A BANKRUPTCY TRAP FOR THE UNWARY CREDITOR: EQUITABLE SUBORDINATION RESULTING FROM EXCESS CREDITOR CONTROL

I. Introduction

Commercial creditors tend to keep a watchful eye over the debtors with whom they conduct business. Such caution is a natural reaction for any creditor who invests a large sum of money with an independent debtor. The financial well being of the debtor directly affects the creditor's ability to recover loan proceeds. As the debtor's financial condition worsens, the creditor instinctively increases its involvement, sometimes to the point of domination. Although beneficial to the creditor in some aspects, increased control of the debtor puts the creditor at a substantial risk of having its claims equitably subordinated to the claims of other creditors in the event of bankruptcy. This discussion addresses the extent to which a nonmanagement creditor may become involved in the management and control of its debtor without being subject to equitable subordination should its debtor file for bankruptcy.

II. Equitable Subordination Standards

Section 510 of the Bankruptcy Code,[1] specifically subsection c, memorializes the long existing authority of the courts to subordinate a creditor's claim on equitable grounds.[2] The Code provides that:

> [A]fter 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.[3]

The Bankruptcy Code fails, however, to specify the circum-

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[1] 11 U.S.C. § 510 (1978).

[2] *In re* Beverages Intern. Ltd., 50 Bankr. 273, 280 (Bankr. D. Mass. 1985).

[3] 11 U.S.C. § 510(c) (1978).

stances under which the courts may order equitable subordination.[4] Thus, the evolution of the doctrine is left to the courts.[5] As a result, the doctrine continues to evolve.[6]

The generally accepted test used by courts to determine whether equitable subordination is appropriate, as first enunciated in *Mobile Steel*,[7] requires the following:

(1) the claimant engaged in some type of inequitable conduct;
(2) the misconduct resulted in injury to creditors or conferred an unfair advantage upon the claimant; and
(3) equitable subordination is not inconsistent with provisions of the Bankruptcy Act.[8]

The question of whether a particular type of conduct is "inequitable" is highly dependant upon the facts of each case.[9] As a result, the first prong of this test is the source of much equitable subordination litigation.

The first prong of the *Mobile Steel* test, read literally, appears to cover a broad range of factual situations.[10] This appearance is deceptive[11] because, in practice, the courts have generally restricted equitable subordination in the bankruptcy context to three categories of cases:[12]

(1) those in which a fiduciary of the debtor misuses his position to the disadvantage of other creditors;[13]

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4 *See, e.g.*, *In re* Universal Farming Industries, 873 F.2d 1334, 1336 (9th Cir. 1989). The scope of subordination should be "to the extent necessary to offset the unfair advantage of the harm which the creditors suffered on account of inequitable conduct." *In re* T.E. Mercer Trucking Co., 16 Bankr. 176, 189 (N.D.T.X. 1981).

5 *See* DeNatale & Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 Bus. Law. 417, 421 (1985) [hereinafter DeNatale & Abram].

6 *See supra* note 2, at 280 (noting that Congress left to the courts the responsibility of developing this principle).

7 *In re* Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1977).

8 *See* Mobile Steel, 563 F.2d at 700.

9 *See* DeNatale & Abram, *supra* note 5, at 426, 442 (describing the "difficulty of establishing general rules for a concept . . . that turns on the facts of each case.").

10 Mobile Steel, *supra* note 7 at 700; DeNatale & Abram, *supra* note 5, at 429.

11 *See In re* CTS Truss, Inc., 868 F.2d 146, 148-49 (5th Cir. 1989)(citing DeNatale & Abram, *supra* note 5). As DeNatale & Abram have noted "only in a handful of cases have the courts seen fit to apply the doctrine." DeNatale & Abram, *supra* note 5, at 429.

12 CTS Truss, 868 F.2d at 148-49.

13 *Id.* at 148 (citations omitted) (citing *In re* Multiphonics, Inc., 622 F.2d 709 (5th Cir. 1980)).

(2) those in which a third party in effect, controls the debtor to the disadvantage of others;[14] and
(3) those in which a third party defrauds other creditors.[15]

While the courts have found a number of categories of conduct which satisfy the first prong of the *Mobile Steel* test,[16] the list formulated by the Fifth Circuit in *In re CTS Truss*[17] appears to be the most accurate[18] and workable.[19] Compilations by other courts tend to overlap, and thus, are essentially equivalent.[20]

The focus of this discussion will be on the second category noted in the *CTS Truss* case, that is, control of the debtor to the disadvantage of others. Before reviewing the factual situations involved when a nonmanagement creditor is subordinated under category two of the *CTS Truss* test, it is first necessary to examine the

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[14] *Id.* (citations omitted) (citing *In re* American Lumber Co., 5 Bankr. 470 (Bankr. D. Minn. 1980) (bank having control over a debtor's operations had duty to deal fairly and impartially with debtor's unsecured creditors)).

