates a creditor's claim. In this Note, Rafael Pardo argues that the Court should have established a bright-line rule that requires such a finding, using prepetition, nonpecuniary loss tax penalty claims of the IRS as a model. After showing that, as codified in the Bankruptcy Code, the doctrine of equitable subordination requires a finding of creditor misconduct, he analyzes circuit courts of appeals cases prior to* Noland *and* Reorganized CF&I Fabricators *that upheld equitable subordination of IRS prepetition tax penalty claims under a no-fault standard. Pardo argues that use of a no-fault standard of equitable subordination by a bankruptcy court constitutes impermissible judicial activism, and concludes that any unfairness resulting from the treatment of claims by the Bankruptcy Code should be remedied by Congress.*

Introduction

One of the basic purposes of bankruptcy law is equality of distribution.[1] The distribution of assets of a bankrupt estate proceeds according to the statutory priorities set forth by Congress in the Bankruptcy Reform Act of 1978 (Bankruptcy Code).[2] To ensure the

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1 See Andrew DeNatale & Prudence B. Abram, The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors, 40 Bus. Law. 417, 418 (1985) ("Although the orchestral functions [of bankruptcy law] are marshalling and distribution, the contrapuntal theme is intended to be equality of distribution."). For a discussion of the general purposes of a bankruptcy case, see id. at 418-21.

2 Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended primarily at 11 U.S.C.). Section 507(a) sets forth categories of claims entitled to priority in bankruptcy cases. See 11 U.S.C. § 507(a) (1994). In the distribution of the assets of an estate under a Chapter 7 liquidation, claims afforded priority under § 507(a) are paid first. See id. § 726(a)(1). Sections 1129(a)(9) and 1322(a)(2) require that repayment plans in Chapters 11 and 13, respectively, provide for full cash payment of all priority claims. See id. §§ 1129(a)(9), 1322(a)(2).

equality of distribution, a bankruptcy court takes into account both legal and equitable considerations when reviewing the relative status of claims.[3] When conducting this review, the bankruptcy court sits as a court of equity,[4] with a mandate to "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate."[5] Thus, once a court has deemed a claim allowable,[6] it must decide, under principles of equity jurisprudence, whether to allow the holder of that claim to share pro rata with other claimants of equal status in the distribution of the estate.[7]

Among the general equity powers a bankruptcy court may use to prevent an unjust or unfair result in the distribution process is the equitable remedy of subordination. Equitable subordination is a judicially developed doctrine now codified in 11 U.S.C. § 510(c).[8] As explained by one bankruptcy court, the purpose of the doctrine is "to reprioritize the order of allowed claims based on the equities of the case, rather than to allow or disallow the claim in the first instance."[9]

Although § 510(c) codifies the doctrine of equitable subordination, it does not enumerate the factors that would mandate subordina-

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[3] See, e.g., 11 U.S.C. § 502(j) (allowing bankruptcy court to reconsider allowed or disallowed claims "according to the equities of the case"); cf. Bostian v. Schapiro (In re Kansas City Journal-Post Co.), 144 F.2d 791, 803 (8th Cir. 1944) ("For claim and distribution purposes, a bankruptcy proceeding is an integrated proceeding, and the 'subject matter in litigation' in its practical aspect is the right of creditors to share in the bankruptcy assets themselves, not merely legally but in equitable relation to each other . . . .").

[4] See Pepper v. Litton, 308 U.S. 295, 307 (1939) ("[T]he bankruptcy court in passing on allowance of claims sits as a court of equity.").

[5] *Pepper*, 308 U.S. at 308; see also Hecht Co. v. Bowles, 321 U.S. 321, 329 (1944) ("The essence of equity jurisdiction has been the power of the [court] to do equity and to mould each decree to the necessities of the particular case."). The court may invoke this power "to the end that fraud will not prevail, that substance will not give way to form, [and] that technical considerations will not prevent substantial justice from being done." *Pepper*, 308 U.S. at 305.

[6] See 11 U.S.C. § 502 (governing allowance and disallowance of claims in bankruptcy case).

[7] See supra note 3 and accompanying text. Equity considerations in a bankruptcy case assume a particular character given the principle of equal treatment of similarly situated creditors in the distribution process. For instance, the Bankruptcy Code allows the trustee to avoid certain prebankruptcy transfers that favor one creditor to the detriment of others. See 11 U.S.C. § 547. Because preferential payment violates the equal treatment of the debtor's legal obligations to his creditors, the transfer is voidable. See Robert Charles Clark, The Duties of the Corporate Debtor to Its Creditors, 90 Harv. L. Rev. 505, 511-12 (1977) (discussing "ideal of Evenhandedness" underlying law of preferential transfers).

[8] Section 510(c) limits application of the doctrine to the subordination of "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).

[9] In re County of Orange, 219 B.R. 543, 559 (Bankr. C.D. Cal. 1997); see also In re Lifschultz Fast Freight, 132 F.3d 339, 341 (7th Cir. 1997) ("Equitable subordination of a claim moves the creditor down in the order of payment out of the assets in the bankruptcy estate, generally reducing (or eliminating) the amount the creditor can recover.").

tion of a claim. Rather, the section merely states that the doctrine is to be applied "under principles of equitable subordination."[10] According to the legislative history of the Bankruptcy Code, Congress "intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle."[11]

At the time the Bankruptcy Code was enacted, the power of a bankruptcy court to subordinate a claim was not unlimited. Application of the doctrine generally was triggered by a showing of creditor misconduct.[12] It would seem, therefore, that the principle of creditor

[10] 11 U.S.C. § 510(c)(1).

[11] 124 Cong. Rec. 32,398 (1978) (statement of Rep. Edwards). The statements made by Senator DeConcini, the other sponsor of the bill, mirror those made by Congressman Edwards. See 124 Cong. Rec. 33,998 (1978) (statement of Sen. DeConcini).

[12] See Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 699-700 (5th Cir. 1977) (holding that creditor must engage in inequitable conduct before court will exercise equitable subordination). The standard for imposing equitable subordination differs depending on whether the creditor is an "insider" of the debtor. For the statutory definition of "insider," see 11 U.S.C. § 101(31); see also S. Rep. No. 95-989, at 25 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5810 ("An insider is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor."). A bankruptcy court will scrutinize strictly the conduct of an insider. See Pepper v. Litton, 308 U.S. 295, 306 (1939) (stating that conduct of insider is subject to "rigorous scrutiny" by court); see also First Nat'l Bank v. Rafoth (In re Baker & Getty Fin. Servs., Inc.), 974 F.2d 712, 718 (6th Cir. 1992) ("'Where the claimant is an insider, his dealings with the debtor will be subjected to more exacting scrutiny.'" (quoting Anaconda-Ericsson, Inc. v. Hessen (In re Teltronics Servs., Inc.), 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983))). Traditionally, inequitable or overbearing behavior on the part of an insider has warranted equitable subordination. Such conduct has included mismanagement, see, e.g., Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 323 (1939) (subordinating parent company's claim "because of the abuses in management due to the paramount interest of interlocking officers and directors"); undercapitalization accompanied by aggravating conduct, see, e.g., Braas Sys., Inc. v. WMR Partners (In re Octagon Roofing), 157 B.R. 852, 858 (N.D. Ill. 1993) (noting that "'only when undercapitalization is combined with inequitable conduct, such as fraud, spoilation, mismanagement or faithless stewardship'" will claims of insiders be subordinated (quoting Estes v. Cranshaw (In re N & D Properties, Inc.), 54 B.R. 590, 601 (N.D. Ga. 1985))); fraud, see, e.g., *Pepper*, 308 U.S. at 311-12 (subordinating claim of dominant stockholder who acted exclusively for purpose of fraudulently gaining priority over other creditors); alter ego cases, see, e.g., Ansel Properties, Inc. v. Nutri/Sys. of Fla. Assocs. (In re Nutri/Sys. of Fla. Assocs.), 178 B.R. 645, 653 n.4 (E.D. Pa. 1995) ("[I]n certain extraordinary situations equity may require a court to disregard a corporation's separate existence in order to impose liability on the person or entity that is dominating the corporation and using the corporation for illegitimate purposes."); impermissible control, see, e.g., Herzog v. Leighton Holdings, Ltd. (In re Kids Creek Partners, L.P.), 212 B.R. 898, 929 (Bankr. N.D. Ill. 1997) (observing that "actual exercise of managerial discretion" and "usurping the power of the debtor's directors and officers to make business decisions" constitute impermissible control); breach of fiduciary duty, see, e.g., De'Medici v. Salson Express Co. (In re Lifschultz Fast Freight), 181 B.R. 346, 356 (Bankr. N.D. Ill. 1995) (stating that "severe breach[ ] of fiduciary duty . . . [is] necessary in order to characterize conduct as inequitable"), rev'd on other grounds, 132 F.3d 339 (7th Cir. 1997); and improper claim acquisition, see, e.g., Citicorp Venture Capital, Ltd. v. Com-

misconduct limits the power of a court to subordinate a claim under § 510(c).[13] Some courts, however, have subordinated valid claims without a finding of creditor misconduct. Instead, they have applied a no-fault standard of equitable subordination that focuses on the nature and origin of the claim.

