

UNITED STATES BANKRUPTCY COURT
For the Southern District of Iowa

In the Matter Of

LOREN E. KOBER,
d/b/a KOBER ELECTRIC,

Case No. 86-1763-DH
Chapter 7

Debtor.

**ORDER - MOTION TO
SUBORDINATE SECURITY INTEREST and CLAIMS**

On March 15, 1988, a hearing was held on Debtor's motion for subordination of security interest and claims. John T. Nolan appeared on behalf of Debtor; Michael W. Kennedy appeared on behalf of creditor City Electric Supply, Inc. (hereinafter "City Electric"); and Thomas H. Gelman appeared on behalf of creditor Iowa State Bank and Trust Company (hereinafter "Bank").

This is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(B). The Court having heard the arguments of counsel and having reviewed the record, now enters its findings and conclusions pursuant to F.R. Bankr. P. 7052.

FINDINGS OF FACT

1. On June 17, 1986, Debtor filed a voluntary Chapter 11 petition.

2. Upon a creditor's motion to convert the Chapter 11 petition to a case under Chapter 7, said motion was set for hearing and notice given to Debtor and his attorney. Neither Debtor nor his attorney appeared for the hearing and no objections were filed.

3. This case was converted to a Chapter 7 proceeding by Order of Court filed November 12, 1987.

4. In November of 1985, Bank loaned money to Debtor as an advance for purchase of materials for construction by Debtor on property owned by the Grain Processing Company (hereinafter "GPC"). Debtor executed a note for the loan, and the note was single pay due in 28 days. Debtor also executed a security agreement granting Bank a lien on Debtor's accounts receivable and the contract rights in the GPC job project. Bank then perfected the security agreement.

5. Said note was not paid when it came due and Bank talked with Debtor almost daily about the progress on the job site. Debtor advised Bank that money was going to be deposited into his account. Debtor made sufficient deposit in December of 1985, and Bank debited the account and paid off the notes.

6. Upon the commencement of his Chapter 11 bankruptcy proceeding in June of 1986, Debtor collected pre-petition accounts receivable and deposited them in an account at the Bank.

7. On August 7, 1987, Bank filed a motion to require Debtor to abandon said assets. In its motion, Bank requested the Court to order Debtor to: 1) abandon said assets to Bank; 2) provide Bank with a current accounting of all his uncollected pre-petition accounts receivable; and 3)

abandon to Bank all his uncollected pre-petition accounts receivable.

8. Bank's motion was set for hearing and notice was given to Debtor and his attorney. Neither Debtor nor his attorney appeared at the hearing and no objections were filed. Upon hearing on October 19, 1987, this Court granted said motion and ordered Debtor to: 1) abandon to Bank all proceeds from the collection of Debtor's pre-petition accounts receivable which were in his possession; and 2) assign all of his uncollected pre-petition accounts receivable to Bank.

9. During the course of the GPC project, City Electric furnished \$3,206.57 of materials to Debtor for work on the job site. Debtor had an account with City Electric and failed to pay as billed. When Debtor failed to pay his bill, City Electric properly filed a mechanic's lien, pursuant to Iowa Code Chapter 572, on the real estate owned by GPC.

10. Shortly thereafter, GPC learned of the lien and contacted City Electric. Upon verifying the accuracy of the lien, GPC sent a check to City Electric and made City Electric and Debtor co-payees on said check. The check was sent to Debtor's attorney for endorsement, but City Electric never heard back from Debtor's attorney.

11. GPC finally paid City Electric the amount of the claim in October 1987. City Electric credited Debtor's

account in the total amount and released the mechanic's lien. Debtor never paid the account.

12. Neither the Bank nor City Electric agreed that any funds they might collect would be subject to the payment of Debtor's payroll and income taxes.

13. On December 28, 1987, Debtor filed the motion to subordinate security interest and claims of secured creditors. In said motion, Debtor alleged that secured creditors, Bank and City Electric, confiscated funds leaving nothing available for payment of tax claims. Debtor further alleged this left him in unconscionable financial distress subject to criminal prosecution and probation requiring restitution of payroll taxes. As a result, Debtor prayed that the security interest of the creditors Bank and City Electric be subordinated to the tax claims of federal and state payroll and income taxes.

DISCUSSION

Bankruptcy Code section 510(c) (1) provides that a bankruptcy court may:

Under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest....

This provision is the codification of a well-established law that a bankruptcy court has the authority to subordinate claims on equitable grounds. See Pepper v. Litton, 308 U.S. 295, 306, 60 S.Ct. 238, 245, 84 L.Ed. 281 (1939).

Before the Court can exercise its equitable subordination power, three conditions must exist:

- i) The claimant must have engaged in some type of inequitable conduct.
- ii) The misconduct must have resulted in injury to the creditors ... or conferred on unfair advantage on the claimant.
- iii) Equitable subordination of the claim must not be inconsistent with the provisions of [bankruptcy law].

Matter of Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1977) (citations omitted); In re Pacific Exp., 69 B.R. 112, 116 (9th Cir. B.A.P. 1986).

In applying the above three-part test, the Court must consider three principles:

- 1) Inequitable conduct directed against the bankrupt or its creditors may be sufficient to warrant subordination of a claim irrespective of whether it was related to the acquisition or assertion of that claim.
- 2) Any claim or claims should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct.
- 3) The burden of proving all the elements of subordination is on the objectant. If the validity of the underlying claim is in issue, the claimant has the burden of providing both the amount and legitimacy of his claim. However, once that burden has been satisfied, the objectant must prove by a preponderance of the evidence the claimant engaged in such substantial inequitable conduct to the detriment of the debtor's other creditors that subordination is warranted.

Pacific Exp., 69 B.R. at 116; Matter of Teltronics Services, Inc., 29 B.R. 139, 168-169 (Bankr. E.D. N.Y. 1983).

Three categories of conduct are generally recognized as sufficient to warrant equitable subordination: 1) fraud, illegality, breach of fiduciary duties; 2) undercapitalization; and 3) claimant's use of debtor as a mere instrumentality or alter ego. In re Missionary Baptist Foundation, Inc., 712 F.2d 206, 212 (5th Cir. 1983).

In the case at bar, Debtor is not entitled to an order subordinating the claims of its secured creditors because he has not proven that either Bank or City Electric engaged in any type of inequitable conduct. Bank was entitled, pursuant to the October 19, 1987, Order of this Court, to possession of Debtor's pre-petition accounts receivable proceeds and his uncollected pre-petition accounts receivable. Both Debtor and his attorney had notice of the hearing but chose not to appear. Further, they filed no objection to Bank's motion to abandon said property. City Electric was also entitled to collect on its mechanic's lien which it properly filed pursuant to Chapter 572 of the Iowa Code.

In addition to being entitled to Debtor's funds, neither Bank nor City Electric ever agreed that any funds they might collect would be subject to the payment of Debtor's payroll and income taxes. As a result, since both creditors were entitled to possess Debtor's funds, and since neither creditor agreed that any funds it might collect would be subject to the payment of Debtor's payroll and

income taxes, there is no inequitable conduct by Bank or City Electric. Since there is no inequitable conduct, Debtor cannot prove all the necessary elements to receive an inequitable subordination order pursuant to section 510(c) (1).

CONCLUSION AND ORDER

WHEREFORE, based on the foregoing analysis, the Court concludes that neither Bank nor City Electric engaged in any type of inequitable conduct.

IT IS ACCORDINGLY ORDERED that Debtors motion to subordinate security interest and claims is hereby denied.

Dated this 28th day of June, 1988.

RUSSELL J. HILL
U.S. BANKRUPTCY JUDGE