[15] *Id.* (citations omitted) (citing *In re* Bowman Hardware & Electric Co., 67 F.2d 792 (7th Cir. 1933) (creditor instructed debtor to conceal loan by not recording the indebtedness on debtor's books and financial statements)).

[16] For instance, many courts list the categories of conduct which satisfy the inequity prong of the Mobile Steel test as:
(1) fraud, illegality or breach of fiduciary duties;
(2) under capitalization; and
(3) a claimant's use of the debtor as a mere instrumentality or alter ego.

See, e.g., In re Clark Pipe and Supply Co., Inc., 893 F.2d 693, 699 (5th Cir. 1990); *In re* Beverages Intern. Ltd., 50 Bankr. 273, 281 (Bankr. D. Mass. 1985). Other courts have represented the categories of conduct by stating that the creditor must:
(1) have acted in a fiduciary capacity;
(2) have breached a fiduciary duty;
(3) have committed a breach that resulted in detriment to those claimants to whom a duty was owed; or
(4) have committed an act of moral turpitude, causing damages to other creditors.

In re Pinetree Partners, Ltd., 87 Bankr. 481, 488 (Bankr. N.D. Ohio 1988) (citations omitted) (citing *In re* W.T. Grant Co., 4 Bankr. 53, 74 (Bankr. S.D. N.Y. 1980)).

[17] 868 F.2d 146 (5th Cir. 1989).

[18] The list compiled in the *CTS Truss* case is the most representative of typical fact patterns that give rise to judicial scrutiny.

[19] Because the *CTS Truss* list is the most accurate, it naturally follows that it is also the most workable when used as precedent and guidance.

[20] For instance, some courts devote several categories solely to elements of breach or types of breaches of fiduciary duty; however, these could be treated, perhaps more appropriately, as subsets within the first category of the *CTS Truss* list. *See In re* Pinetree Partners, Ltd., 87 Bankr. at 488.

burden of proof and level of inequitable conduct required.[21]

A. *The Insider-Noninsider Distinction*

An adverse party to a creditor's claim in bankruptcy has the burden of proving "by a preponderance of the evidence that the claimant engaged in such substantial inequitable conduct to the detriment of the other creditors that subordination is warranted."[22] The level of inequitable conduct which must be proven has been a fertile subject for discussion by the courts. The courts decide this threshold level of inequitable conduct by first determining whether the claimant should be held to the standard of an insider[23] or non-insider.[24] This decision is rela-

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21 The burden of proof relates to the severity of creditor misconduct which must be shown to subordinate its claim; therefore, the burden of proof has a direct impact on the factual circumstances which warrant equitable subordination. As a practical matter, the burdens should be discussed before a factual analysis can be offered.

22 *In re* Teltronics Services, Inc., 29 Bankr. 139, 168-69 (Bankr. E.D.N.Y. 1983) (citing 3 L. KING, COLLIER ON BANKRUPTCY, ¶ 57.18, at 296-97 (14th ed. 1977)).

23 Section 101(31) of the Bankruptcy Code defines the term insider. This section provides that:

> "insider" includes—
> (A) if the debtor is an individual—
> (i) relative of the debtor or of a general partner of the debtor;
> (ii) partnership in which the debtor is a general partner;
> (iii) general partner of the debtor; or
> (iv) corporation of which the debtor is a director, officer, or person in control;
> (B) if the debtor is a corporation—
> (i) director of the debtor;
> (ii) officer of the debtor;
> (iii) person in control of the debtor;
> (iv) partnership in which the debtor is a general partner;
> (v) general partner of the debtor; or
> (vi) relative of a general partner, director, officer or person in control of the debtor;
> (C) if the debtor is a partnership—
> (i) general partner of the debtor;
> (ii) relative of a general partner in, general partner of, or person in control of the debtor;
> (iii) partnership in which the debtor is a general partner;
> (iv) general partner of the debtor; or
> (v) person in control of the debtor;
> (D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;
> (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and

tively simple where the creditor is an insider per se.[25] On the other hand, the decision becomes difficult where the creditor is actually a non-insider who has acted in a manner which may warrant the imposition of a fiduciary standard.[26] Where this occurs, the court must first decide whether the conduct of the non-insider warrants the imposition of a fiduciary standard normally reserved for insiders.[27]

Where a fiduciary standard is imposed upon a creditor governing its conduct with a debtor and competing creditors, the consequences to the restricted creditor can be harmful. An often quoted explanation of effects caused by the imposition or non-imposition of a fiduciary standard was given by the court in *In re Teletronics Services, Inc.*:[28]

