UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC.

Debtors

CASE NO. 96-61376
Chapter 11
Substantively Consolidated

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

Currently before the Court is the May 10, 2000 motion ("Trustee's Motion") by Richard C. Breeden ("Trustee"), as Chapter 11 Trustee of the consolidated estates of The Bennett Funding

Group, Inc. ("Debtors")[1], to partially disallow or equitably subordinate the claims of estate creditors Century Indemnity Company, Cravens, Dargan & Company, Pacific Coast, CIGNA Property and Casualty Insurance Company and International Surplus Adjusting Services (collectively "CIGNA") pursuant to Sections 502 and 510 of the U.S. Bankruptcy Code, 11 U.S.C. §§ 101-1330 ("Code"). On June 5, 2000 Century Indemnity filed its opposition to the Trustee's Motion ("CIGNA Objection") asserting that allowance of the full amount of its claims is mandated by federal law and that categorical subordination of its claims is prohibited. The Trustee submitted a responsive memorandum of law on June 8, 2000 ("Trustee's Reply") and on that date the Court heard oral argument at its regular motion term in Utica, New York. Following oral argument the parties were afforded the opportunity to submit supplemental memoranda of law. On July 5, 2000 CIGNA submitted a supplemental memorandum of law ("CIGNA Reply") and on that date the Court took the matter under submission for written decision.

JURISDICTIONAL STATEMENT

The Court has core jurisdiction over the parties and subject matter of this contested matter pursuant to 28 U.S.C. § 1334(b) and 28 U.S.C. § 157(a), (b)(1), (b)(2)(A), (B) and (O).

FACTS

In 1984 Aloha Leasing ("Aloha"), a division of the Debtor entity The Bennett Funding

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[1]The Debtors are eight related entities, all of whom filed for relief under Chapter 11 of the Code between March 29, 1996 and July 25, 1996. On July 25, 1996 the Debtors' estates were consolidated pursuant to an Order of this Court. The debtor entities that collectively comprise the Debtors herein are: The Bennett Funding Group, Inc., Bennett Receivables Corporation, Bennett Receivables Corporation II, Bennett Management & Development Corporation, The Processing Center, Inc., Resort Service Company, Inc., American Marine International, Ltd., and Aloha Capital Corporation. Richard C. Breeden was appointed Chapter 11 Trustee of the Debtors' estates on April 18, 1996.

Group, Inc., was engaged in the business of financing equipment installment purchase contracts and equipment leasing.[2] On May 1, 1984 CIGNA issued Master Insurance Policy No. IMF 420719 ("Master Policy") insuring Aloha against end-user default on equipment leases entered into between May 1984 and May 1986. During this period over 4,500 leases were entered into that were considered insured under the Master policy. According to CIGNA, under the terms of the Master Policy, when a lessee defaulted on its obligation to Aloha under the terms of an insured equipment lease, Aloha was obligated to attempt to collect payment from the lessee and/or attempt to repossess and sell the subject equipment. Once collection and/or repossession failed, Aloha was to issue a certificate of default. Once a valid certificate of default was issued, Aloha would make a claim under the Master Policy and the payments due under the defaulted equipment lease would be paid to Aloha by CIGNA. The parties do not dispute that between April 1987 and February 1990 CIGNA paid Aloha over $7 million in such claims under the Master Policy.[3]

In February 1990, CIGNA ceased making payments on Aloha's default claims. CIGNA asserts that its cessation of claim payments was based on its February 1990 determination that "Aloha intended to and, in fact, did obtain monies from [CIGNA]...by means of false pretenses, misrepresentations and fraudulent acts." CIGNA Objection, at ¶ 8.

On March 1, 1991 Aloha filed a civil complaint against CIGNA in the U.S. District Court

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[2] This Court has previously taken judicial notice that Aloha Leasing was a division of The Bennett Funding Group. *See Breeden v. Northeast Binding Systems (In re The Bennett Funding Group, Inc.)*, 253 B.R. 316, 318 n.2 (Bankr. N.D.N.Y. 2000, Gerling, C.J.).

[3] Although the Master Policy insured leases entered into between May 1984 and May 1986, some of the leases were for a five-year term allegedly extending Aloha's potential claim rights under the Master Policy well beyond 1986. *See* Trustee's Motion, at ¶ 5.

for Northern District of New York ("District Court action") "alleging several causes of action relating to Claimants' [CIGNA] refusal to pay certain of Aloha's insurance claims under [the] Master Policy..." CIGNA Objection, at ¶ 5; *see also,* Trustee's Motion, at ¶ 3. Aloha filed an amended compliant in the District Court action on June 6, 1991. On April 10, 1992 CIGNA interposed an Answer and Counterclaims in the District Court action wherein CIGNA asserted various affirmative defenses as well as a number of counterclaims against Aloha seeking damages as a result of Aloha's alleged breach of contract and fraud.[4] Aloha filed its Reply to CIGNA's counterclaims on April 27, 1992 raising affirmative defenses of its own.

On February 2, 1994 CIGNA filed a motion for leave to amend its April 10, 1992 pleadings to include counterclaims alleging, *inter alia*, that Aloha violated Section 1962 of the Federal Racketeer Influenced and Corrupt Organizations statute ("RICO").[5] *See generally*, 18 U.S.C. § 1962, *et seq*. Aloha filed an objection to CIGNA's motion for leave to amend on March 1, 1994. By Orders dated March 24, 1994 and June 2, 1994, respectively, U.S. Magistrate Judge Gustave J. DiBianco denied CIGNA's motion for leave to amend its pleadings to include the RICO counterclaim and CIGNA promptly appealed. By Order dated May 3, 1995, U.S. District Judge Con. G. Cholakis granted CIGNA's appeal, reversing the Order of Magistrate Judge DiBianco and permitting CIGNA to amend its pleadings to include the RICO counterclaim. CIGNA filed its Amended Answer and Counterclaims on May 16, 1995. On October 23, 1995

[4]At various intervals during initial motion practice in the District Court action the court extended the deadline within which CIGNA was to interpose its answer. *See e.g.*, *Aloha Leasing v. Century Indemnity Co.*, No. 91-CV-229, Order (N.D.N.Y. March 26, 1992, Cholakis, J.)(resetting answer deadline to April 10, 1992).