Among the claims that have been subject to no-fault subordination are prepetition, nonpecuniary loss tax penalty claims (prepetition tax penalty claims)[14] of the Internal Revenue Service (IRS).[15] Courts

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mittee of Creditors Holding Unsecured Claims, 160 F.3d 982, 987-88 (3d Cir. 1998) (holding that claim acquired improperly warrants equitable subordination). When the claimant is not an insider, most courts require egregious misconduct for imposing equitable subordination. See *Rafoth,* 974 F.2d at 718 (stating that claimant must be "guilty of gross misconduct tantamount to 'fraud, overreaching or spoliation to the detriment of others'" (quoting *Anaconda-Ericsson*, 29 B.R. at 169)); Blasbalg v. Tarro (In re Hyperion Enters.), 158 B.R. 555, 563 (D.R.I. 1993) (requiring noninsider's conduct to be "'egregious and severely unfair in relation to other creditors'" in order for equitable subordination to apply (quoting Boyajian v. DeFusco (In re Giorgio), 862 F.2d 933, 939 (1st Cir. 1988))).

13 See DeNatale & Abram, supra note 1, at 428 (stating that "[m]ere perceived unfairness in the bankruptcy results will not enable the bankruptcy court to alter the statutory scheme as dictated by the drafters of the bankruptcy law if the creditor acted in good faith and did not otherwise engage in improper conduct").

14 For purposes of this Note, such claims consist of "claims by the IRS to collect additions to tax from the debtor for failure to make a reasonable attempt to pay taxes or delinquent payment of taxes." Burden v. United States (In re Burden), 917 F.2d 115, 116 n.1 (3d Cir. 1990). Prepetition tax penalty claims are claims that arise prior to the order for relief, which becomes effective upon filing a petition to commence a voluntary case under any operative chapter of the Bankruptcy Code (Chapters 7, 9, 11, 12, and 13). See 11 U.S.C. § 301. For the standard of an order for relief on an involuntary petition, see id. § 303(h) (ordering relief if debtor does not pay debts as they become due). Conversely, postpetition tax penalty claims are claims that arise subsequent to the filing of the petition.

In cases under Chapter 7, prepetition tax penalty claims are paid after those claims given priority under 11 U.S.C. § 507(a)(1) and after general unsecured claims. See id. § 726(a)(4). Postpetition tax penalty claims, on the other hand, are allowed as administrative expenses. See id. § 503(b)(1)(C). Administrative expenses are treated as first priority claims. See id. § 507(a)(1). In general, assets from the Chapter 7 estate will be used to pay those claims before all other claims. See id. § 726(a)(1). But see id. §§ 364(c)(1), 507(b) (granting priority to certain claims over administrative expense claims). Accordingly, § 726(a)(4) expressly subordinates prepetition tax penalty claims to general unsecured claims, while § 507(a)(1) preserves priority in distribution for postpetition tax penalties in Chapter 7 cases.

Under Chapters 11 and 13, the Bankruptcy Code envisions that claims that are substantially similar to one another be classified together and receive the same treatment. See id. §§ 1122(a), 1322(a)(3)-(b)(1) (providing for equal treatment of claims within particular class). In United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996), the debtor, in addition to arguing that the IRS's prepetition tax penalty claims should be subordinated under § 510(c), argued that placement of those claims in the same class as general unsecured claims was improper under § 1122(a) because of the dissimilarity between the two types of claims. See id. at 227-28. While § 1122 allows claims to be placed in the same class if they are substantially similar, it does not require they be placed in that manner. See 11 U.S.C. § 1122(a). This Note does not address the classification and treatment of claims or interests in Chapters 11 and 13, and considers only the use of § 510(c) to subordinate prepetition tax penalty claims.

that have subordinated prepetition tax penalty claims under a no-fault standard have done so based on the argument that "innocent [creditors] should not have to bear the burden of penalties that were intended to punish the bankrupt."[16] Opponents of no-fault subordination of prepetition tax penalty claims have argued that this reasoning encourages courts to subordinate claims based on their nature and then purport to find facts justifying such subordination ex post.[17] Indeed, because the argument focuses on the general nature of the claim, rather than on the individual circumstances of the case, any balancing of the equities becomes mere pretext for automatic subordination of these claims under a no-fault standard.[18]

Arguably, the legislative history of the Bankruptcy Code provides a response to this attack on no-fault subordination of tax penalty claims:[19] Congress intended for the courts to continue to develop the "principles of equitable subordination."[20] The absence of enumerated factors in § 510(c) that define when equitable subordination is appropriate suggests that Congress recognized the importance of a court's equity power in achieving equality of distribution.[21] Nonetheless, as two commentators have noted, equitable subordination does not grant a bankruptcy court free reign to ignore the dictates of the Bankruptcy

[15] See *Burden*, 917 F.2d at 120-21 (upholding subordination of IRS's prepetition tax penalty claim despite absence of inequitable conduct by IRS); Schultz Broadway Inn v. United States, 912 F.2d 230 (8th Cir. 1990) (same); In re Virtual Network Servs. Corp., 902 F.2d 1246 (7th Cir. 1990) (same). The other principal types of claims courts have subordinated under a no-fault standard have been stock redemption claims, see, e.g., Weisman v. Goss (In re Hawaii Corp.), 694 F.2d 179 (9th Cir. 1982) (subordinating claims of former stockholders for balance due under redemption agreement to claims of general unsecured creditors); In re Main St. Brewing Co., 210 B.R. 662 (Bankr. D. Mass. 1997) (same), and punitive damages claims, see, e.g., In re Colin, 44 B.R. 806 (Bankr. S.D.N.Y. 1984) (subordinating punitive damages claim to claims of general unsecured creditors).

[16] *Schultz Broadway Inn*, 912 F.2d at 232.

[17] See Peter A. Christou, Note, Federal Tax Claims in Bankruptcy and the Doctrine of Equitable Subordination: *United States v. Noland* and *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 50 Tax Law. 237, 246 (1996).

[18] A corollary to the notion that the equitable power of a bankruptcy court is not unlimited, see supra note 12, is the idea that "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," DeNatale & Abram, supra note 1, at 428. The view that "equitable subordination is principally a functional substitute for fraudulent conveyance law," Clark, supra note 7, at 518, suggests that creditor misconduct should be a requirement for equitable subordination. For a discussion of the normative ideals of fraudulent conveyance law and the functional equivalence between it and the doctrine of equitable subordination, see id. at 505-36.

[19] But see infra Part II.B.

[20] See supra text accompanying note 11.

[21] See DeNatale & Abram, supra note 1, at 422 ("In order to remain effective in applying the doctrine, the courts must retain flexibility in recognizing the marks of unfairness and in dealing with it appropriately.").

Code.[22] Thus, the extent to which courts are free to develop the principles of equitable subordination turns on the degree to which they may depart from the precedent that existed at the time the doctrine was codified: namely, whether the requirement of creditor misconduct can be disregarded.

On two occasions in 1996, the Supreme Court reviewed the decision of a bankruptcy court to subordinate the IRS's tax penalty claims under a no-fault standard. In *United States v. Noland*,[23] the Supreme Court concluded that the Sixth Circuit's use of equitable subordination was "inappropriately categorical in nature."[24] The Court noted that a bankruptcy court may not use equitable subordination to change the priorities Congress had set in the Bankruptcy Code.[25] In *United States v. Reorganized CF&I Fabricators, Inc.*,[26] the Court extended to prepetition tax penalty claims *Noland*'s prohibition of the categorical subordination of claims without regard to individual equities.[27] Both cases stand for the proposition that a bankruptcy court may not subordinate categorically whole classes of claims and thereby transgress the line distinguishing adjudication from legislation.[28] The decisions reflect the Supreme Court's concern that any categorical

[22] See id. at 428 ("The doctrine has never been meant to enable the court, or the parties to cause the court, to amend freely the statutory scheme [of the Bankruptcy Code], but merely to enforce it.").

[23] 517 U.S. 535 (1996).

[24] Id. at 543. Deeming the Sixth Circuit's decision impermissible judicial activism, the Court explained:

> [I]f the [Bankruptcy Code] also authorized a court to conclude on a general, categorical level that tax penalties should not be treated as administrative expenses to be paid first, it would empower a court to modify the operation of the priority statute at the same level at which Congress operated when it made its characteristically general judgment to establish the hierarchy of claims in the first place. . . . We find such a reading improbable in the extreme.

Id. at 540-41.

[25] See id. at 543 ("Congress could have, but did not, deny noncompensatory, postpetition tax penalties the first priority given to other administrative expenses, and bankruptcy courts may not take it upon themselves to make that categorical determination under the guise of equitable subordination.").

[26] 518 U.S. 213 (1996).

[27] See id. at 228-29 (relying on *Noland* to vacate court of appeals decision upholding subordination of IRS's prepetition tax penalty claim).

[28] See *Noland*, 517 U.S. at 543 (noting that "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 Code" (citing Stebbins v. Crocker Citizens Nat'l Bank (In re Ahlswede), 516 F.2d 784, 787 (9th Cir. 1975) ("[T]he [equity] chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule.") (alterations in original))); see also In re Columbia Ribbon Co., 117 F.2d 999, 1002 (3d Cir. 1941) (stating that court cannot "set up a sub-classification of claims . . . and fix an order of priority for the sub-classes according to its theory of equity").

subordination of claims would exceed the constitutional limits on judicial power and encroach upon Congress's Article I powers.[29]

Although both *Noland* and *Reorganized CF&I Fabricators* clearly direct a bankruptcy court to engage in a case-by-case analysis to determine whether subordination is proper, the cases do not resolve whether a finding of creditor misconduct is necessary for equitable subordination.[30] The Court's failure to address this issue[31] leaves unanswered whether the circuit court decisions that applied a no-fault standard on a case-by-case basis to subordinate prepetition tax penalty claims remain good law.[32]

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[29] See *Noland*, 517 U.S. at 540 ("[T]he distinction between characteristic legislative and trial court functions would simply be swept away, and the statute would delegate legislative revision, not authorize equitable exception.").