> The primary distinctions between subordinating the claims of insiders versus those of non-insiders lie in the severity of misconduct required to be shown, and the degree to which the court will scrutinize the claimant's actions toward the debtor or its creditors. Where the claimant is a non-insider, egregious conduct must be proven with particularity. It is insufficient for the objectant in such cases merely to establish sharp dealing; rather, he must prove that the claimant is guilty of gross misconduct tantamount to fraud, overreaching or spoliation to the detriment of others. Where the claimant is an insider, his dealings with the debtor will be subjected to more exacting scrutiny. If the objectant comes forward with sufficient substantiations of misconduct on the part of the insider claimant, the burden will shift to the insider to establish that each of his challenged transactions with the debtor had all the earmarks of an arm's length bargain.[29]

(F) managing agent of the debtor;
11 U.S.C. § 101(31) (West Supp. 1990).

24 *See In re* Teletronics Services, Inc., 29 Bankr. 139, 169-72 (1983).

25 An insider per se is normally held to a fiduciary standard, and thus, no further inquiry is required. *See id.* at 169.

26 For instance, where the nonmanagement creditor exercises excess control. *See id.* at 170.

27 *Id.*

28 29 Bankr. at 169; *see also In re* Pinetree Partners, Ltd., 87 Bankr. 481 (Bankr. N.D. Ohio 1988).

29 *Teltronics*, 29 B.R. at 169 (citations omitted). The burden varies slightly depending upon the jurisdiction, however; the insider/non-insider distinction is typical.

It is easy to see why a non-fiduciary standard is preferred by creditors.

B. *The Imposition of a Fiduciary Standard Upon Nonmanagement Creditors*

Ordinarily, a nonmanagement creditor has no fiduciary duty toward its debtor or other creditors of its debtor.[30] In fact, the Fifth Circuit in *In re Clark Pipe*[31] stated:

> The permissible parameters of a creditor's efforts to seek collection from a debtor are generally those with respect to voidable preferences and fraudulent conveyances proscribed by the Bankruptcy Act; apart from these there is generally no objection to a creditor's using his bargaining position, including his ability to refuse to make further loans needed by the debtor, to improve the status of his existing claims.[32]

This concept, however, was limited in *In re Pinetree Partners Ltd.*[33] There, the court emphasized that "in the rare circumstances where a creditor exercises such control over the decision making processes of the debtor as amounts to a domination of its will, he may be held accountable for his actions under a fiduciary standard."[34] The factual situations which give rise to imposition of such a standard are discussed below.[35]

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30 *In re* Clark Pipe and Supply Co., Inc., 893 F.2d 693, 702 (5th Cir. 1990)(citations omitted); *Pinetree Partners*, 87 Bankr. at 488. This is a normal result given the fact that nonmanagement creditors are typically noninsiders. *See also* DeNatale & Abram, *supra* note 5, at 430.

31 *Clark Pipe*, 893 F.2d at 702.

32 *Id.* (citing *In re* W.T. Grant Co., 699 F.2d 609, 610 (2nd Cir. 1983)). This relative freedom is a result of the creditor's outsider status.

33 87 Bankr. 481 (Bankr. N.D. Ohio 1988).

34 *Id.* at 489 (citing *In re* Teltronics Services, Inc., 29 Bankr. 139, 170 (Bankr. 1983)).

35 Imposing a fiduciary standard which would relegate a nonmanagement creditor to the status of an insider is not enough for the creditor's claim to be equitably subordinated in bankruptcy. The opposing party must also show that the claimant acted to the detriment of the debtor or other creditors as per the first and second prong of the *Mobile Steel* test. "The [c]ourt must scrutinize the creditor's actual use of its control over debtor's operations to determine whether its control constituted inequitable conduct." *In re* Beverages Intern. Ltd., 50 Bankr. 273, 282 (Bankr. 1985)(citing *In re* T.E. Mercer Trucking Co., 16 Bankr. 176, 190 (Bankr. N.D. Tex. 1981)).

III. Equitable Subordination Due to Excess Control

Although other situations may give rise to equitable subordination of nonmanagement creditors,[36] the focus of this discussion is on the creditor's inequitable control of the debtor.

As noted by DeNatale and Abram,[37] when considering whether there is excess control, the rights of the creditor to protect his position, and of the debtor to be free from unneccessary imposition from the creditor, must be held in balance.[38] In deciding the issue, courts tend to examine the amount of control exerted by the creditor given all the surrounding circumstances.[39] Because the court decisions are predominately focused upon the individual facts of each case, a simple checklist of factors warranting subordination is impractical.[40] Therefore, it is necessary to review the factors considered in individual cases where equitable subordination was considered by the court. It is helpful to study both cases where equitable subordination was granted and where it was denied.