[5]For the sake of clarity, the Court will limit its discussion regarding the procedural posture of the District Court action solely as it relates to CIGNA's RICO counterclaim.

Judge Cholakis denied a motion by Aloha for reconsideration of the May 3, 1995 Order and, upon request of Aloha, certified the matter for immediate interlocutory appeal to the Circuit Court.[6] On February 13, 1996 the Second Circuit Court of Appeals denied Aloha's request for leave to appeal Judge Cholakis' May 3, 1995 Order thus giving effect to CIGNA's amended Answer and Counterclaim including its RICO cause of action.

The filing of the Debtors' original bankruptcy petition on March 29, 1996 effectively stayed all further proceedings in the District Court action. CIGNA filed a claim against the Debtors' Estates in an amount in excess of $15 million representing the expected recovery on its counterclaims in the District Court action. CIGNA's claim represents "actual damages of at least five million dollars ($5,000,000) plus reasonable attorney's fees and costs and trebled damages of fifteen million dollars ($15,000,000) pursuant to RICO..."[7] CIGNA Objection, Exhibit A, at ¶ 4; *see also*, 18 U.S.C. § 1964(c)("Any person injured...by reason of a violation of section 1962 of [RICO]...shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee").

ARGUMENTS

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[6]Judge Cholakis' October 23, 1995 Memorandum Decision and Order certified the following question for immediate interlocutory appeal to the Circuit Court: "[w]hat is the appropriate standard of review to be employed by this District Court on review of the June 2, 1994 Order of Magistrate Judge Gustave J. DiBianco which denied CIGNA's motion for leave to amend its Answer to assert a RICO counter-claim?" *Aloha Leasing v. Century Indemnity Co.*, No. 91-CV-229, slip op., at 4-5 (N.D.N.Y. October 23, 1995, Cholakis, J.), amended October 23, 1995.

[7]The Trustee has asserted, without objection, that "[c]ounsel for CIGNA has advised the Trustee that the Punitive Damages Claim is for $10 million, and that the reference to $15 million includes both the compensatory damages claims and Punitive Damages Claim based on RICO's trebling provisions." Trustee's Motion, at ¶ 15.

The Trustee asserts in the first instance that, assuming *arguendo* that CIGNA could prove its disputed, unliquidated and contingent RICO claims, those claims should nonetheless be disallowed by virtue of this Court's "general equitable powers to determine whether and to what extent a claim should be allowed" pursuant to Code § 502.[8] Trustee's Motion, at ¶ 18; *see also,* Code § 502(b)("the court,...shall determine the amount of such claim...as of the date of the filing of the petition, and shall allow such claim in such amount..."). The Trustee contends that it is an oft-employed judicial doctrine to disallow the punitive damages portion of a judgment creditor's claim under Code § 502, when allowing that portion of the claim would only punish the body of creditors sharing in distribution by diluting their ultimate recovery rather than punish a tortfeasing debtor. Largely relying on the 1988 decision of U.S. District Judge Robert R. Merhige, Jr. in *In re A.H. Robins Co., Inc.*, "[t]he seminal case on the applicability of punitive damages in chapter 11" the Trustee contends that allowing CIGNA's punitive damages claim in the instant case is contrary to the policy considerations behind punitive damages, namely deterring and punishing wrongful conduct, and will additionally frustrate the chapter 11 process as it relates to these

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[8]The Court notes, without lengthy discussion, that it finds that the Trustee's argument that CIGNA's claim for statutory attorneys' fees in the District Court action is punitive in nature and should also be disallowed or equitably subordinated is unavailing. The Trustee has set forth no argument supporting this position save to say that "the circumstances of this case warrant disallowance or subordination." Trustee's Motion, at ¶ 15, n.3. While the claimed attorneys' fees represents a component of the CIGNA claim, disallowing or equitably subordinating that portion of the claim clearly prejudices CIGNA's attorney's potential entitlement to statutory fees and this Court is not inclined to grant such relief absent authority on the subject. This Court is unaware of any court subjecting an attorney's potential entitlement to statutory attorneys' fees to such prejudice nor will this Court do so. To this end, the Trustee's Motion will be denied insofar as it seeks disallowance or equitable subordination of CIGNA's claim for statutory attorneys' fees, pursuant to RICO, in the District Court action. Thus, the discussion herein will be limited to the treble damages component of CIGNA's claim against these Estates.

Debtors. *In re Allegheny Int'l., Inc.*, 106 B.R. 75, 77 (Bankr. W.D. Pa. 1989), *citing In re A.H. Robins Co., Inc.*, 89 B.R. 555 (E.D. Va. 1988).

Second, the Trustee argues that if not disallowed, the punitive damages portion of CIGNA's claim should be equitably subordinated pursuant to Code § 510(c). The Trustee contends that pursuant to Code § 510(c), this Court may, under the circumstances of the instant case, subordinate the claim of "an innocent claimant where failure to do so would offend general notions of fairness." Trustee's Motion, at ¶ 22 (citations omitted). It is the Trustee's position that allowing CIGNA's punitive damages claim in the instant case, thereby diluting the recovery of other innocent creditors does, indeed, offend such notions of fairness.[9] The Trustee asserts that considering most of the general unsecured claims in this particular case are based on fraud, allowing CIGNA to obtain thrice the recovery on its fraud claim simply because it thought to plead RICO causes of action and other creditors did not is "precisely the type of unacceptable result that section 510(c) was meant to prevent."[10] Trustee's Reply, at 5. Furthermore, the Trustee urges that he is seeking subordination of CIGNA's claim solely based on the compelling

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[9]The Court notes that the Trustee has asserted in his moving papers that it is his position that no creditors should be allowed a claim in excess of compensatory damages. *See* Trustee's Motion, at ¶ 24 ("Accordingly, the Trustee does not believe that any creditor should be allowed a claim in excess of compensatory damages.").