[30] See *Noland*, 517 U.S. at 543 ("[W]e need not decide today whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated."); see also *Reorganized CF&I Fabricators*, 518 U.S. at 229 (limiting holding to disallow use of equitable subordination for purpose of reordering priorities on categorical level). In the wake of *Noland*, several lower courts seized upon the Court's failure to answer whether creditor misconduct is a predicate for equitable subordination. These courts have reasoned that pre-*Noland* decisions, such as In re Virtual Network Servs., 902 F.2d 1246 (7th Cir. 1990), and United States v. Noland (In re First Truck Lines, Inc.), 48 F.3d 210 (6th Cir. 1995), rev'd, 517 U.S. 535 (1996), are good law to the extent they permit application of a no-fault standard on a case-by-case basis. See, e.g., SPC Plastics Corp. v. Griffith (In re Structurlite Plastics Corp.), 224 B.R. 27, 35 n.5 (B.A.P. 6th Cir. 1998) ("Because the Supreme Court did not reach the issue whether creditor misconduct is necessary for equitable subordination under § 510, the Sixth Circuit's *First Truck* is controlling on that issue."); In re Lifschultz Fast Freight, 132 F.3d 339, 348 (7th Cir. 1997) ("We need not consider the implications of *Noland*, if any, for *Virtual Network*, so we assume the trustee is right to say that after *Virtual Network*, creditor misconduct is no longer an absolute requirement in this circuit 'in all circumstances' and 'in every instance.'"); Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.), No. 1:98-CV-658, 1999 WL 1005647, at *10 (W.D. Mich. May 25, 1999) ("Bayer is correct that the *First Truck* remains good law in the Sixth Circuit insofar as it is limited to the proposition that 'subordination under § 510(c) is not restricted to cases of creditor misconduct.'" (quoting *In re Structurlite Plastics Corp.*, 224 B.R. at 36)); Rabex of Colo., Inc. v. Reed (In re Rabex of Colo., Inc.), 226 B.R. 905, 908-09 (D. Colo. 1998) ("Applying the flexible approach, the court in *Virtual Network* determined proof of inequitable conduct was not necessary for subordination of nonpecuniary loss tax penalty claims. In my view . . . Tenth Circuit jurisprudence . . . [does not] preclude[ ] application of the flexible test under appropriate circumstances . . . ." (footnote omitted)); cf. Simione v. Nationsbank of Del., N.A. (In re Simione), 229 B.R. 329, 336 (Bankr. W.D. Pa. 1999) (noting that since *Noland*, "[t]he Court of Appeals for the Third Circuit has not decided whether misconduct is always a prerequisite to equitable subordination").

[31] See Christou, supra note 17, at 237, 245-47 (discussing persistence of unresolved ambiguity in judicial development of doctrine of equitable subordination despite Supreme Court's rulings in *Noland* and *Reorganized CF&I Fabricators*).

[32] For a discussion of those cases that involve no-fault equitable subordination of prepetition tax penalty claims, see infra Part I.C. In his Note, Christou argues that "[i]n effect, *Noland* appears to overrule cases such as *In re* Virtual Network Services, that adopted a 'categorical' subordination rule for prepetition tax penalties." Christou, supra note 17, at 247. This view is incorrect insofar as *Virtual Network* did not adopt a categori-

This Note argues that use of a no-fault standard of equitable subordination by a bankruptcy court exceeds the limits of its equitable powers. As evidence of this claim, the Note focuses on application of the standard to prepetition tax penalty claims outside of Chapter 7.[33] The Note posits that a finding of creditor misconduct should be a requirement for equitable subordination in order to prevent a bankruptcy court from engaging in legislative revision of the statutory priorities set forth by Congress in the Bankruptcy Code. Part I presents the common law development of the doctrine of equitable subordination prior to enactment of the Bankruptcy Code, discusses pre-Code treatment of tax penalty claims, and describes the law of equitable subordination of tax penalty claims leading up to the Supreme Court's decisions in *Noland* and *Reorganized CF&I Fabricators.* Part II argues that no-fault subordination of prepetition tax penalty claims constitutes an impermissible use of a bankruptcy court's equitable powers. The Note then concludes that any unfairness resulting from the priority treatment afforded claims by the Bankruptcy Code should be remedied through congressional amendment rather than through judicial revision.

I
EQUITABLE SUBORDINATION AND TAX PENALTY CLAIMS

A. *Equitable Subordination Under the Common Law*

Equitable subordination is a judicially developed doctrine that derives from the general equity powers of courts.[34] Three cases—*Taylor v. Standard Gas & Electric Co.*,[35] *Pepper v. Litton*,[36] and *Comstock v. Group of Institutional Investors*[37] (referred to as the *Taylor-*

cal subordination rule for prepetition tax penalties. Rather, the court there, as well as the other circuit courts that followed suit, held that § 510(c)(1) allows for subordination of such claims only on a case-by-case basis. See infra text accompanying notes 60-64. Those courts, however, did not indicate which equitable considerations would trigger subordination of prepetition tax penalty claims under a no-fault standard. See, e.g., infra note 64.

[33] This Note does not focus on subordination of postpetition tax penalty claims since arguments in favor of no-fault subordination of such claims are weak at best and readily dismissed. See infra note 121.

[34] See DeNatale & Abram, supra note 1, at 421 ("Th[e] development occurred without any specific statutory authority but derived from the equitable jurisdiction of the bankruptcy court and the cardinal principles of equity jurisprudence."); see also Asa S. Herzog & Joel B. Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 Vand. L. Rev. 83, 83 (1961) ("[T]he bankruptcy courts simply drew upon their powers as courts of equity to correct the abuses, fraud and inequity which would otherwise flow from a strict and unswerving application of the [statutory law].").

[35] 306 U.S. 307 (1939).

[36] 308 U.S. 295 (1939).

[37] 335 U.S. 211 (1948).

Pepper-Comstock trilogy)—established the common law principles of equitable subordination. These cases identified behavior by insiders, i.e., individuals who bear a close relationship to the debtor, that constituted inequitable conduct and therefore warranted subordination of those insiders' claims.[38]

In *Taylor*, the Supreme Court classified mismanagement as inequitable conduct. There, a parent company had managed the subsidiary debtor's affairs so "as always to have a stranglehold upon it."[39] The Court subordinated the parent's claims "because of the abuses in management due to the paramount interest of interlocking officers and directors."[40] In *Pepper*, the Court held that fraud constituted creditor misconduct for purposes of equitable subordination. There, a dominant stockholder acted solely for the purpose of fraudulently gaining priority over other creditors. The stockholder caused the debtor to accept a judgment on his behalf that later matured into a lien against the debtor's property held by the stockholder.[41] To support a finding of fraud, the Court reasoned that "sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant [or] a breach of the fiduciary standards of conduct which he owes the corporation, its stockholder and creditors."[42] Finally, the *Comstock* Court determined that the alter ego principle of undercapitalization is a sufficient criterion to subordinate claims of fiduciaries. The Court noted that when an alter ego, such as a parent corporation, asserts a claim, a court may subordinate that claim if such entity unconscionably utilized a position of control to its benefit and to the detriment of other creditors.[43]

Following the Court's decisions in the *Taylor-Pepper-Comstock* trilogy, courts required inequitable conduct before subordinating a creditor's claims.[44] Although the Supreme Court identified certain behavior as inequitable, no general framework existed by which

[38] For a discussion of insiders and conduct by insiders that warrants equitable subordination, see supra note 12.

[39] *Taylor*, 306 U.S. at 315.

[40] Id. at 323.

[41] See *Pepper*, 308 U.S. at 311-12.

[42] Id. at 310-11.

[43] See Comstock v. Group of Institutional Investors, 335 U.S. 211, 229-30 (1948) (citing *Taylor* for rule of subordination in cases where fiduciary enriches itself by breach of its trust, but holding rule did not apply in case at hand because parent company acted in good faith).

[44] See Scott M. Browning, Note, No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are at Risk, 34 Wm. & Mary L. Rev. 487, 496 & n.71 (1993) (citing numerous court decisions following principle developed in *Taylor-Pepper-Comstock* trilogy).

courts could apply equitable subordination uniformly.[45] The Fifth Circuit provided that framework in *Benjamin v. Diamond* (*In re Mobile Steel Co.*).[46] The case established a three-part test to determine whether equitable subordination was warranted:

> (i) The claimant must have engaged in some type of inequitable conduct.
>
> (ii) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant.
>
> (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.[47]

The three-part test provided a structure that permitted courts to apply equitable subordination in a principled and predictable manner.[48] Such was the state of the law regarding equitable subordination on the eve of passage of the Bankruptcy Code.

B. *Pre-Code Treatment of Prepetition Tax Penalty Claims*

In determining whether tax penalty claims should be subordinated under a no-fault theory, it is useful to look at the treatment of those claims under the prior Bankruptcy Act of 1898. Section 57(j) of the Act disallowed prepetition, nonpecuniary loss penalty claims.[49] The Supreme Court interpreted this section to mean that prepetition tax penalty claims could not be asserted against the debtor's estate.[50]

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45 See id. at 496.

46 563 F.2d 692 (5th Cir. 1977).

