UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

In Re:	)	Chapter 11
	)	
MONTGOMERY WARD HOLDING CORP., a Delaware corporation, et al.,	)	Case No. 97-1409 (PJW)
	)	Jointly Administered
Debtors.	)	
	)	
MONTGOMERY WARD HOLDING CORP., a Delaware corporation,	)	
	)	
Plaintiff,	)	
	)	
vs.	)	Adv. Proc. No. A-99-561
	)	
GENE C. McCAFFERY, an individual,	)	
	)	
Defendant.	)	

MEMORANDUM OPINION

Daniel J. DeFranceschi
Richards, Layton & Finger
One Rodney Square
Wilmington, DE 19801

Richard A. Chesley
Jones, Day, Reavis & Pogue
77 West Wacker
Chicago, Illinois 60601-1692

Richard M. Cieri
Jones, Day, Reavis & Pogue
North Point
901 Lakeside Avenue
Cleveland, Ohio 44114

Attorneys for Plaintiff
Montgomery Ward Holding Corp.

William D. Sullivan
Elzufon & Austin, P.A.
1201 Market Street, Suite 1401
P.O. Box 1630
Wilmington, DE 19801

William J. Factor
Seyfarth, Shaw, Fairweather & Geraldson
55 East Monroe Street
Suite 4200
Chicago, Illinois 60603

Attorneys for Defendant
Gene C. McCaffery

Date: December 11, 2000

WALSH, J.

Before the Court in this adversary proceeding is the motion (Doc. # 6) of plaintiff and debtor Montgomery Ward Holding Corp. ("Montgomery Ward") for partial summary judgment on its complaint to subordinate the claim of defendant Gene McCaffery ("McCaffery") filed in the amount of $671,666.65. (Claim No. 10616). By its motion, Montgomery Ward seeks equitable subordination of McCaffery's claim under 11 U.S.C. § 510(c).[1] Montgomery Ward argues that McCaffery's claim, which is based on a stock repurchase transaction, is in the nature of a shareholder interest and should therefore be subordinated to the claims of general unsecured creditors. For the reasons set forth below, the motion will be denied.

Background

On July 7, 1997, Montgomery Ward and related entities filed voluntary petitions for relief under chapter 11. The cases were consolidated, and the Court entered an order confirming the debtors' joint chapter 11 plan. In early August 1999, the debtors emerged from chapter 11 as reorganized entities.

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[1] Section 510(c) provides:
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; or (2) order that any lien securing such a subordinated claim be transferred to the estate.

11 U.S.C. § 510(c).

McCaffery is a former employee of Montgomery Ward. Complaint to Subordinate Redemption Note Claim at ¶ 10 (Doc. # 1) ("Complaint"); Answer to Complaint to Subordinate Redemption Note Claim at p. 3 (Doc. # 5) ("Answer"). He is also a signatory on a stockholders' agreement ("Stockholders' Agreement") regarding Montgomery Ward stock, dated June 17, 1988. Complaint at ¶ 11; Answer at p. 4.

The Stockholders' Agreement permits Montgomery Ward to purchase shares of its common stock held by its employees on termination of employment. Stockholders' Agreement at p. A-20, art. III; Complaint at ¶ 12; Answer at p. 4. McCaffery terminated his employment. On May 8, 1996, Montgomery Ward purchased 52,000 shares of Montgomery Ward common stock held by McCaffery. Complaint at ¶ 13; Answer at p. 4. In exchange for the 52,000 shares of common stock, McCaffery received some cash and a promissory note, dated May 8, 1996, in the amount of $1,061,666.67 payable in five annual installments of $212,333.33. Complaint at ¶ 14; Answer at p. 4.

Sometime in October 1996, Montgomery Ward informed McCaffery it would issue a new promissory note to replace McCaffery's existing one. Complaint at ¶ 15; Answer at pp. 4-5. The new promissory note would be in the amount of $671,666.65. Id.

At the time Montgomery Ward filed for chapter 11 relief, installments due under McCaffery's note were unpaid. Complaint at ¶ 18; Answer at p. 5. McCaffery accordingly filed a proof of claim for $671,666.65. Complaint at ¶ 19; Answer at p. 6.

On November 2, 1999, Montgomery Ward commenced this adversary proceeding in which it seeks to subordinate McCaffery's claim to the claims of general unsecured creditors. Its complaint is in three counts: the first for contractual subordination under § 510(a); the second for statutory subordination under § 510(b); and the third for equitable subordination under § 510(c). On March 27, 2000, Montgomery Ward filed the present motion in which it requests summary judgment on its third count. Montgomery Ward attached to its motion copies of the complaint and answer; McCaffery's proof of claim; the Stockholder Agreement; the promissory note dated May 8, 1996; and a letter from Montgomery Ward to McCaffery dated October 18, 1996. McCaffery does not dispute the authenticity of the attachments.

