Equitable subordination of unsecured claim was unwarranted, even assuming that the claimants were non-statutory insiders of the debtor, where there was no evidence that creditors engaged in any inequitable conduct or received any unfair advantage over other unsecured creditors.

***Norris v. Schlossberg (In re Madeoy)*, 2015 Bankr. Lexis 2326 (Bankr. D. Md. July 15, 2015).**

Summary by Bradley J. Swallow, Funk & Bolton, P.A.

Granting partial summary judgment against a chapter 7 trustee ("Trustee") and in favor of unsecured creditors Todd Norris ("Mr. Norris") and Jennifer Norris (collectively with Mr. Norris, the "Claimants"), the Court held that equitable subordination of Claimants' unsecured claim against Steven Madeoy ("Debtor") based on a promissory note was not warranted. For purposes of its ruling on summary judgment, the Court assumed without deciding that Claimants were "non-statutory insiders" of the Debtor.

For more than 20 years before the Debtor's bankruptcy filing, the Debtor and Mr. Norris had invested in real estate together. Over time, the Debtor became indebted to Claimants through a series of transactions and failed investments. Several years before the Debtor's bankruptcy filing, the Debtor made a promissory note payable to Claimants (the "Note"), which formally evidenced and consolidated Claimants' claims against the Debtor.[1] The Note included a claim for $180,000 of unpaid rent, which accrued after the Claimants purchased a home owned by the Debtor and his spouse for roughly $1.5 million in a short sale and then leased the property back to the Madeoys. The Note also evidenced Mr. Norris's claims arising from various loans and losses relating to real estate investments. Claimants contended in their proof of claim that the balance due on the Note as of the petition date was $535,817. The Trustee asserted that Claimants were insiders of the Debtor and sought equitable subordination of their claims. The Trustee also challenged the validity and amount of the claims.

In addressing whether the Claimants were insiders of the Debtor and, consequently, whether to apply heightened scrutiny to the conduct giving rise to their claims, the Court observed that a party could acquire the status of a "non-statutory insider" if its "relationship with the debtor is sufficiently close so as to subject the relationship to careful scrutiny." *Madeoy*, at *9-10. (quoting *Butler v. David Shaw, Inc.*, 72 F.3d 437, 443 (4th Cir. 1996)). The Court further noted, however, that "simply being an insider is not sufficient to warrant subordination." *Id*. Recognizing that several facts pointed to a close relationship between the parties, the Court nonetheless found that the issue was not free from doubt. Concluding that a resolution of the question would not alter its decision as to equitable subordination, the Court assumed for summary judgment purposes that Claimants were non-statutory insiders.

In holding that equitable subordination of Claimant's claim was not appropriate, the Court applied a three-pronged test articulated in *Matter of Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977), which provides that a claim should be equitably subordinated if (1) there is inequitable conduct on the part of the claimant sought to be subordinated; (2) the misconduct caused injury to the other creditors of the bankrupt or conferred an unfair advantage upon the claimant; and (3) subordination is consistent with the provisions of the Bankruptcy Code. The Court found no evidence that Claimants acted fraudulently, improperly or unfairly when the Note was made or with respect to the claims evidenced by the Note. With respect to the underlying claims, the Court rejected the Trustee's contention that Claimants obtained an unfair advantage in connection with the short sale and lease-back transaction involving the Madeoy's home. The short sale price was based on the appraised value of the property and was approved by the Debtor's secured lender, and Trustee offered no evidence that the transaction was not conducted at arm's

[1] As security for the repayment of the Note, the Debtor pledged his membership interests in certain limited liability companies. However, Claimants liens on the membership interests were avoided during the course of the proceeding, and the Note was unsecured when the Court decided this matter.

length and in good faith. With respect to the Note, the Court found that all of the underlying claims could have been the subject of separate proofs of claim had the Note not been made. In light of the fact that the liens securing the Note were previously avoided, the aggregation of the claims into the Note conferred no advantage on the Claimants.

Having determined that equitable subordination was not warranted, the Court granted summary judgment with respect to several components of the claim evidenced by the Note, finding that sufficient, uncontroverted evidence existed on the record to support the validity and amount of those components. The Court denied Claimants summary judgment as to the validity of certain components of the claim with respect to which Claimants had not established that the Debtor was personally liable and as to the total amount of the claim.