UNITED STATES DISTRICT COURT

DISTRICT OF RHODE ISLAND

MAX SUGARMAN FUNERAL HOME, INC.,
E.M.B. ASSOCIATES, INC. AND
JASON MONZACK, TRUSTEE

v. C.A. No. 93-203

A.D.B. INVESTORS

MEMORANDUM AND ORDER

ERNEST C. TORRES, United States District Judge

This is yet another episode in the convoluted and seemingly interminable litigation regarding whether the claims of A.D.B. Investors against the bankrupt estates of E.M.B. Associates, Inc., and Max Sugarman Funeral Home, Inc., should be subordinated to the claims of debenture holders. The case is presently before the Court for consideration of A.D.B.'s appeal from the Bankruptcy Court's decision that A.D.B.'s claims should be subordinated. I find that the appeal should be denied and the Bankruptcy Court's decision should be affirmed.

Background

It is not necessary to recite all of the facts underlying this dispute. They are recounted in excruciating detail in the prior reported decisions of the Bankruptcy Court, the District Court and

the Court of Appeals. See In re Max Sugarman Funeral Home, Inc., 149 Bankr. 274, 278 (Bankr. R.I. 1992); Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248 (1st Cir. 1991). For present purposes, it is sufficient to note that the sole issue presented is whether the Bankruptcy Court erred in determining that, pursuant to 11 U.S.C. § 510(c), A.D.B.'s secured claim should be subordinated to the claims of persons purchasing debentures of the bankrupt corporations.

Standard of Review

In reviewing a bankruptcy court's decision, a district court must accept the bankruptcy judge's findings of fact unless they are clearly erroneous. Fed. Bankr. R. 8013; Fed. R. Civ. P. 52(a); In re Bible Speaks, 869 F.2d 628, 629 (1st Cir.), cert. denied, 493 U.S. 816 (1989); Briden v. Foley, 776 F.2d 379, 381 (1st Cir. 1985). A bankruptcy court's conclusions of law, on the other hand, are subject to de novo review. In re G.S.F. Corp., 938 F.2d 1467, 1474 (1st Cir. 1991). A finding of fact is clearly erroneous "when, after reviewing the evidence, the appeals court is left with a definite and firm conviction that a mistake has been committed." In re G.S.F. Corp., 938 F.2d 1467, 1474 (1st Cir. 1991).

Discussion

I. Equitable Subordination

A bankruptcy court's authority to subordinate one claim to another derives from § 510(c) of the Bankruptcy Act, which states:

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

Congress did not elaborate on the circumstances under which equitable subordination applies. Instead, it left that task to the courts, intending that they would apply principles established by existing case law. 124 Cong. Rec. H 11095, H 11113 (Sept. 28, 1978).

In order to invoke equitable subordination, three requirements must be satisfied:

> 1. The claimant must have engaged in some type of inequitable conduct;
> 2. The misconduct must have resulted in injury to creditors or conferred an unfair advantage on the claimant;
> 3. Equitable subordination of the claims must not be inconsistent with the provisions of the Bankruptcy Code.

In re Giorgio, 862 F.2d 933, 938-39 (1st Cir. 1988).

The situations in which equitable subordination most commonly applies are those in which:

1. A creditor having a fiduciary relationship with the debtor misuses his position to the disadvantage of other creditors; or

2. A third party creditor (i.e., one not having a fiduciary

relationship with the debtor) dominates or controls the debtor in a way that places other creditors at a disadvantage; or

3. A third party creditor defrauds other creditors.

See, In re 604 Columbus Ave. Realty Trust, 968 F.2d 1332, 1359-60 (1st Cir. 1992).

A.D.B. argues that equitable subordination requires proof of reliance by the other creditors and that the Bankruptcy Judge erred both in finding reliance by debenture holders on A.D.B.'s actions and in refusing to permit A.D.B. to reopen its case for the purpose of presenting evidence of non-reliance. Unfortunately for A.D.B., its argument rests on a flawed premise. It is true that fraud is one of the most common reasons for invoking equitable subordination and that establishing fraud generally requires proof of reliance. However, neither fraud nor reliance is a sina qua non for the application of equitable subordination. Id. at 1361. As already noted, equitable subordination is applicable when the claimant has engaged in inequitable conduct that resulted in injury to other creditors or conferred an unfair advantage on the claimant. The relevant inquiry is whether there has been a showing of special inequity vis a vis other creditors. Giorgio, 862 F.2d at 938-39; see also, Heiser v. Woodruff, 327 U.S. 726 (1946) (describing purpose of court's equitable subordination power "to prevent consummation of a course of conduct by the claimant which, as to the other creditors, would be fraudulent or otherwise inequitable")

(emphasis added). It is not necessary to show that the claimant's conduct caused quantifiable harm to a particular creditor. Columbus Ave, 968 F.2d at 1363. "If the misconduct results in harm to the entire creditor body, the objecting party need demonstrate only that the misconduct harmed the creditor body in some general, albeit concrete, manner." Id. (quoting DeNatale & Abram, "The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors," 40 Bus. Law. 417, 426 (1985)).