47 Id. at 700 (citations omitted).

48 See Browning, supra note 44, at 497 (noting that courts and commentators found *Mobile Steel* provided "a pragmatic solution to the ambiguity that plagued the doctrine of equitable subordination"). Since the enactment of the Bankruptcy Code, most courts have adhered to the *Mobile Steel* limitation that inequitable conduct by a creditor is a prerequisite to subordination. See, e.g., First Nat'l Bank v. Rafoth (In re Baker & Getty Fin. Servs., Inc.), 974 F.2d 712, 717-18 (6th Cir. 1992) (applying three-step test of *Mobile Steel*); Capitol Bank & Trust Co. v. 604 Columbus Ave. Realty Trust (In re 604 Columbus Ave. Realty Trust), 968 F.2d 1332, 1353 (1st Cir. 1992) (same); Bergquist v. Anderson-Greenwood Aviation Corp. (In re Bellanca Aircraft Corp.), 850 F.2d 1275, 1282 (8th Cir. 1988) (applying equivalent of three-step test from *Mobile Steel* as found in Wilson v. Huffman (In re Missionary Baptist Found.), 712 F.2d 206, 212 (5th Cir. 1983)).

49 See Act of July 7, 1952, ch. 579, § 14(a), 66 Stat. 420, 424 (repealed 1978) (amending section 57(j) of Bankruptcy Code to provide that "[d]ebts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose").

50 See Simonson v. Granquist, 369 U.S. 38, 40 (1962) (holding that Act's language manifests congressional intent to "bar all claims of any kind against a bankrupt except those based on a 'pecuniary' loss").

Allowance of such claims, it reasoned, would have the effect of punishing innocent creditors for the debtor's misconduct.[51]

If the trustee incurred postpetition tax penalties, however, the claims were allowed and given first priority in the distribution of the assets of the bankrupt estate.[52] The rationale for enforcing postpetition tax penalty claims through first priority was that such claims provide the government with "a legitimate means to enforce" tax laws in bankruptcy cases.[53] Additionally, enforcement places the debtor's business on equal footing with its competitor. Priority treatment for postpetition tax penalty claims ensures that the debtor, and the debtor's creditors, do not benefit from disregard of the laws to which other businesses must adhere.[54]

C. *No-Fault Equitable Subordination Prior to* Noland *and* Reorganized CF&I Fabricators

The primary objection to no-fault equitable subordination of tax penalty claims is that such subordination alters the statutory priorities set forth by Congress in the Bankruptcy Code, thereby making subordination of these claims impermissible.[55] A discussion of the cases leading to the Supreme Court's decisions in *Noland* and *Reorganized CF&I Fabricators* illustrates the problems that arise when claims are subordinated under a no-fault standard. The three leading circuit court cases allowing equitable subordination of prepetition tax penalty claims outside of Chapter 7 absent creditor misconduct are *In re Virtual Network Services Corp.,*[56] *Schultz Broadway Inn v. United*

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[51] See id. at 41 (noting that "[e]nforcement of penalties against the estates of bankrupts . . . would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors").

[52] See Act of July 1, 1898, ch. 541, § 64(a), 30 Stat. 544, 563 (repealed 1978); see also Boteler v. Ingels, 308 U.S. 57, 59-60 (1939) (noting that

> Subdivision 57(j) prohibits allowance of a tax penalty against the bankrupt estate only if incurred by the bankrupt before bankruptcy by reason of his own delinquency. After bankruptcy, it does not purport to exempt the trustee from the operation of state laws, or to relieve the estate from liability for the trustee's delinquencies.).

[53] Nicholas v. United States, 384 U.S. 678, 694 (1966); see also *Boteler*, 308 U.S. at 61 (stating that if trustee were exempt from penalty, "[the] [s]tate would thus be accorded the theoretical privilege of taxing businesses operated by trustees in bankruptcy on an equal footing with all other businesses, but would be denied the traditional and almost universal method of enforcing prompt payment").

[54] See United States Dep't of Interior v. Elliott (In re Elkins Energy Corp.), 761 F.2d 168, 171 (4th Cir. 1985) ("[C]reditors cannot shield their eyes from the debtor's unlawful activities, activities that may benefit the creditors by increasing the distribution to which the creditors are entitled.").

[55] See supra notes 28-29 and accompanying text.

[56] 902 F.2d 1246 (7th Cir. 1990).

States,[57] and *Burden v. United States (In re Burden)*.[58] In each of these cases, the court upheld application of a no-fault standard of subordination in order to protect innocent creditors from debtor misconduct.[59]

In *Virtual Network*, the court determined that shifting the debtor's punitive obligations to the general unsecured creditors who had not been paid for their pecuniary losses would be unfair. It concluded that, on a case-by-case basis, § 510(c)(1) permits equitable subordination without a finding of creditor misconduct.[60] In *Schultz*, the court interpreted the legislative history of § 510(c) to support the proposition that Congress intended bankruptcy courts to determine on a case-by-case basis whether a penalty claim should be subordinated in a Chapter 11 liquidating case.[61] While the court acknowledged the possibility that sometimes the equities would not favor subordination of tax penalty claims to the claims of general unsecured creditors, it ultimately held that, "given the Congressional preference for compensating creditors' actual losses first," the burden of proof would lie on the government to show the equities did not warrant subordination of its claims.[62] Finally, in *Burden*, the court held that despite the absence of creditor misconduct by the IRS, equitable subordination of the tax penalties was permitted.[63] Relying on legislative history, the court concluded that Congress intended for courts to have flexibility in applying the principles of equitable subordination. The court emphasized, however, that a no-fault standard could not be applied "automatically," but rather the bankruptcy court would have to "bal-

57 912 F.2d 230 (8th Cir. 1990).

58 917 F.2d 115 (3d Cir. 1990).

59 In *Virtual Network*, Virtual Network Services (VNS), the debtor, filed a petition for relief under Chapter 11. Shortly after filing the petition, VNS sold most of its operating assets and subsequently filed an amended reorganization plan to liquidate the company. Thereafter, the IRS filed a proof of claim for a general unsecured claim that included prepetition tax penalties. The penalties accrued because of the debtor's failure to file tax returns. See *Virtual Network*, 902 F.2d at 1246-47. In *Schultz*, the debtor proposed a liquidating Chapter 11 plan. As in *Virtual Network*, the IRS filed a proof of claim for prepetition tax liabilities, including a negligence penalty for underpayment of taxes (i.e., a nonpecuniary loss tax penalty). See *Schultz*, 912 F.2d at 231. In *Burden*, the debtor filed a Chapter 13 petition. The IRS filed a proof of claim for taxes, interest, and penalties for various tax periods before the debtor filed for bankruptcy. The debtor objected to the portion of the proof of claim relating to the prepetition penalties. See *Burden*, 917 F.2d at 116.

60 See *Virtual Network*, 902 F.2d at 1250.

61 See *Schultz*, 912 F.2d at 233-34.

62 Id. at 234.

63 See *Burden*, 917 F.2d at 120-21.

ance the equities" on a case-by-case basis.[64] These three cases represented the trend in no-fault equitable subordination when the Supreme Court decided *Noland* and *Reorganized CF&I Fabricators*.

II
Impermissible Use of a Bankruptcy Court's Equitable Powers: No-Fault Subordination of Prepetition Tax Penalty Claims

The remainder of the Note argues that no-fault equitable subordination of prepetition tax penalty claims exceeds the scope of a bankruptcy court's equitable powers. This Part first examines the improper reliance on *Jezarian v. Raichle* (*In re Stirling Homex Corp.*)[65] by those courts that have subordinated prepetition tax penalty claims absent inequitable conduct by the IRS. It then argues that the legislative history of the Bankruptcy Code does not support a no-fault standard of equitable subordination. Next, this Part discusses the Bankruptcy Code's treatment of prepetition tax penalty claims. It suggests that there are no equitable factors that would render subordination of such claims permissible within the principles of equity jurisprudence. This Part concludes that the Supreme Court's rulings in *Noland* and *Reorganized CF&I Fabricators* fall short of clarifying the judicial uncertainty that surrounds no-fault equitable subordination. The two decisions should have specified that equitable subordination requires a finding of creditor misconduct. The requirement would prohibit a bankruptcy court from equitably subordinating prepetition tax penalty claims under a no-fault standard, notwithstanding a case-by-case consideration of equitable factors that might warrant such subordination.

A. *Apples and Oranges: Misplaced Reliance on* Stirling Homex

On the eve of passage of the Bankruptcy Code, case law implicitly held, with one possible exception, that absent a finding of creditor misconduct, a creditor's claim could not be subordinated.[66] Courts that since have applied a no-fault theory of equitable subordination[67]

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[64] Id. at 120. The court did not specify the particular equities that would warrant equitable subordination of prepetition tax penalty claims outside of Chapter 7. Rather it merely directed bankruptcy courts "to explore the particular facts and circumstances presented in each case before determining whether subordination of a claim is warranted." Id.

[65] 579 F.2d 206 (2d Cir. 1978).

[66] See supra Part I.A.