Montgomery Ward submits that it is entitled to judgment as a matter of law because a promissory note issued to redeem shares of stock, such as McCaffery's note, is in the nature of an equity interest and thus subject to equitable subordination under § 510(c). It argues that equitable subordination does not require a finding of creditor misconduct, and that therefore summary judgment is appropriate because there are no issues of material fact in dispute.

McCaffery responds that the Court may not categorically subordinate all claims arising from a corporation's purchase of its stock without regard to the facts surrounding the transaction. He argues that the recent Supreme Court decision in United States v. Noland, 517 U.S. 535, 116 S.Ct. 1524, 134 L.Ed. 748 (1996),

precludes judgment as a matter of law and that numerous factual issues surrounding the stock repurchase transaction are unresolved.

Discussion

Summary judgment is appropriate if "the pleadings, depositions, answers to interrogatories, and admissions on file, together with affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." Fed.R.Civ.P. 56.[2] A dispute is "genuine" if the evidence is such that a reasonable jury could return a verdict for the non-movant. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248, 106 S.Ct. 2505, 2510, 91 L.Ed.2d 202 (1986). A fact is "material" only if it will affect the outcome of a lawsuit under applicable law. Id.

The moving party has the initial burden of demonstrating the absence of any genuine issue of material fact. Celotex Corp. v. Catrett, 477 U.S. 317, 323, 106 S.Ct. 2548, 2553, 91 L.Ed.2d 265 (1986). The inferences drawn from the underlying facts must be viewed in the light most favorable to the nonmoving party. United States v. Diebold, Inc., 369 U.S. 654, 655, 82 S.Ct. 993, 994, 8 L.Ed.2d 176 (1962)(per curiam).

Montgomery Ward argues that judgment as a matter of law is appropriate because it is undisputed that McCaffery's claim is based on a stock redemption transaction. Montgomery Ward relies on a number of cases in which courts have subordinated stock

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[2] Federal Rule of Bankruptcy Procedure 7056 makes F.R.Civ.P. 56 applicable to adversary proceedings.

redemption claims in bankruptcy under principles of equitable subordination. See, e.g., In re Envirodyne Indus., Inc., 79 F.3d 579, 580 (7th Cir. 1996); Liebowitz v. Columbia Packing Co., 56 B.R. 222, 225 (D.Mass. 1985), aff'd mem., 802 F.2d 439 (1st Cir. 1986); SPC Plastics Corp. v. Griffith (In re Structurlite Plastics Corp.), 224 B.R. 27, 36 (6th Cir. B.A.P. 1998); In re Main Street Brewing Co., Ltd., 210 B.R. 662, 666 (Bankr. D.Mass. 1997); Ferrari v. Family Mut. Sav. Bank (In re New Era Packaging, Inc.), 186 B.R. 329, 337 (Bankr. D.Mass. 1995); In re SPM Mfg. Corp., 163 B.R. 411, 416, 421 (Bankr. D.Mass. 1994).

Courts following this approach find it inequitable to place stock redemption debt on equal footing as general unsecured claims because doing so violates the priority enjoyed in bankruptcy by debt over stock. See, e.g., Envirodyne Indus., 79 F.3d at 582-83. They equate a redemption claim with stockholder status on the basis that the underlying nature of the transaction survives, i.e., the note remains an equity obligation. Envirodyne Indus., 79 F.3d at 583; Liebowitz, 56 B.R. at 224 ("When 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").

According to these courts, a stock redemption is a method for a corporation to make a distribution to a stockholder, for which the corporation acquires nothing of value in return. Envirodyne Indus., 79 F.3d at 582; In re New Era Packaging, 186

B.R. at 336; In re SPM Mfg., 163 B.R. at 416. A redemption claimant, therefore, is trying to recover what is essentially a liquidating dividend on his or her stock. In re SPM Mfg., 163 B.R. at 416. Consequently, a note based on stock redemption is of a different nature than one based on debt. Id. at 416 ("Loan debt is not redemption debt. The question to be decided is the relative priority which redemption debt and other debt should enjoy under principles of equitable subordination based upon their respective natures").

Consistent with the articulation that subordination is warranted based on the shareholder nature of the claim, courts have not restricted such cases to those in which there is evidence of creditor misconduct. See In re Structurlite Plastics, 224 B.R. at 35 (collecting cases). In other words, courts recognize "no fault" equitable subordination under § 510(c).[3] Id.