A. *Cases Where the Creditor was Subject to Equitable Subordination*

One of the most influential cases concerning domination and control is *In re American Lumber v. First National Bank of St. Paul.*[41] In that case, the district court found the evidence of inequitable control "overwhelming."[42] The court focused on the following conduct: a) the bank had the right to a controlling interest in the stock of the debtor in case of default;[43] b) since the bank was the debtor's sole source of credit, its decision not to honor the debtor's payroll checks placed the debtor within the

[36] For example, where a creditor misrepresents "to other creditors, either directly or indirectly, the nature of the debtor's indebtedness," courts have subordinated the claims of the offending creditor to the claims of the injured creditors. *See* DeNatale & Abram, *supra* note 5, at 430 (citing *In re* Bowman Hardware & Electric Co., 67 F.2d 792 (7th Cir. 1933)).

[37] *See generally* DeNatale & Abram, *supra* note 5.

[38] DeNatale & Abram, *supra* note 5, at 442.

[39] *Id.*

[40] *Id.*

[41] 5 Bankr. 470 (Bankr. D. Minn. 1980).

[42] *Id.* at 478.

[43] *Id.*

coercive powers of the bank;[44] c) the bank's foreclosure of its security interests in accounts receivable and contract rights deprived the debtor of the only source of ready cash available to conduct business, thus making loans necessary for every expenditure;[45] d) the bank forced compliance with its wishes by hiring security guards to watch over the lumber yard and by cutting corporate officers' salaries to one-sixth their original amount;[46] e) the bank forced the debtor to execute security agreements on its only remaining assets, later telling one of the debtor's employees that he could quit if he disapproved;[47] and f) the bank determined which creditors would be paid and made sure that the only accounts paid were those which would enhance its position.[48]

Other creditors were injured by the fact that the bank refused to pay them after October 24, 1975 and that the bank subsequently received $488,744.65 worth of proceeds from the sale of assets which should have been available to them.[49] The Minnesota District Court, in affirming the bankruptcy court's findings, found that the bank had a duty to deal fairly and impartially with the other creditors due to its control over the debtor.[50] It further found that the bank breached its duty by liquidating assets to its advantage and the disadvantage of the other creditors.[51] The bank's claims were therefore subordinated.[52]

Another important nonmanagement creditor case is *In re Process-Manz Press, Inc.*[53] In that case, the creditor was held to the standard of conduct normally reserved for fiduciaries because the creditor exercised excess control over the debtor.[54] Two of the factors which the court cited as giving the creditor the requisite control were: a) the creditor controlled over ninety percent of the debtor's stock; and b) the creditor controlled all of the debtor's

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44 *Id.*
45 *Id.*
46 *Id.*
47 *Id.*
48 *Id.*
49 *Id.*
50 *Id.* at 477.
51 *Id.*
52 *Id.* at 479.
53 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966).
54 *Id.* at 348-49.

income through assignment of receivables and control of payments.[55] The Illinois district court concluded that the creditor breached the standard of a fiduciary by unfair, inequitable and fraudulent conduct to the detriment of the debtor and other creditors.[56] Specifically, the court determined that "the loan agreement was made with an intent to hinder, delay and defraud creditors" and that the creditor "directed the illegal redemption of stock that deprived the debtor of almost two million [dollars] of working capital."[57] As the court stated "the net effect of the creditor's conduct was to deplete substantially the assets available to general unsecured creditors and to apply these assets to the prior payment of equity interests at a time when the financial condition of the debtor was deteriorating."[58] In closing, the court affirmed the Referee's order to subordinate the creditor's entire claim.[59]

Although the Bankruptcy court in *In re T.E. Mercer Trucking Co.*[60] did not actually order subordination,[61] it declared that if certain factors were proven at trial it would find enough control to impose a fiduciary standard upon the lender.[62] The court further stated that if "actual control was as dominant as the consolidated loan agreements indicate," enough control would exist to impose a fiduciary duty.[63] The court found the terms of the loan agreements "remarkable,"[64] and summarized them by stating that:

> [T]he loan contracts gave Fruehauf joint control of all bank accounts of the Corporate Debtors requiring co-signatures for substantial checks; gave Fruehauf the right to place its designee on the Board of Directors of the Debtors; required all corporate by-laws, stock books and certificates to be delivered to Fruehauf's counsel; gave Fruehauf the right to have one of its employees participate in the day-to-day operations of the

55 *Id.* at 339, 348.
56 The court agreed with the Referee below. *Id.* at 348.
57 DeNatale & Abram, *supra* note 5, at 436.
58 *Id.*
59 *Id.*
60 16 Bankr. 176 (Bankr. N.D.T.X. 1981).
61 The court denied a motion for summary judgment, holding that the determination required further evidentiary hearings. *Id.* at 190.
62 *Id.*
63 *Id.*
64 *Id.* at 189.