[10]In its Reply, CIGNA takes umbrage with the Trustee's characterization of its RICO claims as nothing more than afterthought clever pleading which may now afford CIGNA three times the recovery than that received by creditors who were not as savvy in their pleading. In defense of this position CIGNA asserts that its RICO claims were "based on approximately six years of audits, investigations, discovery and litigation relating to the massive equipment lease and insurance fraud scheme executed by the Debtors, the compilation of tens of thousands of pages of documentary evidence, the expenditure of over $1 million in professional fess [*sic*] relating to such investigations and litigation, and cooperation with the United States Attorney." CIGNA Reply, at ¶ 1.

justification for such action in this case alone and that he is not seeking categorical subordination as CIGNA maintains. In this regard, the Trustee asserts that based on the facts and equities of the instant case, none of the salutary purposes of RICO are served, namely policing, deterring and punishing wrongful conduct, thus the claim is justifiably subordinated without offense to the statute itself.

CIGNA sets forth a number of arguments in opposition to the Trustee's request for disallowance or equitable subordination. First, CIGNA asserts that because the Second Circuit Court of Appeals has held that the imposition of treble damages is required under the language of the RICO statute, this "[C]ourt is powerless to change the statute's terms" and the claim must be allowed as filed. CIGNA Objection, at ¶ 17 (internal quotation and citation omitted). In this regard, CIGNA contends that disallowance or equitable subordination of the punitive damages portion of its claim "would be for the bankruptcy court to upend an explicit statutory directive of Congress and undermine Congress' clear intent in the implementation of RICO." *Id.,* at ¶ 19.

Second, CIGNA argues that federal courts should interpret competing federal statutes in such a way so as to give maximum effect to both. In this regard, CIGNA contends that while RICO mandates the allowance of the trebled damages in order to further an important public policy, namely to encourage private suits that further public ends, nothing in the Code requires a different result. CIGNA asserts that the full amount of the statutorily mandated treble damages under RICO must be allowed since doing so would engender no offense to any provision of the Code. To this end, CIGNA contends that its "federal rights [under RICO] should not be disregarded simply because of the happenstance of a bankruptcy filing, absent a clear mandate to the contrary in the Code." *Id.*, at ¶ 27. According to CIGNA, for this Court to exercise its authority in the manner suggested by the Trustee would be to ignore the mandates of the Congress in enacting RICO as well as the position of both U.S. Supreme Court and the Second Circuit Court of Appeals in similarly situated cases.

Third, CIGNA contends that categorical subordination of the type suggested by the Trustee's Motion was specifically rejected by the Supreme Court in *U.S. v. Noland*, and thus must be rejected by this Court in the instant case. *See generally, U.S. v. Noland*, 517 U.S. 535 (1996). CIGNA asserts that, as per *Noland*, subordination of its claimed treble damages would "trump the legislative will embodied in the Code" by penalizing the CIGNA claimants on a categorical basis to the benefit of other claimants in the same class where such prioritizations have never been manifested in legislative will. CIGNA Objection, at ¶ 34. CIGNA contends that the Trustee's predominant reliance on the facts of this particular case should be unavailing and his Motion should be seen simply as an attempt at categorical subordination in derogation of the Supreme Court's decision in *Noland*.

Finally, CIGNA alleges that the equitable concerns allegedly relied upon by the Trustee and considered in the cases cited by the Trustee are simply not present in this case and merit no consideration by the Court. In furtherance of this contention CIGNA asserts first that "allowance of the Claims will not even remotely deplete the assets of the Debtors' estate or significantly prejudice the recovery of other creditors." CIGNA Objection, at ¶ 39. In this regard, CIGNA represents to the Court that under its arithmetical construct, if its RICO claim is allowed in the full amount, the recovery by the general unsecured creditors would be reduced by less than one-half of one *per cent*, thus characterizing the harm which would inure to the creditors as *de* *minimis*. Alternatively, CIGNA contends inequity will result only if its right to prosecute its RICO claims is denied under the auspices of equitable subordination especially in light of CIGNA's expenditure of over $1 million in professional fees to investigate those claims. In addition, CIGNA contends that allowing its RICO claim in full presents no risk to reorganization of these Debtors, since its claim has been clearly quantified and these Debtors do not intend to emerge from bankruptcy as a reorganized going concern.

DISCUSSION

The Court must consider, as a threshold matter, whether CIGNA is correct in its assertion that "allowance of the full amount of...[its] Claims is mandated by federal statute..." and that a bankruptcy court is "'powerless'" to hold otherwise. CIGNA Objection, at ¶ 17 (citation omitted). While any argument constricting this Court's authority to adjudicate claims under its jurisdiction appears unavailing on its face, the argument urged by CIGNA quite simply ignores the distinction between the liquidation of a claim and its allowance against a bankrupt estate. The distinction drawn between the claims liquidation process and the claims allowance process has most often been addressed by the courts in the context of jurisdiction, that is, whether a bankruptcy court's liquidation and/or estimation of an unliquidated claim for purposes of estate administration offends its core responsibility to allow, disallow or subordinate that claim. *See generally, In re Chateaugay Corp.*, 111 B.R. 67, 71-74 (Bankr. S.D.N.Y. 1990); *Baumgart v. Fairchild Aircraft Corp. (In re Fairchild Aircraft Corp.)*, 1990 WL 119650, *9 (Bankr. W.D. Tex. 1990); *In re Comstock Fin. Servs.*, 111 B.R. 849, 855-857 (Bankr. C.D. Calif. 1990). "That bankruptcy courts have exclusive jurisdiction over the liquidation and allowance process of bankruptcy claims is a principle long recognized and not reasonably disputed." *Id.*, *citing Pepper* *v. Litton*, 308 U.S. 295, 304 (1939); *Katchen v. Landy*, 382 U.S. 323, 328-330 (1966); *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989). While the distinction between liquidation and allowance is not manifest in Code § 502, the statute governing the claims process in bankruptcy, there is support for such distinction in the subtlety of its language. *See In re Comstock Fin. Servs.,* 111 B.R. at 856. For example, Code § 502(b)(1) excepts from allowance a "claim [that] is unenforceable against the debtor...under any agreement or applicable law for a reason other than because such claim is contingent or unmatured..." Code § 502(b)(1). Standing alone, this provision appears to treat the liquidation of a claim as a component of the larger allowance/disallowance process. *See In re Comstock Fin. Servs.,* 111 B.R. at 856; *Baumgart*, 1990 WL 119650, at *8. Code § 502(c) supports this reading. Code § 502(c)(1) states, in pertinent part, that the bankruptcy court "shall...estimate[] for purpose of allowance...any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case;..." Code § 502(c)(1). This statutory language "appears to use the words 'liquidation' and 'allowance' to describe two different procedures or concepts." *In re Comstock Fin. Servs.,* 111 B.R. at 856.