Montgomery Ward urges this Court to apply the same reasoning. It argues that all it must establish for equitable subordination under § 510(c) is that McCaffery's claim is based on a note issued by Montgomery Ward to repurchase stock.

In response McCaffery argues that not all stock repurchase claims are "evil" such that subordination under § 510(c) is warranted. He also argues that granting summary judgment solely on a finding that the claim arises from a stock repurchase agreement contradicts the Supreme Court's ruling in Noland.

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[3] Unless otherwise indicated, all references to "§___" are to a section of the Bankruptcy Code, 11 U.S.C. § 101 et. seq.

In Noland, the Supreme Court held that a bankruptcy court may not equitably subordinate claims under § 510(c) on a categorical basis in derogation of Congress' scheme of priorities. Noland, 517 U.S. at 536-37, 116 S.Ct. at 1525-26. The bankruptcy court in the underlying case had subordinated the United States' claim for a post petition, noncompensatory tax penalty that would have otherwise enjoyed administrative expense priority under § 503(b)(1)(C) and § 507(a)(1). In re First Truck Lines, Inc., 141 B.R. 621, 629 (Bankr. S.D.Ohio 1992) aff'd sub nom. I.R.S. v. Noland, 190 B.R. 827 (D.Ohio 1992) aff'd In re First Truck Lines, Inc., 48 F.3d 210 (6th Cir. 1995) rev'd sub nom. United States v. Noland, 517 U.S. 535, 116 S.Ct. 1524 (1996). The bankruptcy court had done so without any finding of inequitable conduct on the part of the Government. See Noland, 517 U.S. at 536, 116 S.Ct. at 1525 (discussing underlying case). The bankruptcy court determined that the penalties were subject to subordination based on "the Code's preference for compensating actual loss claims." Id., 517 U.S. at 537, 116 S.Ct. at 1526, quoting In re First Truck Lines, Inc., 141 B.R. at 629.

The District Court and the Court of Appeals for the Sixth Circuit affirmed the bankruptcy court. According to the Sixth Circuit, it did

> not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not.

> . . . Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. 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. In re First Truck Lines, Inc., 48 F.3d at 218.

The Supreme Court reversed. It held that although § 510(c) may be applied to subordinate a tax penalty in a given case, it did not permit a court to conclude on a general, categorical level that a tax penalty should not be treated as an administrative expense. Noland, 517 U.S. at 540-41, 116 S.Ct. at 1527. The Court noted that despite language in the Sixth Circuit's opinion about balancing the equities in individual cases, the Sixth Circuit's conclusion that "post-petition, nonpecuniary loss tax penalty claims" should be subordinated by their very "nature" would result in the inevitable subordination of all such claims, based not on individual equities but on the general unfairness of satisfying such claims before the claims of general creditors. Id., 517 U.S. at 541, 116 S.Ct. at 1527. This, the Court held, was impermissible. Id., 517 U.S. at 543, 116 S.Ct. at 1528.

Montgomery Ward asks this Court to subordinate McCaffery's claim based on the general unfairness of satisfying a stock redemption claim on par with that of unsecured creditors. But such a ruling would be based solely on the nature of McCaffery's claim as a stock redemption claim. The rationale is

categorical and disregards a consideration of the facts and circumstances surrounding the purchase of McCaffery's stock.

Montgomery Ward's reliance on "no fault" equitable subordination as a basis for summary judgment is misplaced. That creditor misconduct may not be required for equitable subordination, see Burden v. United States, 917 F.2d 115, 120-21 (3d Cir. 1990), does not relieve the court from weighing the equities on a case-by-case basis. In Burden, the Third Circuit considered the subordination of a nonpecuniary loss tax penalty claim under § 510(c) and concluded that § 510(c) permits the subordination of such claims. 917 F.2d at 120. It also held that creditor misconduct is not required for such a finding. Id. at 120-21. However, the Third Circuit admonished that subordinating such a claim could not be automatic and that a bankruptcy court must consider the equities of the individual case.[4] Id. at 119.

As explained by the Third Circuit, if "the courts were free to subordinate a class of claims as a matter of law, then the notice and hearing requirement of § 510(c) would be nullified in any instance where the claimholder does not dispute that its claim is of a particular type. We believe that the notice and hearing

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[4] This holding is consistent with that in Noland, where the Supreme Court recognized that § 510(c) "may allow a bankruptcy court to reorder a tax penalty in a given case," 517 U.S. at 540, 116 S.Ct. at 1527, but that the court could not do so categorically. 517 U.S. at 543, 116 S.Ct. at 1528. The Supreme Court, however, did not decide whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated. Id., 517 U.S. at 543, 116 S.Ct. at 1528.

requirement calls on courts to explore the particular facts and circumstances presented in each case before determining whether subordination of a claim is warranted." Burden, 917 F.2d at 120.