> Debtor's premises with complete veto powers on any items or matters whatsoever; gave Fruehauf the right to require the liquidation of all assets of the Debtors and the various other ventures; gave Fruehauf the right to set salaries of officers and directors; required the Corporate Debtors to pledge all their stock, and provided in the event of a dispute between the Mercer Management and the Fruehauf monitoring agent that an appeal would lie to the Fruehauf management for final determination.[65]

The Bankruptcy court concluded that these elements evidenced substantial meddling with management functions normally reserved for the debtor itself.[66] This evidence, however, was only sufficient to bar summary judgment.[67] The court admitted that further evidentiary hearings would be necessarty to resolve the subordination issue.[68]

B. *Cases Where the Creditor Was Not Subject to Equitable Subordination*

The above cases have held creditors to a fiduciary standard based upon excess control of the debtor. Cases where a request for equitable subordination has been denied are also very instructive. These cases help reveal the confines within which a creditor must remain and the limits to which it may jaunt. The following cases illustrate some of the factors the courts may consider in deciding whether the requisite control exists.

In *In re Teltronics Services*,[69] the United States Bankruptcy Court determined that Teltronic's creditor, L M Ericsson Telecommunications, Inc. (LMU) did not have enough control to warrant imposition of a fiduciary standard.[70] The court reasoned that the trustee must "demonstrate that [the creditor] engaged in a very substantial misconduct tantamount to fraud, overreaching or spoilation, which caused other creditors and Teltronics to suffer damages" before the court would impose a fiduciary relationship.[71]

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[65] *Id.* at 189-90.
[66] *Id.* at 190.
[67] *Id.*
[68] *Id.*
[69] 29 Bankr. 139 (Bankr. E.D.N.Y. 1983).
[70] *Id.* at 172-73.
[71] *Id.* at 173.

In discussing the general parameters of imposing a fiduciary duty the court said:

> [A] creditor is not ordinarily a fiduciary of either his debtor or fellow creditors, and owes them no special obligation of fidelity in the collection of his claim. Apart from the provisions of bankruptcy law, such as the automatic stay on collection activity, a creditor normally has an unqualified right to call a loan when due, to refuse to extend a loan for any cause or no cause at all, and to lawfully enforce collection.
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> The general rule that a creditor is not a fiduciary of his debtor is not without exception. In the rare circumstances where a creditor exercises such control over the decision-making processes of the debtor as amounts to a domination of its will, he may be held accountable for his actions under a fiduciary standard. Where the creditor controls the corporate debtor by voting control of its stock, dominant influence in its management or ability otherwise to control its business affairs, the creditor may have a fiduciary duty to its corporate debtor.
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> [Existing case law] strongly suggests that a non-insider creditor will be held to a fiduciary standard only where his ability to command the debtor's obedience to his policy directives is so overwhelming that there has been, to some extent, a merger of identity. Unless the creditor has become, in effect, the alter ego of the debtor, he will not be held to an ethical duty in excess of the morals of the marketplace.[72]

In finding that LMU did not have the requisite control over Teltronics to warrant a fiduciary duty,[73] the court discussed the following factors:

(a) LMU did not own stock or participate in the management of Teltronics;[74]

(b) LMU and Teltronics had no common officers or directors;[75]

(c) "LMU did not control Teltronics indirectly," and the arm's length loan agreements restricting additional outside secured financing were not unconscionable;[76]

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[72] *Id.* at 171 (citations omitted).

[73] *Id.* at 173.

[74] *Id.* at 172 (citations omitted).

[75] *Id.* (citations omitted).

[76] *Id.* (citations omitted).