Furthermore, pursuant to 28 U.S.C. § 157(b)(2)(B), bankruptcy courts may hear and determine all core proceedings, including "allowance or disallowance of claims against the estate... and estimation of claims...for the purposes of confirming a plan...but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a case under title 11..." 28 U.S.C. § 157(b)(2)(B). This section "parses the allowance or estimation of [certain enumerated] claims to the district court for distribution purposes, but to the bankruptcy court for all other purposes including the allowance and estimation of the claim." *Baumgart*, 1990 WL 119650, at *8, *citing In re Chateaugay Corp.*, 111 B.R. at 75-76; *see also, Baumgart*, 1990 WL 119650, at *8, *discussing* 28 U.S.C. § 157(b)(5) ("[T]hat statute directs that the trial of the liquidation or estimation of personal injury claims to be conducted before an Article III tribunal, but only ***for distribution purposes***.")(emphasis in *Baumgart*). "There is a clear distinction drawn in the statute between the ***liquidation*** of a claim and its ***allowance***." *Baumgart*, 1990 WL 119650, at *8 (emphasis in original). Thus, in both Code § 502 and 28 U.S.C. § 157, the Congress appears to treat liquidation and allowance as two different procedures or concepts, or, more accurately, that liquidation is but one step in the allowance process. *See In re Comstock Fin. Servs.*, 111 B.R. at 856. As the court in *Baumgart* reasoned,

> Liquidation of a claim is but one step in the larger process of allowance. Once this step is completed, the balance of the allowance process is entrusted to the bankruptcy court, which determines under Section 502 whether the claim should be allowed against estate assets, under Section 510 whether the claim should be subordinated, under Section 506 the extent to which the claim should be allowed as a secured claim, under Section 507 the extent (if any) that the claim should be accorded priority status, and so forth. All of these "allowance" questions are directly related to the extent to which a claim will be permitted to share in the estate's assets, either under a confirmed plan or under a scheme of liquidation.

Baumgart, 1990 WL 119650, *9(footnote and internal citations omitted).

The *Comstock* Court characterized the place of liquidation in the allowance process in the following manner,

> "[L]iquidation" is merely one step in the allowance process. In many cases, this step is taken prior to the commencement of the bankruptcy case. If the claim is liquidated or not prior to the commencement of the case, the creditor may file a proof of claim in the case, 11 U.S.C. § 501, and if filed properly, the claim is deemed allowed. *Id.* Any party in interest, although usually it is the debtor, debtor-in-possession or trustee, may object to the filed claim. 11 U.S.C. § 502(a). ***The bankruptcy court may then liquidate the claim if it is unliquidated***, i.e., determine the merits of the claim according to applicable state law or agreement

> between the parties, abstain from liquidating the claim or give relief from stay to the claimant to liquidate the claim in state court; or, ***if the claim is complex or will unnecessarily delay the administration of the bankruptcy estate, the bankruptcy court may forego formal liquidation and estimate the claim***. 11 U.S.C. § 502(c). ***Once liquidated or estimated, the claim is ripe for determination of its allowance or disallowance pursuant to many and diverse provisions of the Bankruptcy Code.***

In re Comstock Fin. Servs., 111 B.R. at 856-857 (emphasis added). Thus, the liquidation of a claim at any time pre- or post-petition does nothing to prejudice the bankruptcy court's exclusive jurisdiction to allow, disallow or subordinate all or a portion of that claim if asserted against a bankrupt estate. *See Keene Corp. v. Acstar Insurance Co. (In re Keene)*, 162 B.R. 935, 946 (Bankr. S.D.N.Y. 1994) ("a Bankruptcy Court can subordinate, disallow or limit punitive damages claims...[and]...the preclusive effect of a final judgment would not bar consideration of this argument if the judgment creditor asserted the judgment as a claim against the estate.")

Disallowance/Equitable Subordination

The Code "neither clearly mandates nor clearly proscribes the allowance of claims for punitive damages in reorganizations under chapter 11." *See In re Allegheny Int'l, Inc.*, 106 B.R. at 79. The allowance or disallowance of a claim or interest is governed by Code § 502, "the statute that is the cornerstone of the claims process in bankruptcy". *In re Comstock Fin. Servs.,* 111 B.R. at 856; *see also,* Code § 502. Code § 502(b) "sets forth the type of claims which cannot be allowed or only allowed with limitations...[and while t]here is nothing in this subclause which deals with claims for punitive damages....there is a plethora of case law which deals with this subject, especially in Chapter 11 cases." *Jim Walter Homes, Inc. v. Bell (In re Hillsborough Holdings Corp.)*, 247 B.R. 510, 511 (Bankr. M.D. Fla. 2000). Disallowance of such claims "is the most extreme method of handling punitive damages claims in bankruptcy....[because]

'[d]isallowance of a claim negates its validity and existence and completely ousts the claimant from creditor status for all purposes.'" Thomas C. Grant, *How United States v. Noland Prohibits the Disallowance of Punitive Damages Claims in Chapter 11*, 14 BANKR. DEV. J. 199, 202 (Fall 1997), *quoting* Asa S. Herzog & Joel B. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83, 86 (1961). Alternatively, a bankruptcy court may, "under the principles of equitable subordination, subordinate for the 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..." Code § 510(c)(1). The equitable subordination of a claim in bankruptcy "'simply adjusts the equities among the creditors and regulates distribution[]'...[such that the] separately classified creditor retains a claim against the estate and may, therefore, participate in the bankruptcy case." Grant, *supra, quoting* Herzog & Zweibel, *supra.* It is "the equitable powers of the bankruptcy court [that] enable[s the court]...to eliminate, subordinate, or limit punitive damages." *In re Allegheny Int'l, Inc.*, 106 B.R. at 79. However, the "principles of equitable subordination" are not limitless in concept or application. *See In the Matter of Colin*, 44 B.R. 806, 810 (Bankr. S.D.N.Y. 1986). The application of the doctrine of equitable subordination is generally triggered by the presence some type of inequitable conduct on the part of the creditor seeking allowance of her claim.[11] *See U.S. v. Noland*, 517 U.S. at 538, *discussing Benjamin v. Diamond (In the Matter of Mobile Steel Co.)*,