Montgomery Ward attempts to distinguish its case from Burden and Noland based on the argument that subordinating an equity interest is consistent with the priority scheme of the Bankruptcy Code, in contrast to the subordination of a tax penalty claim which it argues defies the priority scheme of the Code. It apparently interprets Noland as only prohibiting equitable subordination of claims in direct contravention to the priority provisions in the Code, which it argues is not the case here. Memorandum of Law in Support of Plaintiff Montgomery Ward's Motion for Partial Summary Judgment, p. 11, n.7.

But whether subordination of McCaffery's claim is consistent with other provisions of the Bankruptcy Code is only one of several factors the court must consider when determining if equitable subordination is warranted. What the Supreme Court found offensive in Noland was not the reordering of priority, but rather, the court's decision to subordinate based on the type of claim at issue, rather than on the unique facts of the case. Noland, 517 U.S. at 540-41, 543, 116 S.Ct. at 1527-28.

A decision to subordinate based on type, the Supreme Court explained, occurs "at the level of policy choice at which Congress itself operated in drafting the Code," and is impermissible. Id., 517 U.S. at 543, 116 S.Ct. at 1528. Thus "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." Id. Similarly, Congress could have subordinated claims based on stock redemption to those of general unsecured creditors but it did not.

Under Noland, I cannot subordinate McCaffery's claim simply because it is a stock redemption claim. That is not to say that, after consideration of the facts of the case, subordination of the claim may not be appropriate for that reason. However, I cannot do so without first "explor[ing] the particular facts and circumstances" presented in this case to determine that subordination is warranted. Burden, 917 F.2d at 120. As it stands, there simply are no facts on which to decide the equities of this case, other than that McCaffery's claim is based on a note Montgomery Ward issued as payment for purchase of its stock. Montgomery Ward, as the moving party, has failed to meet its burden of establishing the absence of any genuine issue of material fact and summary judgment is therefore inappropriate.[5]

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[5] For example, and not as an exhaustive list, there is no evidence regarding McCaffery's former position with Montgomery Ward, or the manner in which he acquired Montgomery Ward stock. There is no indication that McCaffery is a "type 1 management," "type 2 management," or other type of employee as discussed in the Stockholders' Agreement. Nor is there any evidence regarding the terms under which McCaffery terminated his employment, or who initiated the stock repurchase transaction. McCaffery does not even concede that the contested transaction is a "stock redemption" in the sense such a characterization is a term of art with legal consequences. Answer at p. 4. There is no evidence regarding the

Conclusion

For the reasons set forth above, Montgomery Ward's motion (Doc. # 6) requesting partial summary judgment on the third count of its complaint seeking equitable subordination of McCaffery's claim is hereby DENIED.

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relative effect of subordination on other claims. Nor is there any evidence regarding Montgomery Ward's solvency at the time of the repurchase agreement or the likely validity of the transaction under applicable corporate law. See 8 Del.C. § 160(a)(1) ("Nothing in this subsection shall invalidate or otherwise affect a note, debenture or other obligation of a corporation given by it as consideration for its acquisition by purchase, redemption or exchange of its shares of stock if at the time such note . . . was delivered by the corporation its capital was not then impaired or did not thereby become impaired"); In re Motels of America, Inc., 146 B.R. 542, 544 (Bankr. D.Del. 1992); see also, Klang v. Smith's Food & Drug Ctrs., Inc., 702 A.2d 150, 154 (Del. 1997) (discussing impairment of capital and holding that corporations are allowed to revalue assets and liabilities to conform with 8 Del.C. § 160).

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	)	Jointly Administered
Debtors.	)	
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MONTGOMERY WARD HOLDING CORP., a Delaware corporation,	)	
	)	
Plaintiff,	)	
	)	
vs.	)	Adv. Proc. No. A-99-561
	)	
GENE C. McCAFFERY, an individual,	)	
	)	
Defendant.	)	

ORDER

For the reasons set forth in the Court's Memorandum Opinion of this date, the plaintiff Montgomery Ward Holding Corp.'s motion (Doc. # 6) requesting partial summary judgment to subordinate the claim of defendant Gene McCaffery pursuant to 11 U.S.C. § 510(c) is hereby DENIED.

_____
Peter J. Walsh
United States Bankruptcy Judge

Date: December 11, 2000