(d) Although LMU "recommended that Teltronics scale down its growth projections in accordance with LMU's decision to phase-out LMU guaranteed financing," LMU fell "well short of undue entanglement" with Teltronics' operations.[77] There is nothing wrong with suggesting a prudent course of action;[78]

(e) Although LMU imposed C.O.D. payment terms upon Teltronics, the decision to decline to provide additional financing was based on sound business judgment.[79]

The court opined, "[t]here is nothing inherently wrong with a creditor carefully monitoring his debtor's financial situation, or with suggesting what course of action the debtor ought to follow."[80] In light of this standard, the court concluded that "LMU's actions with Teltronics were motivated by sound business judgment," and thus did not warrant imposition of a fiduciary standard.[81]

In *In re Tinsley and Groom*,[82] the bankruptcy court concluded that a non-fiduciary standard was proper.[83] In that case, the creditor Production Credit Association (PCA) loaned the debtors money under "full proceeds" loans whereby the lender takes a secured interest in all assets of the farmer-debtors.[84] Over several years money was loaned to finance crops and expansion on a liberal basis.[85] When the creditors failed to renew the loans during a bad year, the debtors claimed unfair control and sought to have PCA's claims disallowed under the theory of equitable subordination.[86] They specifically claimed that the full proceeds loans constituted enough control over the debtor to impose the benefit of a fiduciary standard.[87]

The bankruptcy court, upon determining that the debtors acted with the advice of independent consultants and exercised independent business judgment at all times, decided that excessive control

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[77] *Id.*
[78] *Id.* (citations omitted).
[79] *Id.* at 172-73 (citations omitted).
[80] *Id.* at 172 (citations omitted).
[81] *Id.* at 173.
[82] 49 Bankr. 85 (Bankr. W.D.K.Y. 1984).
[83] *See id.* at 91.
[84] *Id.* at 88.
[85] *Id.*
[86] *Id.*
[87] *Id.* at 89.

and a corresponding fiduciary standard did not exist.[88] The court further reasoned, "[w]hile the power to approve or reject a loan renewal application is a recognized element of control, exercise thereof in a prudent nonarbitrary manner cannot and does not as a matter of law thereafter impute liability for a loan default on to the approving officer."[89] Although conceding that some control existed,[90] the court denied equitable subordination based on the lower, noninsider standard, citing a lack of "inequitable" control. The court stated "it is not the right of control which is determinative of such result, but rather the unreasonable, arbitrary and/or unwarranted exercise of such control in a given case which dictates applicability of such doctrine."[91] The court observed that the debtors failed to show fraud, overreaching or inequitable conduct.[92]

In *In re Pinetree Partners, Ltd.*,[93] the court denied equitable subordination[94] and gave weight to the fact that "[t]he management of Pinetree was, at all times, in control of the debtor and made the day-to-day decisions necessary for the operation of the business."[95] Although the loan agreement contained many constraints,[96] it was

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[88] *Id.* at 91.

[89] *Id.* at 90.

[90] Some control existed, but not enough to warrant the use of a fiduciary standard. *Id.* at 91.

[91] *Id.* at 90.

[92] *Id.* at 91.

[93] 87 Bankr. 481 (Bankr. N.D. Ohio 1988).

[94] *Id.* at 491.

[95] *Id.* at 489.

[96] The provisions of the OTR-Pinetree transaction documents included:

a. Pinetree was prohibited from engaging in any business other than the operation of the Project without the consent of OTR [the lender].
b. Pinetree was prohibited from constructing new buildings or additions to existing structures without the prior written consent of OTR.
c. Pinetree was prohibited from obtaining secondary financing or other borrowing without OTR's consent.
d. Pinetree was required to pay all closing costs and expenses plus up to $15,000.00 of OTR's legal fees.
e. OTR possessed an absolute veto power with respect to cancellation, modification, or rental adjustments to any existing tenant lease.
f. All existing and prospective leases were to be approved by OTR and assigned to OTR.
g. OTR was entitled to 12.5% fixed interest plus 50% of the difference between the fair market value of the Project and the then outstanding principal balance of the loan on final payment of the promissory note.
h. The $9,000,000.00 loan was payable in monthly installments of $98,175.00 commencing October 1, 1982.

an arm's length agreement and no coercion was applied by the lender (OTR).[97] Additionally, OTR never utilized its veto powers under the agreement to a point where it virtually controlled Pinetree.[98] This case demonstrates the proposition that although power of control may exist, actual control must be exercised before a fiduciary standard will be imposed.[99] It also demonstrates that lending industry standards will be given great weight when determining whether a creditor transcended the relationship of debtor and creditor.[100]