[67] See supra Part I.C.

have relied on *Stirling Homex*[68]—decided by the Second Circuit three months before Congress passed the Bankruptcy Code—for the proposition that not all cases preceding codification of the doctrine of equitable subordination required a finding of creditor misconduct.[69]

But the reliance on *Stirling Homex* is misplaced. Although the decision was not based upon an explicit finding of inequitable conduct, "it did not abandon the concept that equitable subordination must be based on the conduct of the individual claimant."[70] The court recognized that the shareholders, by suing, were attempting to achieve parity with the general unsecured creditors and increase their share in the liquidation proceeding (from nothing to something). Arguably, the focus of the court was not on the general nature of the claim, but rather on the individual conduct of the claimants and their attempt to disguise an equity claim as a debt claim.[71] Accordingly, the decision marked only a slight departure from existing precedent: The court simply identified a subtle form of misconduct that would merit subordination.[72] This approach to *Stirling Homex* undermines the argument, made by some courts, that § 510(c), when read in conjunction with *Stirling Homex,* allows for equitable subordination absent inequitable conduct by a creditor.[73] On this reading of the case, all decisions prior to passage of the Bankruptcy Code required a finding of creditor misconduct before a claim could be equitably subordinated.

Even if this view is rejected, the case, at a minimum, stands as an "equitable" exception to the limiting principle that inequitable conduct must be shown for a bankruptcy court to subordinate a claim.

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[68] In the case, the court of appeals affirmed the district court's subordination of the claims of allegedly defrauded shareholders to the claims of general creditors, despite the absence of misconduct by the shareholders. See *Stirling Homex*, 579 F.2d at 208.

[69] See, e.g., In re Virtual Network Servs. Corp., 902 F.2d 1246, 1248-49 (7th Cir. 1990) (arguing that in light of *Stirling Homex*, IRS was incorrect to argue that prior to enactment of Bankruptcy Code equitable subordination required creditor misconduct); Burden v. United States (In re Burden), 917 F.2d 115, 117-19 (3d Cir. 1990) (agreeing with *Virtual Network*'s reasoning, including its analysis of *Stirling Homex*); Schultz Broadway Inn v. United States, 912 F.2d 230, 233 (8th Cir. 1990) (concluding that *Stirling Homex* evidences that Congress did not intend to prohibit equitable subordination in absence of inequitable conduct).

[70] *Burden*, 917 F.2d at 122 (Alito, J., concurring in part and dissenting in part). In its ruling in *Noland*, the Supreme Court relied on Judge Alito's position that principles of equity do not allow courts to alter the statutory ordering of categories of claims in bankruptcy. See United States v. Noland, 517 U.S. 535, 540-41 (1996) (quoting *Burden*, 917 F.2d at 122 (Alito, J., concurring in part and dissenting in part)).

[71] See *Burden*, 917 F.2d at 122 (Alito, J., concurring in part and dissenting in part) ("[I]ts decision was clearly based on the view that their conduct was designed to achieve an inequitable result that should not be permitted.").

[72] See id. (observing that *Stirling Homex* "[a]t most . . . represented an incremental change in the established doctrine").

[73] See supra note 69 and accompanying text; see also supra Part I.C.

Since the stockholders sued in an attempt to achieve parity with the general unsecured creditors, equitable subordination of their claim arguably was mandated because of the Bankruptcy Code's prioritization of debt over equity holders.[74]

In sum, when Congress codified the doctrine of equitable subordination in § 510(c), "existing case law" required proof of inequitable conduct. Moreover, by "leav[ing] to the courts development of this principle,"[75] Congress most likely envisioned subtle change rather than radical departure from the existing case law.[76] Accordingly, *Stirling Homex* does not support the proposition that creditor misconduct is not a necessary prerequisite for application of equitable subordination.[77] Any argument for a no-fault standard of equitable subordina-

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[74] See, e.g., 11 U.S.C. § 510(b) (1994). Section 510(b) requires a bankruptcy court to subordinate any claim for recission of a purchase or sale of a security of the debtor or an affiliate, or for damages arising from the purchase or sale of such a security, to all claims or interests that are senior to the claim or interest represented by the security. See id. Under this section, if the security is a debt instrument, the claim will be treated as a general unsecured claim. If the security is an equity security, the claim is subordinated to all creditors. See H.R. Rep. No. 95-595, at 359 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6315; S. Rep. No. 95-989, at 74 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5860.

[75] 124 Cong. Rec. 32,398 (1978) (statement of Rep. Edwards).

[76] See *Burden*, 917 F.2d at 123 (Alito, J., concurring in part and dissenting in part) ("This 'development,' however, while very likely meant to permit the kind of incremental change effected by *In re Stirling Homex*, cannot include a fundamental break from 'existing case law' . . . .").

[77] The subordination by bankruptcy courts of stock redemption claims under § 510(c) supports this view. These cases involve stockholder claims that arise after a corporation, having purchased its stock on credit, files for bankruptcy. Treating the redemption debt as an obligation to make a distribution on stock, many courts have subordinated the claims of former stockholders for the balance due under the redemption agreement to the claims of general unsecured creditors. See, e.g., Weisman v. Goss (In re Hawaii Corp.), 694 F.2d 179, 181 (9th Cir. 1982) (holding that investors' "claim on the assets of the issuing corporation was deemed to be that of a shareholder, subordinate to general unsecured creditors"); In re Main St. Brewing Co., 210 B.R. 662, 666 (Bankr. D. Mass. 1997) (holding that claim based on distribution on stock rights should be subordinated, since to "give [the claim] parity with other debt runs counter to the priority of debt over equity in bankruptcy"); Liebowitz v. Columbia Packing Co., 56 B.R. 222, 224 (Bankr. D. Mass. 1985) (observing that "[w]hen a stockholder sells his stock to a corporation and receives cash and a promissory note from the corporation in return, that stockholder does not thereby become a debt creditor who stands on equal footing with trade or general creditors should the corporation become bankrupt"). Courts justify subordination of such claims on the ground that giving redemption claims parity with the claims of general unsecured creditors would oppose the priority of creditors over stockholders in bankruptcy. See, e.g., Robinson v. Wangemann, 75 F.2d 756, 757 (5th Cir. 1935) ("The 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."). Subordination of redemption claims to general unsecured claims is distinguishable from subordination of tax penalty claims, and is therefore permissible, since subordination of redemption claims does not conflict with the Bankruptcy Code's priority scheme. See *Main St. Brewing Co*., 210 B.R. at 666 (arguing that reasoning in *Noland* "supports rather than undermines equitable subordination of claims for the purchase of equity interests").

tion of prepetition tax penalty claims, therefore, cannot rest on this case, but rather must be based on the provisions and legislative history of the Bankruptcy Code.

B. The Limiting Principle of Creditor Misconduct

1. Legislative History of Section 510(c)

When Congress passed the Bankruptcy Code, it codified the doctrine of equitable subordination in § 510(c), which reads in part:

> (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 . . . .[78]

Congress did not list specific criteria that would permit subordination of claims or interests, but rather chose the broad language "under principles of equitable subordination." The language used in the final version of the bill marked a change from the original bill. Under the first bill passed by the House of Representatives, the text of § 510(c) allowed subordination simply "on equitable grounds."[79] According to the report that accompanied that bill, such language would have allowed "subordination on *any* equitable grounds,"[80] and would have marked a departure from existing doctrine. The final legislation rejected this broad language and in its place substituted the phrase "under principles of equitable subordination."[81]

The absence of determinative factors in the statute delimiting those principles under which a claim can be subordinated obliges resort to the legislative history to clarify the meaning of the broad language used by Congress in § 510(c).[82] When considering the

[78] 11 U.S.C. § 510(c)(1).

[79] H.R. 8200, 95th Cong. § 510(b) (1977).

[80] H.R. Rep. No. 95-595, at 359 (1977) (emphasis added), reprinted in 1978 U.S.C.C.A.N. 5963, 6315.

[81] See 124 Cong. Rec. 32,416 (1978) (statement of Rep. Edwards); 124 Cong. Rec. 34,016 (1978) (statement of Sen. DeConcini).

[82] In general, the new textualist philosophy of legal interpretation would argue that a court should not make reference to legislative history in determining the meaning of a statute. See Antonin Scalia, Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in Interpreting the Constitution and Laws, in A Matter of Interpretation 3, 29-37 (1997) (arguing that judges virtually should abandon use of and reliance on legislative history of statute); see also Frank H. Easterbrook, Legal Interpretation and the Power of the Judiciary, 7 Harv. J.L. & Pub. Pol'y 87, 87-91 (1984) (viewing legislative intent as incoherent concept and arguing that it is not province of courts to decipher legislative intent when interpreting statutes). Under this approach, a court generally would subordinate a claim only upon a finding of creditor misconduct since case law

legislative history of § 510(c), it is important to keep in mind the special circumstances surrounding passage of the Bankruptcy Code. First, negotiation of the final version of the bill involved only a few members of Congress.[83] Second, because Congress did not hold a conference on the bill, the Senate and House floor managers met to reach compromises on the differences between the two bills.[84] Third, as a result of "eleventh-hour" hearings, congressional committees did not evaluate the final document.[85] Instead, members of Congress relied on Congressman Edwards and Senator DeConcini, the sponsors of the House and Senate bills, to inform them of the language ultimately enacted in § 510(c).[86] It is against this backdrop that the controversy surrounding no-fault equitable subordination has erupted.

2. Statutory Interpretation of 11 U.S.C. § 510(c)

In light of the extraordinary circumstances surrounding passage of the Bankruptcy Code,[87] the Supreme Court has afforded the statements of the floor managers considerable, but not limitless, weight.[88]

prior to enactment of the Bankruptcy Code required such a finding. Cf. Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 120 S. Ct. 1942, 1949 (2000) (Scalia, J.) (noting that Court's reliance in *Noland* on "prior practice to fill in the details of a pre-Code concept that the Code had adopted without elaboration" was appropriate in interpreting Code's reference to "principles of equitable subordination"). Accordingly, the "plain meaning" of "equitable subordination" would encompass only those circumstances where creditor misconduct was evident. The equitable exception to the limiting principle of creditor misconduct, however, would permit a court to subordinate an equity claim disguised as a debt claim. See supra Part II.A.