[11]"In *In re Mobile Steel*, the court observed that the doctrine [of equitable subordination] was generally triggered by a showing that the creditor had engaged in 'some type of inequitable conduct.'...the misconduct must have 'resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant,' and that the subordination must 'not be inconsistent with the provisions of the Bankruptcy Act.'" *New Jersey Steel Corp. v. Bank of New York*, 1997 WL 716911, *4 (S.D.N.Y. 1997), *quoting Mobile Steel*, 563 F.2d at 700 (internal citations omitted in *New Jersey Steel Corp.*)

563 F.2d 692, 700 (1977)("*Mobile Steel*"). This notion is not a new or novel jurisprudential concept. *See e.g., Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939)(subordination of parent corporation claims to preferred stockholders appropriate based on parent corporation's inequitable conduct).

Courts within the Second Circuit, however, have long recognized that a bankruptcy court's inherent equity jurisdiction permits the court to disallow or subordinate claims, absent inequitable conduct, where the facts of a particular case merit such treatment. *See In the Matter of Colin*, 44 B.R. 806; *In re Johns-Manville Corp.*, 68 B.R. 618 (Bankr. S.D.N.Y. 1986), *aff'd*, 78 B.R. 407 (Bankr. S.D.N.Y. 1986), *aff'd sub nom., Kane v. Johns-Manville Corp.*, 843 F.2d 636 (2d Cir. 1988); *Keene Corp.*, 162 B.R. 935.

In the Matter of Colin, noted *supra*, involved the prosecution of an adversary proceeding by one Chapter 11 bankruptcy estate against another Chapter 11 bankruptcy estate. *See In the Matter of Colin*, 44 B.R. at 807. In September 1981 Swift Aire Lines, Inc. ("Swift") filed for Chapter 11 protection. *See id.* In May 1982 the Chapter 11 Trustee for the Swift estate commenced an adversary proceeding against Justin Colin ("Colin"), a former director of Swift, alleging breach of contract and fiduciary duties while Colin was a Swift director and seeking compensatory damages of approximately $11 million and punitive damages in the amount of $10 million. *See id.* Colin filed his own Chapter 11 case in August 1982 and the Swift Trustee subsequently filed a claim against the Colin estate based on the Swift adversary complaint ("Swift claim"). *See id.* at 807-808. The creditors committee of the Colin estate objected to the allowance of the Swift claim and sought subordination of the of its punitive damages component pursuant to Code § 510(c). *See id.* at 808. The Swift Trustee argued that equitable subordination was unavailable since there had been no demonstrated inequitable conduct on the part of Swift. *See id.* at 810.

In rejecting the Swift Trustee's "suggestion that Congress determined that inequitable conduct represents the exclusive basis for equitable subordination under [Code] § 510(c)" the court subordinated the punitive damages component of the Swift claim reasoning that punitive damages "are imposed, not to afford redress, but to deter future conduct...[and i]f, as in this case, punitive damages are to be paid, not by the alleged wrongdoer, but by his estate, the purpose of the [punitive damages] penalty is not served...[and t] the effect would be to force innocent creditors sharing in the debtor's assets to pay for his wrongdoing. Such a result is clearly untenable, and patently inequitable." *In the Matter of Colin*, 44 B.R. at 810.

In the notable and protracted case *In the Matter of Johns-Manville Corp.*, the debtor, a producer of asbestos and asbestos related products, was the target of tens of thousands of asbestos-related claims at the time of the filing of its Chapter 11 petition in August 1982. *See generally, In re Johns-Manville Corp.*, 68 B.R. 618 (Bankr. S.D.N.Y. 1986), *aff'd*, 78 B.R. 407 (Bankr. S.D.N.Y. 1986), *aff'd sub nom., Kane v. Johns- Manville Corp.*, 843 F.2d 636 (2d Cir. 1988). The debtor's plan of reorganization provided for the creation of a trust to assume and maintain the debtor's current and future asbestos claim liability exposure. *See id.* at 621. The basic structure of the trust, as proposed in the debtor's reorganization plan, was as follows:

> The Trust will initially be funded with $815 million in cash, receivables and insurance proceeds. The Trust will also receive $75 million per year from Manville for a 24 year period commencing 3 years after its inception. Ultimate funding is in excess of approximately $2.5 billion. In addition, the Trust will own or have access to up to 80% of Manville's common stock. Finally, the Trust will have the right to call on up to 20% of the profits of the corporation, beginning 4 years after its inception and continuing for as long as necessary to satisfy asbestos health claims.

Id. The plan also provided for an injunction limiting the trust's exposure to punitive damages by future claimants. *See id.* A group of claimants identified by the court as the "Asbestos Health Victims" objected to the confirmation of the debtor's plan and the resulting trust citing, *inter alia*, the "features of the [i]njunction which disallow punitive damages in asbestos-related claims against the Trusts..." *Id.* at 621.

In overruling the Asbestos Health Victims' objection to confirmation, the court, much akin to the court in *Colin*, opined that "[t]o allow recovery of punitive damages, of course, would be to risk the depletion of Trust assets to the benefit of known victims at the expense of future claimants. Such a result is inequitable on its face." *Id.* at 627. Furthermore, the court found that none of the salutary purposes of punitive damages, namely to punish the tortfeasor and deter wrongful conduct, would be served because the punitive damages would be paid from the resulting trust rather than out of the pockets of the tortfeasors.[12] *See id.* at 627.