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i. Pinetree was not permitted to prepay the loan prior to the 11th year.
j. Pinetree was required to obtain OTR's consent before selling its interest in the Project.
k. Pinetree was required to obtain OTR's consent before granting to any other party any lien or interest in and to Pinetree's rights in the Project.
l. The ground lease and mortgage both contained cross defaults so that a default by Pinetree under either was a default under both.
m. Pinetree was required to deliver to OTR monthly operating statements and an annual audited financial statement. Additionally, OTR had the right at all reasonable times to inspect books, records, plans, drawings and other documents applicable to the Project.
n. OTR had the right at all reasonable times to enter into and inspect the Project.
o. The ground lease between Pinetree and OTR was for 25 years, unless sooner terminated as provided in the lease.
p. Pinetree, as lessee, had no option to extend the term of the lease. Pinetree had the right to repurchase the land from OTR upon full amortization of the mortgage. The purchase price was to be the fair market value.
q. OTR was entitled to receive additional rent of 50% of the annual cash flow. Annual cash flow was defined as gross revenues minus permitted expenditures for each lease year.
r. Pinetree was prohibited from entering into leases or other agreements which were based on income or profits.
s. OTR had the option to convert the loan, beginning in the 8th year of the loan, to a 60% interest in Pinetree, thereby completely terminating the loan.
t. If OTR did not exercise the conversion option, it was permitted to call the promissory note due and payable at the end of the 11th year after giving Pinetree 12 months' notice.
u. Upon default, OTR had the right to select and require the employment of a managing agent for the Project.

Id. at 484-85. Expert testimony was presented that the above were customary and usual terms. *Id.*

[97] *Id.* at 489.

[98] *Id.*

[99] *Id.*

[100] *Id.* at 485, 488-89. (The court emphasized the arm's length nature of the

In *In re Clark Pipe and Supply Co., Inc.*,[101] the Fifth Circuit, on rehearing en banc, determined that "the sort of control Associates asserted over Clark's financial affairs did not rise to the level of unconscionable conduct necessary to justify application of the doctrine of equitable subordination."[102] Clark Pipe, a steel pipe distributor, agreed with Associates to make "revolving loans secured by an assignment of accounts receivable and an inventory mortgage."[103] All accounts receivable were deposited directly into Associate's account.[104] The amount available to Clark "was determined by a formula, i.e., a certain percentage of the amount of eligible accounts receivable plus a certain percentage of the cost of inventory."[105] Associates had the option of reducing the percentage rates at its discretion.[106]

When Clark's business slumped in 1981, Associates began reducing percentage advance rates.[107] Clark used the advances to keep operating and sold inventory, "the proceeds of which were used to pay off past advances from Associates."[108] Associates never directed Clark to refrain from paying specific vendors nor did it threaten to cut off advances.[109] After paying Associates, Clark had no funds remaining to pay other creditors.[110]

In early 1982, other creditors initiated foreclosure proceedings which culminated in Clark's reorganization petition under Chapter Eleven of the Bankruptcy Act.[111] "The case was converted to a Chapter Seven liquidation on August 31, 1982, and a trustee was appointed."[112] The trustee sought to equitably subordinate the claims of Associates.[113]

In rejecting the contention that Associates had control of Clark,

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transaction and stressed that the rights possessed by OTR "were not excessive in light of the nature of the transaction.").

[101] 893 F.2d 693 (5th Cir. 1990).

[102] *Id.* at 699.

[103] *Id.* at 695.

[104] *Id.*

[105] *Id.*

[106] *Id.*

[107] *Id.*

[108] *Id.*

[109] *Id.*

[110] *Id.*

[111] *Id.* at 695-96.

[112] *Id.* at 696.

[113] *Id.*

the Fifth Circuit pointed out, "we cannot escape the salient fact that, pursuant to its loan agreement with Clark, Associates had the right to reduce funding, just as it did, as Clark's sales slowed."[114] The court considered the following: a) Clark was not insolvent at the time of the agreements;[115] b) "Clark was represented by counsel during . . . negotiations;"[116] c) the loan documents were arm's length agreements and were typical of similar asset-based financings;[117] d) Associates owned no stock of Clark;[118] e) Associates never interfered with the operations of Clark to the extent that the bank did so in *American Lumber*;[119] f) Associates never told Clark who to pay;[120] g) Associates never "place[d] any of its employees as either a director or officer of Clark;"[121] h) Associates never insisted on the removal of any Clark employees;[122] i) "Clark handled its own daily operations;"[123] j) the same procedures for "reporting of collateral, calculation of availability of funds, and the procedures for the advancement of funds were followed throughout the relationship;"[124] k) any control that Associates had was based solely on the powers granted in the loan agreement;[125] and perhaps most importantly; l) "Associates did not coerce Clark into executing security agreements after Clark became insolvent."[126] The loan agreements were entered into at arm's length.[127] The court emphasized, "[a]lthough the terms of the agreement did give Associates potent leverage over Clark, that agreement did not give Associates total control over Clark's activities. At all material times Clark had the power to act autonomously."[128]

In addressing permissive control versus total control the court explained:

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114 *Id.* at 700.
115 *Id.*
116 *Id.*
117 *Id.*
118 *Id.* at 701-02
119 *Id.* at 702.
120 *Id.*
121 *Id.*
122 *Id.*
123 *Id.*
124 *Id.*
125 *Id.*
126 *Id.*
127 *Id.* at 700-02.
128 *Id.* at 702.

> Through its loan agreement, every lender effectively exercises "control" over its borrower to some degree. A lender in Associates' position will usually possess "control" in the sense that it can foreclose or drastically reduce the debtor's financing. The purpose of equitable subordination is to distinguish between the unilateral remedies that a creditor may properly enforce pursuant to its agreements with the debtor and other inequitable conduct such as fraud, misrepresentation, or the exercise of such total control over the debtor as to have essentially replaced its decision-making capacity with that of the lender. The crucial distinction between what is inequitable and what a lender can reasonably and legitimately do to protect its interests is the distinction between the existence of "control" and the exercise of that "control" to direct the activities of the debtor. It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong.[129]

IV. Avoiding Equitable Subordination

Although there is no clear control boundary upon which nonmanagement creditors may rely,[130] a general theme has developed. Actual domination of the will of the debtor to the detriment of other creditors will justify subordination.[131] Additionally, the threat of control, used to coerce the debtor into acting to the detriment of other creditors, will justify subordination.[132]

Although the courts look at all the circumstances in each case to decide whether enough control exists to warrant imposition of a fiduciary standard,[133] they give more weight to certain factors.[134] Among the more weighty factors indicating control are: rights to a controlling interest in the debtor's stock, coupled with use of those rights to coerce the debtor into acting to the

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[129] *Id.* at 701.

[130] DeNatale & Abram, *supra* note 5, at 434.

[131] *Id.* at 432.

[132] *Id.* at 432-33.

[133] *Id.* at 442.

[134] *Id.* at 442 n.112 "Of course, certain indicia of control may be so significant as to tip the scales by themselves. One such indicium would presumably be the exercise of the right to vote the majority of a debtor's stock." *Id.*

detriment of other creditors;[135] actual ownership of a controlling interest in the debtor's stock;[136] a merger of identity between debtor and creditor;[137] unreasonable, arbitrary and unwarranted exercise of control;[138] joint control of the debtor's bank accounts requiring the creditor's signature for all substantial checks;[139] placing employees of the creditor as directors or officers of the debtor;[140] participation of the creditor's employees in the day to day operation of the debtor;[141] loan agreements with provisions that are not within industry standard and provide the creditor with control exceeding the industry norm,[142] and coercing the debtor into executing security agreements after it becomes insolvent.[143] This list is not exhaustive, but simply outlines some of the more important factors that draw judicial scrutiny.[144] Any one factor may not be enough to impose a fiduciary standard. Indeed, the courts usually require a combination of factors. But where one of the listed factors exist, a creditor should review its course of action in light of the development of the doctrine of equitable subordination.

V. Conclusion

The general theme of the doctrine of equitable subordination should always be kept in mind. Creditors who engage in inequitable conduct to the detriment of other creditors will be subject to equitable subordination whenever consistent with the Bankruptcy Code.[145] Although caution is wise, a creditor has

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[135] In re American Lumber Co., 5 Bankr. 470, 478 (Bankr. D. Minn. 1980).

[136] In re Process-Manz Press, Inc., 236 F.Supp. 333, 348 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966).

[137] In re Teltronics Services Inc., 29 Bankr. 139, 171 (Bankr. E.D.N.Y. 1983).

[138] In re Tinsley and Groom, 49 Bankr. 85, 90 (Bankr. W.D.K.Y. 1984).

[139] In re T.E. Mercer Trucking Co., 16 Bankr. 176, 189 (Bankr. N.D.T.X. 1981).

[140] *Id.*

[141] *Id.*

[142] *See* In re Pinetree Partners, Ltd., 87 Bankr. 481, 485, 489 (Bankr. N.D. Ohio 1988); In re Clark Pipe and Supply Co., Inc., 893 F.2d 693, 700 (5th Cir. 1990).

[143] In re Clark Pipe and Supply Co., Inc., 893 F.2d at 702.

[144] It is important to avoid the fallacy that a "simple checklist of indicia can be developed." DeNatale & Abram, *supra* note 5, at 442. The individual facts of each case should carefully be weighed against the facts of other cases where the court considered equitable subordination due to excess control.

[145] *In re* Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1977).

wide latitude in monitoring the activities of the debtor.[146] "Accordingly, a creditor should not forego prudent business practices out of fear of being deemed in control but should apply those practices so as to minimize the danger of control."[147] Planning at the start of a debtor-creditor relationship can minimize the inherent risks.[148]

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146 DeNatale & Abram, *supra* note 5, at 444.
147 *Id.* at 444-45.
148 *Id.* at 445.