83 See Kenneth N. Klee, Legislative History of the New Bankruptcy Law, 28 DePaul L. Rev. 941, 941-57 (1979) (presenting legislative history of Bankruptcy Reform Act of 1978).

84 See 124 Cong. Rec. 32,392 (1978) (statement of Rep. Edwards) (reporting on his work with Senate managers to reconcile differences between House and Senate versions of bill); Klee, supra note 83, at 953-54 (describing process by which House and Senate bills were reconciled).

85 See Frank R. Kennedy, Foreword: A Brief History of the Bankruptcy Reform Act, 58 N.C. L. Rev. 667, 676 (1980) (noting that "conventional procedure of utilizing a conference committee" to resolve differences in two bills "was not followed").

86 Cf. Patricia M. Wald, Justice in the Ninety-Fifth Congress: An Overview, 64 A.B.A. J. 1854, 1855 (1978) (noting that changes to bill "were understood and discussed by only a small fraction of the legislators who passed the bill").

87 See supra text accompanying notes 83-86.

88 See Begier v. IRS, 496 U.S. 53, 64 n.5 (1990) ("Because of the absence of a conference and the key roles played by Representative Edwards and his counterpart floor manager Senator DeConcini, we have treated their floor statements on the Bankruptcy Reform Act of 1978 as persuasive evidence of congressional intent."); cf. 124 Cong. Rec. 32,391 (1978) (statement of Rep. Rousselot) (expressing view that remarks of floor manager of Bankruptcy Reform Act have "effect of being a conference report"). For the argument that statements by sponsors and committees reasonably might represent congressional consensus, so long as those statements are not opposed by other members of Congress, see James M. Landis, A Note on "Statutory Interpretation," 43 Harv. L. Rev. 886, 888-90 (1930). Critics of this deferential approach argue that such reliance is inappropriate since

The inquiry into what constitutes the "principles of equitable subordination" that Congress sought to codify in § 510(c) properly begins, therefore, with the floor statements of Congressman Edwards:

> 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.[89]

In determining the meaning of bankruptcy codifications, the Court has held 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."[90] Keeping in mind that equitable subordination is a judicially developed doctrine,[91] any statutory interpretation of § 510(c) necessarily involves balancing the restraint imposed by the above-mentioned rule of statutory construction against the idea that floor statements regarding passage of the Bankruptcy Code are given significant weight.[92]

The rejected language, "on equitable grounds," and its replacement with "under principles of equitable subordination,"[93] can be interpreted as Congress's desire to limit the application of equitable subordination to those circumstances in which it had been applied prior to the codification of the doctrine.[94] This reading comports with general principles of statutory construction; namely, the Court will not interpret a statute in accordance with statutory language that Con-

sponsors will have incentives to distort the legislative history through their statements. See William S. Moorhead, A Congressman Looks at the Planned Colloquy and Its Effect in the Interpretation of Statutes, 45 A.B.A. J. 1314, 1314 (1959) (describing "'friendly colloquy'" as process by which members of Congress, aware that courts will look to record of statements by sponsors of legislation, "may be able to legislate more effectively than all of Congress").

89 124 Cong. Rec. 32,398 (1978) (statement of Rep. Edwards). Senator DeConcini made an identical statement to the Senate. See 124 Cong. Rec. 33,998 (1978) (statement of Sen. DeConcini).

90 Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection, 474 U.S. 494, 501 (1986).

91 See supra note 34 and accompanying text.

92 See supra note 88 and accompanying text.

93 See supra text accompanying notes 79-81.

94 See Brief for the United States at 18, United States v. Noland, 517 U.S. 535 (1996) (No. 95-323) ("The history of Section 510(c) thus confirms that Congress consciously elected to adopt only the 'existing' principles of equitable subordination and rejected a broader equitable authority for the bankruptcy courts.").

gress has considered and rejected.[95] At the time the Bankruptcy Code was adopted in 1978, equitable subordination of a claim required proof of inequitable conduct by the claimant.[96] On this evidence alone, it seems that the intent of Congress was to allow equitable subordination only in cases involving creditor misconduct.

Uncertainty is introduced, however, by the attempt on the floor to describe the state of the law and application of the doctrine prior to the passage of the Bankruptcy Code. Recall that Congressman Edwards stated: "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*."[97] Courts that have applied a no-fault standard of equitable subordination have construed this statement as an expression of congressional intent to permit subordination of prepetition tax penalty claims under § 510(c), not because of creditor misconduct, but rather because of the nature of the claim.[98]

Arguably, the floor statements misdescribe the doctrine of equitable subordination as it existed at the time the Bankruptcy Code was enacted.[99] The IRS argued this position in *Noland* and further contended that the Senate Report on § 510(c) supported its view.[100] According to the Senate Report, a tax claim rarely would be subordinated under the doctrine.[101] It follows that a tax penalty claim

95 See William N. Eskridge, Jr. & Philip P. Frickey, Legislation: Statutes and the Creation of Public Policy 814 (2d ed. 1995) (explaining "Rejected Proposal Rule" of statutory interpretation); see also, e.g., Runyon v. McCrary, 427 U.S. 160, 174-75 (1976) (reaffirming Supreme Court interpretation of Civil Rights Act of 1866 in light of congressional consideration and rejection of amendment that would have reversed that interpretation).

96 See supra Part I.A; see also S. Rep. No. 95-989, at 74 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5860 ("[S]ubordination ordered under this provision must be based on principles of equitable subordination. These principles are defined by case law, and have generally indicated that a claim may normally be subordinated only if its holder is guilty of misconduct.").

97 124 Cong. Rec. 32,392, 32,398 (1978) (statement of Rep. Edwards) (emphasis added); see also 124 Cong. Rec. 33,998 (1978) (statement of Sen. DeConcini).

98 See Burden v. United States (In re Burden), 917 F.2d 115, 120 (3d Cir. 1990) ("[W]e conclude that § 510(c) permits equitable subordination of nonpecuniary loss tax penalties."); Schultz Broadway Inn v. United States, 912 F.2d 230, 232 (8th Cir. 1990) ("Congress intended section 510(c)(1) to encompass penalty claims."); In re Virtual Network Servs. Corp., 902 F.2d 1246, 1249-50 (7th Cir. 1990) ("After considering the congressional statements and legislative history and scheme, . . . [i]t is clear that in principle, equitable subordination no longer requires, in all circumstances, some inequitable conduct on the part of the creditor.").

99 See, e.g., Oral Argument at 9, United States v. Noland, 517 U.S. 535 (1996) (No. 95-323) (statement by petitioner) ("[W]hat the history manifests is an intent to incorporate existing case law and then a misdescription of one aspect of that case law.").

100 See id. ("The intent to incorporate existing case law is manifest in the Senate report which doesn't contain the misdescription of the existing case law.").

101 The Senate Report on § 510(c) states:

cannot be "of a status susceptible to subordination." The sponsors of the bill, therefore, mistakenly described the state of the law in their floor statements.

On the other hand, the notion that "Congress is not in the business of figuring out what case law says . . . [but rather] of figuring out what disposition should be made,"[102] supports the view that floor statements on the Bankruptcy Code should be treated as per se indicative of congressional intent. Furthermore, because the floor statements regarding the existing case law appear verbatim in both the House and the Senate debates, the statements have been granted the respect ordinarily reserved for a committee report.[103]

As a result of the contradiction between the Senate Report on § 510(c) and the identical floor statements regarding the existing case law on equitable subordination, a tension emerges between Congress's intent with respect to application of equitable subordination and its understanding of what constituted "principles of equitable subordination" at the time the doctrine was codified. This inconsistency must be resolved.[104]

One court has justified no-fault subordination of tax penalty claims on the ground that the Senate version of § 510(c), specifically exempting tax claims from equitable subordination, was ultimately rejected by Congress.[105] This reasoning is consistent with the "rejected proposal rule" of statutory construction.[106] Arguably, however, the House sought to conform to the Senate Report's view on subordination of tax claims when Congressman Edwards stated: "Since the House amendment authorizes subordination of claims only under principles of equitable subordination, and thus incorporates principles

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> As originally introduced, the bill provided specifically that a tax claim may not be subordinated on equitable grounds. The bill deletes this express exception, but the effect under the amendment should be much the same in most situations since, under the judicial doctrine of equitable subordination, a tax claim would *rarely* be subordinated.

S. Rep. No. 95-989, at 74 (emphasis added), reprinted in 1978 U.S.C.C.A.N. 5787, 5860.

102 Oral Argument at 9, *Noland* (No. 95-323) (statement by unidentified Justice). This statement is not wholly accurate since Congress sometimes seeks to override precedent through legislation.

103 See Oral Argument at 8, *Noland* (No. 95-323) (statement by unidentified Justice) (analogizing Bankruptcy Code floor statements to committee reports).

104 See id. at 6 (statement by unidentified Justice) ("[I]t may be that the person who made the statement about the intent was wrong in describing what courts had been doing, but the intent still seems to be there, and what is the tie-breaker?").

105 See Schultz Broadway Inn v. United States, 912 F.2d 230, 232 (8th Cir. 1990) ("We thus deem it significant that Congress ultimately rejected a Senate version of section 510(c)(1) that would have expressly exempted governmental tax claims from equitable subordination.").