The corporate debtor in *Keene Corp. v. Acstar Insurance Co. (In re Keene Corp.)* was defending over 100,000 asbestos-related property damage, death and personal injury cases when it filed for Chapter 11 protection in 1993. *See Keene Corp.*, 162 B.R. at 938. At the time of filing, the enforcement of approximately $63 million in adverse judgments against the debtor was stayed by virtue of the debtor having posted *supersedeas* bonds pending appeal. *See id.*

[12]Inherent in the litany of cases interpreting the bankruptcy court's equity jurisdiction noted herein is that it is a proper invocation of that jurisdiction to disallow or equitably subordinate contingent, unliquidated claims, in most cases contingent punitive damage awards, with no offense to the Constitutional prohibition against decisions that are advisory in nature. *See generally*, Phillip M. Kannan, *Advisory Opinions by Federal Courts*, 32 U. RICH. L. REV. 769 (May 1998)(discussing the history and development of the jurisprudential prohibition against issuing advisory opinions). The type of dispute that exists in the instant case has been visited by other courts and they, along with this Court, found such disputes ripe for adjudication. This fact is noted without further discussion simply to allay any concerns by the parties that no part of this decision should, in any manner, be construed as advisory in nature.

However, because approximately $29 million of the aforementioned adverse judgments were final, non-appealable judgments, the debtor moved in bankruptcy court for a temporary restraining order and preliminary injunction to prevent execution on the *supersedeas* bonds. *See id.* In support of its motion for preliminary injunction the debtor argued, *inter alia*, that the punitive damage component of the subject judgments should be disallowed or equitably subordinated pursuant to the court's general equitable powers. *See id.* at 945. The court recognized that the debtor "correctly argue[d] that ***a Bankruptcy Court can subordinate, disallow or limit punitive damage claims***...", but noted that such relief was inappropriate because enforcement would not be had against the bankrupt estate, but rather against the sureties bonding the judgment. *Id.* at 946-947(citation omitted).

Courts in other Circuits have similarly disallowed or equitably subordinated certain claims based upon the bankruptcy court's equitable power to do so in light of the impact of allowing the claim based on the merits of the particular case. *See Novak v. Callahan (In the Matter of GAC Corp.)*, 681 F.2d 1295 (7th Cir. 1982)(holding that the bankruptcy court properly disallowed claims for punitive damages where the detriment of allowing such claims would inure to the innocent creditors and no deterrent effect would be realized since the claims would be paid out of estate rather than out of the pocket of the wrongdoer); *Olympia Equipment Leasing Co. v. Western Union Telegraph Co.*, 786 F.2d 794 (7th Cir. 1986)(stating in *dicta* that the effects of bankruptcy itself were punishment enough such that the policy considerations behind punitive damages could not justify their allowance against the debtor); *In re A.H. Robins Co.*, 89 B.R. 555 (holding that the bankruptcy court's equity jurisdiction provides the court with the power to disallow punitive damages claims considering the effect on reorganization in allowing such claims, the debtor's uncertain exposure to such claims, the hardship such claims would visit on other creditors rather than the wrongdoer and the lack of policy ends achieved in allowing such claims); *In re Allegheny Int'l, Inc.*, 106 B.R. at 79 (stating that "[w]e believe that the equitable powers of the bankruptcy court enable us to eliminate, subordinate, or limit punitive damages" but found such a ruling premature until the debtor's exposure to punitive damages had been liquidated in the pending district court court personal injury action); *Jim Walter Homes, Inc.*, 146 B.R. at 1022 ("this Court is satisfied that considerations of fundamental fairness, applied to the circumstances of these reorganizations, mandate that punitive damage claims like those asserted by the Homeowners be disallowed."); *cf. In re Allied Mechanical Services, Inc.*, 38 B.R. 959 (Bankr. N.D. Ga. 1984)(holding that $700 fine for OSHA violation would not be disallowed or equitably subordinated since, due to debtor's reorganization and continued operation, remedial effect of fine could be achieved);

In 1996 the Supreme Court addressed the appropriate exercise and scope of the bankruptcy court's power of equitable subordination under Code § 510(c) in *U.S. v. Noland*, noted *supra*. The corporate debtor in *Noland* filed a Chapter 11 petition in April 1986 and continued to operate as debtor-in-possession until June 1988 when the company moved to convert its case to one under Chapter 7 due to the incurrence of several post-petition tax liabilities. *See Noland*, 517 U.S. at 536. After the bankruptcy court approved the debtor's motion to convert and a Chapter 7 trustee was appointed, the Internal Revenue Service ("IRS") filed claims for post-petition, pre-conversion taxes, interest and penalties. *See id.* The debtor and the IRS disagreed on the priority to be given to the penalty component of the IRS's claim. *See id* at 537. The bankruptcy court held that the penalty component of the IRS's claim was an administrative expense, but subjected that portion to equitable subordination pursuant to Code § 510(c). *See id.* at 537. "In so doing, the [bankruptcy] court read that section to provide authority not only to deal with inequitable conduct..., but also to adjust a statutory priority of a category of claims." *Id.* The District Court affirmed, as did the Sixth Circuit Court of Appeals stating that "***[b]ecause of the nature of*** postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe ***such claims are susceptible to subordination***." *In re First Truck Lines, Inc.*, 48 F.3d 210, 218 (6th Cir. 1995), *as quoted in Noland*, 517 U.S. at 538 (emphasis added).