The nature of the claimant's relationship to the debtor is an important factor in determining whether a special inequity has been established. When the claimant has a fiduciary responsibility to the debtor or exercises control over the debtor, the claimant is held to a more stringent standard of conduct. Id. at 1360. Thus, a claimant's duty to deal fairly with a debtor is directly proportional to the degree of power and control the claimant exercises over the debtor's affairs. DeNatale & Abram at 424 (cited in Columbus Ave., 968 F.2d at 1360). Accordingly, "[c]laims arising from dealings between a debtor and an 'insider' are rigorously scrutinized by the courts." Columbus Ave., 968 F.2d at 1360; see also, In re Missionary Baptist Foundation, Inc., 712 F.2d 206, 210 (5th Cir. 1984); In re Acme-Dunham, Inc., 50 Bankr. 734, 739 (D.Me. 1985).

In order to apply equitable subordination to the claims of an "insider," the trustee must present material evidence of unfair

conduct. In re N & D Properties, 799 F.2d 726, 731 (11th Cir. 1986). On the other hand, if the claimant is not an insider, "evidence of more egregious conduct, such as fraud, spoliation or overreaching is necessary." Columbus Ave. 968 F.2d at 1360 (quoting In re Fabricators, 926 F.2d 1458, 1465 (5th Cir. 1991).

II. The Bankruptcy Judge's Findings

A.D.B. argues that the Bankruptcy Court's decision is erroneous because there was no evidence from which it could have found that Brier had a fiduciary duty to debenture holders, that he breached any such duty or that his conduct was so egregious as to warrant equitable subordination in the absence of such a breach. That argument misses the mark for several reasons.

In his decision, the Bankruptcy Judge does make a passing reference to what he described as a fiduciary duty Brier owed to those who purchased debentures in what Brier knew was a failed enterprise. In re Max Sugarman Funeral Home, Inc., 149 Bankr. at 280. However, that reference was made in the context of a determination "that Brier (A.D.B.) was an insider of the Debtor based upon the degree of control he held and exercised over the financial activity of the funeral home." In re Max Sugarman Funeral Home, Inc., 149 Bankr. at 280.

The principal indicia of insider status relied upon by the Bankruptcy Court were Brier's unique access to important information regarding the debtor's financial condition and the

control A.D.B. exerted over the debtor's actions. Thus, the Bankruptcy Judge found that Brier had knowledge regarding the terms of the debtors' loan obligations and their inability to pay those obligations and that such information was not available to debenture holders. The Bankruptcy Judge also found that A.D.B. caused the debtors to enter into two transactions designed solely to benefit A.D.B. The first was the "1980 refinancing" which was designed to provide A.D.B. with security for an antecedent loan to the debtors and was prompted by the discovery that the security interest previously received in connection with that loan was unperfected. The other transaction was represented by the "1981 and 1982 transfers" pursuant to which property was transferred to A.D.B. through a "straw" for what the First Circuit said was "no legitimate . . . purpose." Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d at 1255. Those findings are amply supported by the record.

The Bankruptcy Court's determination that A.D.B.'s conduct was inequitable, injured other creditors, and conferred an unfair advantage on Brier (A.D.B.) also is well supported. It is based on findings that:

1. As the accountant for S.F.H. and E.M.B., Brier prepared misleading financial statements and false federal income tax returns in an effort to conceal the financial difficulties of the two companies so that they could increase debenture sales.

2. The "1980 refinancing" and the "1981 and 1982 transfers" were designed to place the debtors' property beyond the reach of debenture holders.

3. Sixty percent of debenture sales occurred after the 1980 refinancing, and the money invested enabled the debtors to continue paying commissions to Brier and interest to A.D.B. pursuant to the 1973 loan agreement.

None of these findings is clearly erroneous. In fact, they have been described by the First Circuit as "supported by the evidence." Id. at 1250.

In its brief, A.D.B. expresses concern that the Bankruptcy Court's order could be interpreted to subordinate A.D.B.'s claim to the claims of pre-1978 debenture holders. Specifically, it cites that portion of the order stating that A.D.B.'s claim "is subordinated to the claims of unsecured creditors, including the holders of debentures issued between 1978 and 1982." In re Max Sugarman Funeral Home, Inc., 149 Bankr. at 281 (emphasis added). A.D.B. contends that including pre-1978 debenture holders in the category of "unsecured creditors" would be inconsistent with the Bankruptcy Court's May 1989 ruling that A.D.B.'s claim should be subordinated to the claims of "post-1977 debenture holders," (describing prior ruling) (emphasis added), and that such an interpretation would be inconsistent with the evidence which fails to demonstrate that Brier (A.D.B.) engaged in

any misconduct prior to 1978.

There are two flaws in that argument. First, the bankruptcy court is not limited by any previous ruling it may have made on the subject. The Court of Appeals remanded the case to the bankruptcy court for the purpose of determining "whether any allowed claim of A.D.B. should be subordinated to any other allowed claim, under the principles of equitable subordination." Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d at 1257.

In addition, A.D.B.'s inequitable conduct consisted principally of utilizing its control over the debtors to obtain security for an antecedent debt at a time when A.D.B. knew that the debtors had become insolvent. The effect was to unfairly place A.D.B. in a favored position vis a vis all debenture holders. The adverse effect on those who purchased debentures before 1977 is not diminished by the fact that the conduct enabling A.D.B. to obtain preferential treatment occurred after 1977.

Conclusion

For all of the foregoing reasons, A.D.B.'s appeal is denied and the decision of the Bankruptcy Court is affirmed.

IT IS SO ORDERED,

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Ernest C. Torres
United States District Judge

Date: May , 1995