106 See supra note 95 and accompanying text.

of existing case law, a tax claim would rarely be subordinated under this provision of the bill."[107] This can mean only that a tax claim rarely would be subordinated under principles of equitable subordination because the IRS rarely would be guilty of creditor misconduct, a requirement under then-existing principles of case law.[108] Thus, the Senate provision was merely redundant and not rejected on substantive grounds.

C. Bankruptcy Code Treatment of Tax Penalty Claims

Prior to the 1978 Bankruptcy Code, under § 57(j) of the Bankruptcy Act of 1898, prepetition tax penalty claims were disallowed in bankruptcy cases.[109] Courts allowing a no-fault standard of equitable subordination have relied on this provision to argue that there could not have been any existing case law regarding the subordination of prepetition tax penalty claims to incorporate into § 510(c).[110] Moreo-

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107 124 Cong. Rec. 32,416 (1978) (statement of Rep. Edwards).

108 At oral argument in *Noland*, when asked by the Court if, in theory, the government could acquire a claim through misconduct, the government responded: "[I]t would be rare . . . and the Senate report on this bill made that very point, but certainly, if the United States acquired a claim through misconduct, it would be subject to equitable subordination." Oral Argument at 6, *Noland* (No. 95-323) (statement by petitioner). The following colloquy that ensued between the Court and counsel for the IRS illustrates a situation where subordination of the IRS's claim would be warranted:

> [THE COURT]: Well, what about a case in which some factotum of the Government said the payment, let's say to an ERISA plan or whatever it may be, is due in January, and in fact it was due in December and the Government is not estopped?
>
> I suppose you could say that's not a case of malicious wrongdoing, but it would be a case in which the taxpayer relied detrimentally on the Government and then ends up with perhaps a nonwaivable penalty. That would be a case, I suppose, in which there could be subordination.
>
> [COUNSEL]: . . . I will agree with you that if there was a situation where an authorized representative of the United States had taken some action that was unfair to other creditors in achieving a preference for a Government claim that wouldn't otherwise have been factually appropriate, that would be the kind of context in which equitable subordination might apply.

Id. at 10-11.

109 See supra note 49.

110 See Burden v. United States (In re Burden), 917 F.2d 115, 117 (3d Cir. 1990) ("Prior to the enactment of the Bankruptcy Act of 1978, subordination of tax penalty claims did not occur because noncompensatory penalty claims owed to the government were specifically disallowed."); *Schultz Broadway Inn*, 912 F.2d at 232 ("Under the earlier 1898 Act, courts ordinarily had no need to address the applicability of equitable subordination principles to governmental penalty claims because section 57(j) of the 1898 Act prohibited the government from collecting non-pecuniary loss penalties."); In re Virtual Network Servs. Corp., 902 F.2d 1246, 1248 (7th Cir. 1990) ("[E]quitable subordination of tax penalty claims did not occur prior to passage of the [Bankruptcy Code] because under the then-existing law, the Bankruptcy Act of 1898, noncompensatory penalty claims owed to the Government were specifically disallowed." (citations omitted)).

ver, when Congress enacted the Bankruptcy Code, it provided for automatic subordination of prepetition, nonpecuniary loss penalty claims in Chapter 7.[111] Courts applying a no-fault standard of equitable subordination have relied on the policies underlying pre-Code and Chapter 7 treatment of such claims to justify their equitable subordination in cases under other chapters of the Bankruptcy Code.

Although the Bankruptcy Code does not contain a provision similar to § 57(j)'s disallowance of prepetition, nonpecuniary loss penalty claims, § 726(a)(4) automatically subordinates these claims in Chapter 7.[112] In addition, § 724(a) allows a trustee to avoid a lien that secures a penalty claim to the extent that the claim is for nonpecuniary loss.[113] By allowing payment of those claims only if sufficient assets remain after paying secured and general unsecured claims, these two sections of the Bankruptcy Code continue Congress's long-standing policy of protecting unsecured creditors from debtor misconduct.[114]

Nevertheless, how should one interpret the fact that Congress did not provide for automatic subordination of prepetition tax penalty claims outside of Chapter 7? The concept of legislative inaction suggests that omission by Congress is as significant as action taken by it:

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[111] See 11 U.S.C. § 726(a)(4) (1994); see also infra notes 112-14 and accompanying text. Congress, however, did not enact similar provisions in other chapters of the Bankruptcy Code.

[112] See 11 U.S.C. § 726(a)(4).

[113] See id. § 724(a).

[114] The portion of the Senate Report pertaining to § 724(a) explains: "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 protection afforded." S. Rep. No. 95-989, at 96 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5882.

The policy of paying prepetition tax penalty claims only after general unsecured claims are paid is consistent with the notion that, in a Chapter 7 liquidation, the purpose of the penalty—namely to deter and punish, see *Virtual Network*, 902 F.2d at 1250 (stating that purpose behind tax penalties is "to punish those who fail to abide by the taxing structure, and to deter those who might be inclined to avoid tax payment")—loses its force, since the penalty claim would be paid not by the delinquent debtor, but rather by its creditors. Because the estate of the debtor ceases to exist, the penalty no longer serves its punitive purpose. Also, any deterrent effect that the penalty claim may exercise is not compelling enough to overcome the unfairness that would result from paying that claim before general unsecured claims.

If Congress had granted prepetition penalty claims a higher priority than general unsecured claims in Chapter 7, the result would be to diminish the assets available for distribution at the expense of those creditors who had invested value in the debtor's estate. See United States Dep't of Interior v. Elliot (In re Elkins Energy Corp.), 761 F.2d 168, 171 (4th Cir. 1985) ("Penalties incurred by the debtor before the filing of the bankruptcy petition should not reduce the distribution to which the creditors are entitled, because the creditors could not prevent the accrual of the penalties."). It should be noted that Congress distinguished prepetition, nonpecuniary loss tax penalty claims from prepetition, *pecuniary* loss tax penalty claims and specifically assigned eighth priority to tax penalties for actual pecuniary loss. See 11 U.S.C. § 507(a)(8)(G).

Inaction represents congressional reaffirmation of an existing policy.[115] A court, therefore, should give effect to an existing policy of Congress unless an act or its legislative history reveals congressional intent to change the policy.[116]

With the enactment of the Bankruptcy Code, Congress explicitly changed its pre-Code policy toward prepetition, nonpecuniary loss penalty claims, including tax penalty claims: Whereas Congress had formerly chosen to disallow such claims, it decided that the claims generally were to be allowed and not subordinated.[117] By not including a similar provision to § 724(a)(4) in other chapters of the Bankruptcy Code, Congress did not afford unsecured creditors outside of Chapter 7 the same protection from debtor misconduct as it did for unsecured creditors in Chapter 7. Through its choice, Congress made clear that prepetition tax penalty claims were not to be categorically subordinated outside of Chapter 7.[118]

Because Congress did not provide for subordination of prepetition tax penalty claims outside of Chapter 7, one can understand the driving force behind the adoption of no-fault equitable subordination. The dilemma faced by a bankruptcy court is this: It can either (a) allow the penalty claim to share in *pari passu* with the claims of general unsecured creditors, pursuant to the statutory provisions of the Bankruptcy Code, and thereby unjustly punish innocent creditors; or (b) equitably subordinate the claim under a no-fault standard and thereby create a fair result. Courts that have applied a no-fault standard of equitable subordination have concluded that it would be unjust to consider claims for prepetition tax penalty claims on par status with other general unsecured creditors' claims. Absent subordination of the IRS's claims, innocent creditors would be punished for the misconduct of the debtor.[119] Given the policies underlying automatic

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115 See Eskridge & Frickey, supra note 95, at 813.

116 See id. ("When no one in the legislative discussions says that an important policy is being changed, a court should presume that no big changes are intended.").

117 Under 11 U.S.C. § 502, prepetition, nonpecuniary loss penalty claims are allowed.

118 Perhaps Congress envisioned that the classification and voting requirements for confirmation of a plan under either chapter would act as a self-regulating mechanism that would provide unsecured creditors the means to insulate themselves from a debtor's prepetition delinquent behavior. For the argument that prepetition tax penalty claims should be classified below general unsecured claims and receive payment accordingly, see supra note 14.

119 See Schultz Broadway Inn v. United States, 912 F.2d 230, 234 (8th Cir. 1990) ("[T]he general unsecured creditors who suffered actual losses should receive preference over the Government's claim for a non-pecuniary loss tax penalty in this liquidating chapter 11."); In re Manchester Lakes Assocs., 117 B.R. 221, 225 (Bankr. E.D. Va. 1990) ("[T]he general unsecured creditors should not be penalized for [nonpecuniary] losses in view of the fact that tax penalties are to punish late-paying debtors, not the creditors.").

subordination of these claims in Chapter 7,[120] as well as the idea that there is no way for creditors to account for the debtor's prepetition behavior, as opposed to its postpetition behavior, the urge of a bankruptcy court to subordinate these claims is understandable.[121]

At the same time, automatic subordination of these prepetition tax penalty claims outside of Chapter 7 would exceed the judicial scope of a bankruptcy court and could be achieved only by congressional amendment to the Bankruptcy Code.[122] Nonetheless, courts have suggested that no-fault equitable subordination of these claims is permissible so long as a court balances the equities on a case-by-case

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120 The policies underlying subordination in Chapter 7 are detailed supra note 114.

121 The arguments for no-fault subordination of postpetition, nonpecuniary loss tax penalty claims, on the other hand, are not compelling. The concept of a bankruptcy case as a "continuum of court administration" supports the position in favor of creditors' liability for tax penalty claims, regardless of whether the trustee or the debtor in possession incurs the penalty. See Nicholas v. United States, 384 U.S. 678, 696 (1966) (Harlan, J., concurring in part and dissenting in part) (stating that period beginning with Chapter 11 and carrying through liquidation under Chapter 7 is "a continuum of court administration . . . and that the court-appointed trustee does fall heir to the responsibilities of the court-supervised debtor in possession to file [tax] returns"). Both the trustee and the debtor in possession, as officers and agents of the court, must file tax returns and pay taxes arising from operation of the debtor's business activities. See 28 U.S.C. § 960 (1994). This obligation applies to all federal, state, and local taxes. See id. Moreover, a Chapter 11 trustee must file income tax returns and pay taxes on the income attributable to the property of the debtor even if the plan does not so require. See Holywell Corp. v. Smith, 503 U.S. 47, 52 (1992) (concluding that "the trustee must pay the tax due on the income attributable to the corporate debtors' property . . . [and] the United States did not excuse the trustee from these duties by failing to object to the plan"). The trustee also owes the estate and its creditors a general duty of loyalty. See Mosser v. Darrow, 341 U.S. 267, 271 (1951) ("Equity tolerates in bankruptcy trustees no interest adverse to the trust."). This fiduciary obligation applies equally to the debtor in possession since § 1107 not only gives him the rights and powers of a Chapter 11 trustee, but also imposes the obligations of a trustee. See 11 U.S.C. § 1107(a). Any argument that the enforcement of postpetition, nonpecuniary loss tax penalty claims as first priority punishes "innocent creditors" necessarily fails, given that the close connection between the creditors' committee and the trustee or debtor in possession results in the loss of their "innocent" status. For the argument that the enforcement of postpetition, nonpecuniary loss tax penalty claims as first priority punishes "innocent creditors," see United States v. Noland (In re First Truck Lines, Inc.), 48 F.3d 210, 218 (6th Cir. 1995) (stating that

> [A]ssessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. . . . To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around.),

rev'd, 517 U.S. 535 (1996).

122 See Burden v. United States (In re Burden), 917 F.2d 115, 119 (3d Cir. 1990) ("[W]e also believe that Congress did not intend such a radical alteration in the equitable subordination doctrine as to permit automatic subordination simply because the claim is for nonpecuniary loss tax penalties. Such a major revision in the bankruptcy law would certainly warrant explicit direction from Congress.").

basis.[123] Under a no-fault standard, however, any case-by-case weighing of the equities will result in categorical subordination of such claims. With regard to nonpecuniary loss tax penalty claims (or any other nonpecuniary loss penalty claim for that matter), equitable considerations such as fairness to creditors and the punitive character of the claim turn on the general nature of the claim. Thus, any weighing of the equities becomes irrelevant as those considerations are static and result in the same outcome in each case. The inevitable result is categorical equitable subordination of those claims. Therefore, when a bankruptcy court applies a no-fault standard of equitable subordination to tax penalty claims, even on a "case-by-case" basis, it violates the holdings in *Noland* and *Reorganized CF&I Fabricators*.

D. The Excess of No-Fault Subordination

The Supreme Court in *Noland* should have held expressly that equitable subordination of tax penalty claims is permissible only if the IRS engages in some type of inequitable conduct.[124] Likewise, in *Reorganized CF&I Fabricators*, the Court should have extended its ruling beyond affirming the prohibition against categorical subordination established in *Noland*.[125] To preserve the statutory priorities set forth in the Bankruptcy Code, the Court should have held that use of a no-fault standard to subordinate a tax penalty claim inevitably will result

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123 See supra text accompanying notes 60, 62, 64. For example, the court of appeals in *Virtual Network* concluded that "the district court accurately addressed the equities of th[e] case." In re Virtual Network Servs. Corp., 902 F.2d 1246, 1250 (7th Cir. 1990). The district court concluded that the equities of the case favored applying subordination because

> 1) the goal of equitable subordination focuses not on the conduct of the creditor but on fairness to creditors in a particular case, 2) punishing or deterring [the debtor's] innocent creditors because of [the debtor's] wrongful conduct serves no purpose, and 3) the IRS's claims in this case are punitive in nature.

Id.

124 The Court did recognize that despite the Sixth Circuit's mandate to balance the equities in each individual case, focusing on the inequitable result would end in automatic subordination. See United States v. Noland, 517 U.S. 535, 541 (1996) (stating:

> And although the court said that not every tax penalty would be equitably subordinated, . . .that would be the inevitable result of consistent applications of the rule employed here, which depends not on individual equities but on the supposedly general unfairness of satisfying 'postpetition, nonpecuniary loss tax penalty claims' before the claims of a general creditor.

(citations omitted)). Although *Noland* involved postpetition, nonpecuniary loss tax penalty claims, the Court's reasoning applies equally in the case of prepetition tax penalties, because the nature of those claims, generally speaking, is also unfair. See supra Part II.C.

125 See United States v. Reorganized CF&I Fabricators of Utah, 518 U.S. 213, 229 (1996) (stating that automatic subordination of IRS's prepetition tax penalties constitutes "categorical reordering of priorities . . . beyond the scope of judicial authority to order equitable subordination under § 510(c)").

in categorical subordination of that claim. Consequently, subordination of prepetition tax penalty claims outside of Chapter 7 requires a finding of creditor misconduct.[126] Lastly, the Court should have clarified that any unfairness resulting from the priority scheme established by Congress in the Bankruptcy Code would have to be remedied through statutory amendment. Such a decision would have eliminated unequivocally the debate over whether creditor misconduct is a limiting principle on the doctrine of equitable subordination.

Congress specifically did not provide for automatic subordination of prepetition tax penalty claims outside of Chapter 7.[127] If creditor misconduct is not the basis for subordination, then the inevitable result of balancing the equities under a no-fault standard will be automatic subordination of those claims.[128] This logic dictates that equitable subordination of prepetition tax penalty claims outside of Chapter 7 requires a finding of creditor misconduct. Absent inequitable conduct by the IRS, its prepetition tax penalty claims should be allowed to share in *pari passu* with other general unsecured creditors' claims.[129]

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[126] Similarly, the Court in *Noland* could have held that in a converted Chapter 7 case, any nonpecuniary loss tax penalty claim that accrues after the debtor seeks relief under Chapter 11, but before the case is converted to Chapter 7, should never be subordinated absent creditor misconduct, but rather continue to receive the first priority it is entitled to under § 507(a)(1). Any argument that such claims should be viewed as prepetition claims since the conversion from Chapter 11 to Chapter 7 is "tantamount to the filing of a new petition," Respondent's Brief at 16 n.7, United States v. Noland, 517 U.S. 535 (1996) (No. 95-323), is incorrect. While § 348(d) provides that a claim arising after the original order for relief, but before conversion, is treated as a prepetition claim, that section exempts expenses of administration from such treatment. See 11 U.S.C. § 348(d). Nonpecuniary loss tax penalty claims that arise before conversion to Chapter 7 should not be treated like prepetition penalties. As the Court in *Noland* recognized, this kind of revision of the priorities set forth in the Bankruptcy Code would require statutory amendment by Congress. See *Noland*, 517 U.S. at 541 n.3. If such claims were automatically subordinated under a no-fault standard, it would create a disincentive for the debtor in possession or the trustee to file tax returns, giving the debtor business economic advantage over its nondebtor competitors. See supra note 54 and accompanying text.

[127] See *Burden*, 917 F.2d at 119 ("Since the legislation is silent on this issue, we must reject the contention that bankruptcy courts may automatically impose a harsh result without consideration of the equities of the claims."); supra notes 115-18 and accompanying text.

[128] See *Burden*, 917 F.2d at 123 (Alito, J., concurring in part and dissenting in part) ("Congress did not want penalties to be subordinated on a wholesale basis in proceedings under Chapters 9, 11, and 13. Yet [no-fault equitable subordination] seems very likely to bring about precisely that result.").

[129] Arguably, *Virtual Network* was decided correctly on the basis of creditor misconduct given that the district court concluded that the IRS "had waited too long to collect its debt, therefore, making it unfair for the court to shift the burden of the debt to other innocent creditors." In re Virtual Network Servs. Corp., 902 F.2d 1246, 1250 (7th Cir. 1990). There is, however, no force behind this argument. Any delay in collecting its debt would not improve the IRS's priority position. Because this behavior does not constitute misconduct,

Conclusion

Any unfairness that results from equal treatment of prepetition tax penalty claims with general unsecured claims should be dealt with through statutory revision of the Bankruptcy Code by Congress. Judicial creation of a subclass of claims, which inevitably results from no-fault equitable subordination, exceeds a bankruptcy court's powers. Moreover, the sole manner by which a bankruptcy court can provide creditors with certainty in its application of equitable subordination lies in adherence to the limiting principle of creditor misconduct. A rule requiring inequitable conduct would clarify much of the ambiguity surrounding the doctrine of equitable subordination, yet still provide bankruptcy courts with the flexibility to define the types of misconduct that justify equitable subordination of claims.[130] In the end, bankruptcy courts should not use equitable subordination as a panacea for the unfairness that results from the distribution scheme established by the Bankruptcy Code. Rather, they must apply the doctrine with tempered discretion, lest they exceed the scope of their equitable powers.

the IRS's claim should not have been subordinated. For an example of behavior that would constitute misconduct by the IRS, see supra note 108.

130 See Christou, supra note 17, at 246.