After granting *certiorari*, the Supreme Court queried whether the expansive language of Code § 510(c), clearly a sign that the Congress intended bankruptcy courts to further develop the doctrine of equitable subordination, was so expansive so as to permit a bankruptcy court to subordinate or reorder claims "at odds with the congressional ordering of priorities by category." *Noland*, 517 U.S. at 540. The Court held that Congress' "adoption in § 510(c) of 'principles of equitable subordination' permits a court to make exceptions to a general rule ***when justified by particular facts***...[b]ut if the provision 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...and the statute would delegate legislative revision, not authorize equitable exception." *Id.* (internal citation omitted). Notably, while acknowledging the authority of the bankruptcy court to subordinate claims when justified by the particular facts of a given case, the Court found the type of categorical subordination employed by the lower courts in derogation of the statutory priority scheme an extremely improbable reading of the broad language used in Code § 510(c). *Id.* Particularly offensive to the Court's construction of the principles of equitable subordination was the Court of Appeals' acknowledgment that a balancing of equities in individual cases is required in the employment of the doctrine, yet it nonetheless subordinated the IRS's penalty claims because by their very "nature" were "susceptible to subordination." *Id.* at 541, *quoting In re First Truck Lines, Inc.*, 48 F.3d at 218. Such rationale, the Court opined, "was inappropriately categorical in nature." *Noland*, 517 U.S. at 543. In so finding, the Court reasoned that the result of employing equitable subordination based on the nature of certain claims would inevitably result in consistent application of the rule to claims of that nature which, in turn, renders moot a balancing of the merits of such subordination based on the equities of a given case and thereby usurping Congressional policy judgment. *See id.* at 541. To this end, "the 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." *Id*. at 543. Thus, the principle to be divined from the Supreme Court via *Noland* "is simply that categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority to order equitable subordination under [Code] § 510(c)." *U.S. v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 229 (1996)(applying *Noland* in a Chapter 11 context).

In the instant case, the Trustee maintains that he does not seek categorical disallowance or subordination of the punitive damages component of CIGNA's claims based on their nature as punitive damages, rather, the Trustee contends that the equities of this case merit such treatment. In support of this argument the Trustee directs the Court to the detriment that would inure to the innocent general unsecured creditor class if the punitive damages component were allowed in full. However, at least one post-*Noland* court in this Circuit has rejected this rationale as the sole basis for equitably subordinating or disallowing punitive damages in a Chapter 11 bankruptcy case. In *In re Infiltrator Systems, Inc.*, Bankruptcy Judge Robert L. Krechevsky opined that a "debtor's argument that punitive damages should be disallowed as a matter of law because they impose a penalty on innocent creditors lacks merit...[because]...the United States Supreme Court [has] held that the bankruptcy courts could not categorically disallow such claims." *In re Infiltrator Systems, Inc.*, 248 B.R. 707, 711 (Bankr. D. Conn. 2000), *citing Noland*, 517 U.S. 535; *see also, Jim Walter Homes, Inc.*, 247 B.R. 510 (holding that the negative impact on a reorganized debtor's future operation alone is insufficient to disallow punitive damages claims where the debtor's plan is substantially consummated). This Court agrees with Judge Krechevsky's learned interpretation. Equitably subordinating or disallowing the punitive damages component of a creditor's claim based solely on the notion that refusal to do so would punish an innocent creditor body is, by its nature, categorical treatment. The rationale as employed by the Trustee in the instant case is simply a pretense to a balancing of the equities test, shrouding what in reality is categorical treatment. This is necessarily so because the allowance, of any punitive damages claim, in any case, would likely be to the detriment of those similarly situated or inferior classes of claims. The result being the evolution of a *per se* rule favoring such treatment of punitive damages in all bankruptcy cases in clear derogation of the Supreme Court's ruling in *Noland*. *See Moyer v. Official Creditors Comm. of Paint and Assembly Corp.*, 2001 WL 290384, *4 (S.D. Ind. 2001)("The power of equitable subordination cannot be exercised in such a way that the inevitable result would be the equitable subordination of every claim that falls within a certain category.")(citation and internal quotation omitted).

However, this is not to say that the Supreme Court's decision in *Noland* should be read as abrogating the bankruptcy court's authority to subordinate punitive damages claims ***at all***, rather, it serves as a quantification of considerations when employing the doctrine. That is to say that the bankruptcy court's equity jurisdiction does, in fact, permit it to make exceptions to a general rule when specific facts merit such exception, but not where such exception is denial of a category of claims at a legislative level of generality. *See In re Infiltrator Systems, Inc.*, 248 B.R. at 710. Thus, in the instant case this Court must consider whether the facts of this particular case justify equitably subordinating the punitive damages component of CIGNA's claim and if so, would such subordination offend the *Noland* rule. The Court will address the perceived equities in favor of subordination in turn.

First, the parties generally do not dispute that if not subordinated or disallowed, the trebled damages component of CIGNA's claim would reduce the proceeds available to fund a distribution to the general unsecured creditor class. CIGNA characterizes the dilution of available proceeds to that class by one-half of one *per cent* as *de minimis*. Under certain circumstances, a less than one *per cent* reduction in distribution may, indeed, be appropriately characterized as *de minimis*, but quite simply, that cannot be said based on the facts of this case. As the Trustee correctly points out, many of the individual members of the class of general unsecured creditors are unsuspecting investors in the Debtor entities who, during the protracted five-year administration of this case have been assured of one thing, namely that the dividend they will ultimately receive from these Estates will be something significantly less than their respective investments. This Court is loath to further dilute the distribution owing to that class and to further dishearten that body of creditors. While this fact may not, as discussed above, be the sole consideration for subordinating a creditor's claim for punitive damages, it is a consideration nonetheless and one that weighs heavily in favor of subordinating CIGNA's claim for trebled damages based on the equities of this case. *See Moyer*, 2001 WL 290384, *6 ("Thus, while the nature and substance of a...claim is an important issue to be resolved by the bankruptcy court, it cannot be the only factor in determining when equitable subordination is appropriate.").

Second, the Trustee seeks not to subordinate or disallow the compensatory components of CIGNA's claims, rather, only that portion of CIGNA's claims which, under the federal RICO civil remedial scheme entitles successful claimants to triple its awarded damages. Assuming *arguendo*, that CIGNA were to be successful in the prosecution of its claims in the District Court action, the resulting award of compensatory damages would, in effect, make CIGNA whole. While the Court is cognizant of the punitive and/or deterrent effects of trebling provisions in certain types of cases, the Court is more concerned that parties-in-interest in this case receive maximum recovery based on actual loss, than with policy considerations that may or may not play a role with respect to these Debtors. CIGNA is no more entitled to a higher percentage of recovery merely because it thought to plead a cause of action which trebles its compensatory recovery. This too weighs in favor of subordination.

Third, the Court finds it unlikely, in any event, that any of the policy concerns behind RICO's trebling provisions will be served by leveling such recovery against these Estates. While this Court is aware that some courts have interpreted RICO's trebling provision to be punitive in nature, that is to say that it is meant to punish the wrongdoer by enhancing the actual damage award to the wrongdoer's victim, and still others have interpreted RICO's trebling provision as exemplary in nature, that is to say that imposing an enhanced award will make an example out of the wrongdoer and deter similar activity by prospective wrongdoers, this Court need not address those policy concerns. *See e.g., Southwest Marine, Inc. v. Triple A Machine Shop, Inc.*, 720 F. Supp. 805, 810 (N.D. Calif. 1989) ("The civil remedy provision of RICO, 18 U.S.C. § 1964, provides for treble damages which are themselves punitive in character."); *Pine Ridge Recycling, Inc. v. Butts County, Georgia*, 855 F. Supp. 1264, 1273 (M.D. Ga. 1994)("In the court's best judgment, RICO's treble damages are punitive..."); *Holford USA Ltd., Inc. v. Harvey*, 169 F.R.D. 41, 43 (S.D.N.Y. 1996)("I hold that an action under Section 1964(c) for treble damages is remedial...")(citation omitted); *see generally*, Judith A. Morse, *Treble Damages Under RICO: Characterization and Computation*, 61 NOTRE DAME L. REV. 526, 533-534 (1986)(The RICO trebling provision "can be used to (1) encourage private citizens to bring RICO actions, (2) deter future violators, and (3) compensate victims for all accumulative harm.")(footnotes omitted). This is necessarily so because ***neither*** purpose would be served in this case by allowing CIGNA to triple its prospective award. In this regard, if the treble damages provision found in RICO is, indeed, punitive in nature then its punitory effect would not be borne out by the wrongdoer, but rather by the body of general unsecured creditors, as discussed *supra*. However, if exemplary in nature, then trebled damages in this case would be devoid of any deterrent effect. The Debtors in this case have been scrutinized under the watchful eye of the Trustee for over five years, embroiling these Debtors in protracted and complex litigation. Some of the Debtors' principals have been convicted and sentenced to lengthy sentences in federal prison. Millions of dollars have been or will be allocated for the employment of attorneys to sort out the Debtors' financial shortcomings and the legal morass created by its pre-petition business activities. Ultimately, the Debtors will be liquidated and, if the Trustee has anything to say about it, the Debtors will be remembered as having perpetrated the largest Ponzi scheme in American history. In light of the legacy that the Debtors have etched, allowing trebled damages of $10 million, would be beating the proverbial dead horse. What has become of these Debtor entities and those associated with them provides adequate deterrence to such activity and allowing treble damages in this case would likely go unnoticed by anyone other than CIGNA, the Trustee, the class of general unsecured creditors and this Court.

Fourth, while the Court will not go so far as to say that allowing CIGNA's trebled damages would result in a "windfall", there are certainly fundamental elements of unfairness to allowing CIGNA's claims in full. The Court agrees with the Trustee that allowing CIGNA triple recovery is essentially taking the recovery out of the pocket of one fraud victim and placing in the pocket of another, simply because the latter had the foresight to plead a RICO cause of action. This foresight should not afford CIGNA greater rights than those similarly situated creditors holding claims against these Estates. From the outset of this case, great care and careful scrutiny has been taken to ensure equal treatment of the victims of the Debtors' fraud, and CIGNA's claim is no different.

Fifth, the uncertainty of the resulting exposure and delay these Estates would be subjected to if CIGNA's claims were allowed in full, troubles the Court. Were this Court to be inundated with thousands of motions by similarly situated creditors seeking to amend their proof of claim to now include treble damages based on a potential RICO cause of action, the administration of these Estates would be set back months if not years while the Trustee defended against such motions and attempted to determine the Debtors' exposure on those potential claims. While admittedly the Debtors' exposure to CIGNA's claim has been limited by CIGNA's claim to $15 million, the resulting exposure from similarly situated claimants is, indeed, potentially staggering.

Thus, the equities of this case, having been fully considered by this Court, clearly favor the treatment sought by the Trustee in the form of equitable subordination. The Court notes that it has considered two factors which might weigh against subordination in this case. First, there is no expectancy that the Debtors will emerge from bankruptcy as a going concern and as such, any recovery cannot be seen as prejudicing the Chapter 11 process or the Debtors' ability to garner a fresh start in the marketplace. Second, CIGNA's RICO claim comes in the form of a counterclaim in a suit brought by Aloha and the effect of subordinating the allowance of treble damages against these Estates may or may not be conclusive of CIGNA's desire to prosecute its RICO cause of action in the District Court. Nonetheless, the Court finds that the equities of this particular case justify subordinating a trebled recovery by CIGNA in the District Court action. Furthermore, because the Court finds that the relief sought by the Trustee may adequately be had by equitably subordinating that portion of CIGNA's claim representing treble damages, an order totally disallowing that portion of CIGNA's claim is not warranted.

As a final note, there should be no misunderstanding that this holding is based on and limited to the findings herein. Nothing in this decision should be construed as holding, as a matter of law, that treble damages are, by their very nature, susceptible to subordination. Such a finding would clearly violate the Supreme Court tenet as expressed in *Noland* and its progeny. *See Noland*, 517 U.S. at 543; *Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. at 229; *see also, In re Infiltrator Systems, Inc.*, 248 B.R. at 711.

Based on the foregoing , it is hereby

ORDERED, that the Trustee's Motion pursuant to Code § 510 to equitably subordinate that portion of the claim of CIGNA's claim representing treble damages pursuant to RICO is granted, and it is further,

ORDERED, that the Trustee's Motion pursuant to Code § 510 to equitably subordinate that portion of the claim of CIGNA's claim representing statutory attorneys's fees pursuant to RICO is denied, and it is further,

ORDERED, that the Trustee's Motion pursuant to Code § 502 to disallow that portion of the claim of CIGNA representing treble damages and statutory attorneys' fees pursuant to RICO is denied.

Dated at Utica, New York

this 5th day of July 2001

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge