12-1-1994

# A creditor's dilemma-equitable subordination of security interests in bankruptcy courts.

Joseph J. Gross

# CENTER FOR APPLIED RESEARCH

# WORKING PAPERS

No. 131 December 1994

## A Creditor's Dilemma – Equitable Subordination of Security Interests in Bankruptcy Courts

by

Joseph J. Gross, J.D., LL.M.
Professor of Law
Lubin School of Business
Pace University

THE LUBIN SCHOOL OF BUSINESS

PACE UNIVERSITY

# THE CENTER FOR APPLIED RESEARCH
## Lubin School of Business
## Pace University



The Center for Applied Research is responsible for organized research within the Lubin School of Business. It provides organizational and editorial assistance to faculty members and students engaged in approved research and development projects.

The Center acts as liaison between the Lubin School of Business, industry, and the public sector through organized research projects, the dissemination of informative publications, and sponsorship of executive seminars and professional conferences on topical issues.

The Center for Applied Research publishes an ongoing series of Working Papers, Case Studies, Monographs, and MBA Papers of Distinction, as well as a Reprint Series of Lubin faculty articles. It also directs the activities of the Case Development Laboratory which assists faculty-student teams in researching, developing, analyzing, and writing business cases for academic use.

The Center sponsors a "Scholarly Colloquia" series which provides a forum for the presentation, discussion, intellectual sharing, and peer-critique of ongoing faculty research.

Associate Membership in the Center ($25 annually) entitles the subscriber to free copies of all Center publications. Single copies of CFAR papers may be obtained upon request. Address all requests to:

The Center for Applied Research
Lubin School of Business
Pace University
Pace Plaza, New York, N.Y. 10038
Telephone: (212) 346-1971

11-94

# A CREDITOR'S DILEMMA - EQUITABLE SUBORDINATION OF SECURITY INTERESTS IN BANKRUPTCY COURTS

by

**Joseph J. Gross, J.D., LL.M.***

Joseph J. Gross is professor of law at the Lubin School of Business, Pace University.

This paper was presented at the annual meeting of the American Association of Legal Studies (American Business Law Association) in Colorado Springs, CO, on August 20, 1993.

The age of economic anguish has returned to the land, from the mountains to the shining seas. No longer do we relish the fantasy of ever-increasing sales, growth, and profits; we seek stability, security, and reassurance.

Commercial lenders are more concerned today with preserving their capital than with romanticizing about phenomenal returns on their investments. The search for security and stability has always relied upon the security interest in personal property and the mortgage of real property as solid footpaths on the trail leading to financial soundness.

The nineties have resulted in an awakening of America to the harsh realities of unemployment, business failure, bankruptcy, homelessness, and disillusionment. This decade has shaken feet firmly rooted in security interests.

Federal Bankruptcy Courts, by subordinating security interests previously created by debtors, have left the financial scene nothing less that chaotic.

The common law of yesteryear and the modern statutes found in the Uniform Commercial Code (U.C.C.), Article IX,[1] have provided creditors (both lenders and sellers) comfortable feelings about the credit value of their money by virtue of the law's recognition of the creditor's security interest in the property of the borrower or buyer (debtor). The chattel mortgage and conditional sales agreement, now the "security agreement" under the U.C.C., create the security interest of the creditor (lender or seller). The real property mortgage which has existed since time immemorial has undergone only slight change in the development of security interests and was only peripherally modified by portions of the U.C.C., Article IX.

Under Article IX,[2] a security agreement (between a lender and borrower or seller and buyer) relating to obtaining money or property, or securing an antecedent debt, or hypothecating collateral, created a security interest in some specific personal property of the debtor or even a floating security interest in unspecified property of the debtor.

Federal law and the Bankruptcy Code[3] have always recognized the enforceability of these secured interests which, in effect, created a super class of preferred creditors in any bankruptcy proceeding. The secured creditors are ordinarily paid first, to the extent of the realized value of the secured asset after sale or other disposition, almost always according to the terms of the security agreement.

The U.C.C. provisions of the state in which the lien is perfected usually determine issues such as validity and priority and other matters.[4] Therefore, the specific provisions applicable to the state in issue under the law of that state should apply.[5] Unfortunately for some secured parties, Federal Bankruptcy Courts, acting under the powers granted under the supremacy clause of the U.S. Constitution[6] have dealt harshly with provisions of Article IX of the U.C.C., particularly where these provisions appear to be at odds with the goal of uniformity which appears to be present in the Bankruptcy Code.

In a leading case, *In re Hamilton*,[7] the U.S. Court of Appeals, Fifth Circuit, discussed the ongoing conflict between security interests created and perfected under Article IX of the U.C.C. and the Bankruptcy Code. The court stated that the conflict results from "a deliberate congressional determination to rely much on the basis of state law, some, if ever, specifically identified and frequently obscure."[8]

However, the Bankruptcy Code had to limit the state law in cases involving security interests. This case held that the state law of Texas, which allowed for a twenty-day grace period for perfection of a security interest by filing the financing statement for a purchase money security interest, was in conflict with the Bankruptcy Code.[9] The Texas statute (U.C.C. Section 9.301 (b)) provides:

> If the secured party files with respect to a purchase money interest before or within twenty days after the debtor receives possession of the collateral, he takes priority over the rights of the transferee in bulk or of a lien creditor which arise between the time of the security interest attached and the time of the filing.[10]

In *Hamilton*, the defendant bank-dealer contended it had priority over other creditors in the bankruptcy proceeding of the debtor because it had filed its lien eleven days after the debtor's agent took possession of the new car from the dealer.[11] The trustee in the bankruptcy sued to recover the auto which had been surrendered to the original selling dealer by the debtor's agent. The trustee contended that this was a voidable preference under Section 547(b) of the Bankruptcy Code and demanded a return of the auto or its cash value from the bank-dealer. Thusly, a supremacy conflict between the state (Texas) law and the Federal Bankruptcy Code was crystallized.[12]

The court held that Section 547(b) of the Bankruptcy Code[13] prohibited an action to avoid a preference of a security interest in property acquired by the debtor if the security interest was perfected on or before ten days after the debtor received possession of the collateral. This holding effectively negated the Texas statute which allowed for twenty days.[14] However, the decision of the court noted that in another circuit it allowed the twenty-day grace period for filing in such a situation under a Tennessee statute.[15]

The issues relating to equitable subordination are much more obfuscated under the Bankruptcy Code.[16] While equality of distribution is the underlying theme of the Bankruptcy

Code, it has its limits.[17] Even though the Code does not expressly authorize a departure from strict equality, tradition has always considered bankruptcy courts as equitable tribunals.[18] *In the Matter of Mobile Steel Company*,[19] the U.S. Court of Appeals for the Fifth Circuit noted that a bankruptcy court:

> [P]ossessed the power to prevent the consummation of a course of conduct by [a] claimant which ... would be fraudulent or otherwise inequitable by subordinating his claims to the ethically superior claims asserted by other creditors.[20]

The court attempted to support the authority for equitable subordination in two diverse statutory provisions of the Bankruptcy Act as it then existed in 1977.[21] The first was Section 2a[22] which states "investing the bankruptcy courts with jurisdiction at law and in equity as will enable them to exercise original jurisdiction under [the Bankruptcy Act]." It then referred to Section 57K[23] authorizing the Bankruptcy Court to reconsider previously allowed claims and to reallow or disallow them "according to the equities of the case."

The U.S. Supreme Court, relying upon this section, had earlier disallowed and subordinated management claims for deferred compensation which had been reduced to judgment. (*Pepper v. Litton*, 308 U.S. at 304-05).[24] However, with the enactment of Rule 307 of the Bankruptcy Rules, superseding 57K of the earlier Bankruptcy Act, the operative language of 57K of "equities" and "equitable considerations" were deleted.[25] The Fifth Circuit held, however, in *Mobile Steel* that the basis of equitable jurisdiction remained in the Bankruptcy Courts notwithstanding the change in statutory language.[26]

A leading case, recently decided in the Bankruptcy Court of the District of Massachusetts, *In re O'Day*,[27] is replete with the equitable nuances discussed in *Mobile*. *In re O'Day* deals with a financial transaction that has become the pandora's box of contemporary corporate America, i.e., the leveraged buy-out.[28]

The O'Day Corporation had its origin in the small company started by George M. O'Day, a boating enthusiast who started building fiberglass O'Day Sailors in 1959. The quality of the boats gave them a first class reputation.

In 1966, Bangor Punta Corporation acquired all the assets of the O'Day Corporation.[29] Later, Bangor acquired CAL, another major sailboat company.[30] Until 1984, Bangor successfully manufactured and marketed both O'Day and CAL auxiliary and non-auxiliary powered fiberglass sailboats.[31] In that year, Lear Siegler, Inc. ("LSI"), a publicly held corporation, acquired the O'Day and CAL lines of sailboats, as well as the Prindle lines of racing catamarans.[32] Following this, all of these boats were then manufactured by Lear Siegler

Marine, a division of Lear Siegler Industrial/Recreation Group, at plants in Fall River, Massachusetts, and Santa Ana, California.[33]

In February 1987, LIS was acquired by an investment group headed by Forstmann Little & Co.[34] This was one of the big leveraged buy-outs of that period, multimillion dollar in size, through which LSI was taken private.[35] Forstmann created Lear Siegler Holdings Corp.[36] to acquire all the stock of LSI, and subsidiary corporations to acquire the assets of subsidiaries and divisions of LSI, including Lear Siegler Marine.[37]

On February 10, 1987, the name of the subsidiary involving O'Day and CAL sailboats was changed to O'Day/Cal Sail Boats Corp ("O'Day/Cal").[38] As part of its leveraged buy-out, Forstmann hired Goldman, Sachs & Co. to sell off O'Day/Cal.[39] Forstmann continued to operate O'Day/Cal until June 30, 1987.[40]

During the same period of time Goldman, Sachs was engaged in trying to sell O'Day/Cal, they had circulated an offering memorandum of O'Day/Cal.[41] Meritor Savings Bank had become aware of Forstmann's desire to sell O'Day/Cal.[42] Meritor had a close relationship with Lance T. Funston,[43] who was in the business of corporate acquisitions, and through one of its leading lending officers, Kenneth E. Jones,[44] brought Funston to Goldman, Sachs. As a result of a letter of interest by Funston, he was given full access to the books and facilities of O'Day/Cal and Prindle (which was a separate corporation owned by Forstmann).[45] Funston then began negotiations with Meritor about financing the stock acquisition. As a result, a deal was made for Funston to borrow $7,200,000 for seven years, and to obtain a revolving credit line of an additional $2,500,000, plus another $1,000,000 in short-term loans.[46] The financial projections made by Jones to support the loan were optimistic to the extent that even in a worst case scenario, the $7,200,000 loan would be repaid in seven years and the revolving credit line would stand at $1.7 million.[47]

A deal between Forstmann and Funston was made for the sale of O'Day/Cal and Prindle for a total of $14.275 million, less a necessary adjustment for less than $2.6 million in operating earnings.[48] The final stated price for the acquisition was $13,195 million. The closing took place on June 30, 1987. Meritor advanced a total of $9,571,411.10, of which O'Day was left with $1,343.45 in cash. O'Day executed a security agreement with Meritor covering personal property. As to O'Day's real property, Meritor, after the closing, obtained real property mortgages on two separate parcels: a large lot on which O'Day's plant was situated and a smaller one (the existence of which was unknown at the time of closing).[49]

Shortly after the closing, O'Day, at Meritor's insistence, sought to extend payments to existing suppliers in order to ease its cash crunch. In December 1987, O'Day obtained an additional $500,000 for shares of equity. In June 1988, Meritor recorded its $10.6 million mortgage, covering all of O'Day's real property.[50]

From the date of closing, O'Day suffered business losses. In the period between May 31, 1987 to May 31, 1988, sales declined 4 percent, gross profit fell to 23 percent, and net income fell from $790,000 to a loss of $346,000. The first and second quarters of fiscal 1988 proved worse than the first fiscal year.[51]

In April 1989, O'Day ceased operations. On April 27, 1989, three creditors of O'Day filed an involuntary petition against O'Day for relief under Chapter 7 of the Bankruptcy Code.[52] On June 1, 1989, Meritor moved for an order seeking to end the court's stay against Meritor in execution of its security interest on chattels and real property mortgages in O'Day's assets.[53] Meritor asserted that O'Day owed it in excess of $8 million.[54] The court ordered a trustee's sale of O'Day's personal property, including intangibles. The sale realized $1.9 million. The real property was not sold. The $1.9 million was put in escrow pending further order of the court.[55]

On March 19, 1990, the trustee filed a complaint against Meritor basically seeking to void Meritor's real property mortgages on O'Day's real property and its claim to the proceeds in the escrow of $1.9 million.[56] It also sought, as alternative relief, to equitably subordinate Meritor's claim to that of the unsecured creditors.[57]

The court held in favor of the trustee with respect to the permanency of the stay against Meritor with respect to its security interest.[58] While it did not hold that payments previously made to Meritor were recoverable by the trustee, the court specifically voided the real property mortgage granted by O'Day to Meritor on June 16, 1988, and subordinated the personal property security interests created on the day of the closing, i.e., June 30, 1987, to the extent necessary to satisfy the claims of unsecured creditors of O'Day pursuant to Section 510 of the Bankruptcy Code.[59]

The reasoning of the court with regard to voiding the real property mortgage hinged upon the issue of fair consideration for the creation of the mortgage lien. The opinion employed a test to determine whether to subordinate the secured parties' debt:

> (1) whether the claimant engaged in inequitable conduct, (2) whether that conduct resulted in injury to other creditors, and (3) whether subordination would be consistent with other provisions of the Bankruptcy Code.[60]

The court pointed to four actions by Meritor that the trustee asserted would justify equitable subordination:

> 1. Creating cash to meet its debt payments by ordering cessation of third-party payments post LBO [leveraged buy-out] ...

> 2. Demanding that the IRB [industrial revenue bond] to be paid off at a time when the Company could least afford, requiring an additional stretch of the third-party accounts payable ...
>
> 3. Demanding and receiving otherwise nonrequired principal prepayments under its term loan to reduce an acknowledged collateral shortfall in the amount of $2.7 million; and
>
> 4. Recording a $10.6 million mortgage in its favor on June 16, 1988, at a time when the Company was not only insolvent, but clearly lacked sufficient working capital on a going-forward basis.[61]

The court, in concluding that Meritor's post LBO conduct constituted overreaching, noted:

> ... the Bank and Funston suffered from an overweening optimism about the Debtor's financial abilities, and their own which addled their ability to valuate the company in light of its financial condition in the months [sic] prior to the LBO, and permitted them to disregard the cyclical nature of the Debtor's business and the industry. The projections prepared by the Bank had no cushion, no room for error. Nevertheless, the Bank approved the loan facilities requested by Funston despite a collateral shortfall. Indeed, the Bank proceeded to close the loan, even though the company did not own assets that comprised a significant portion of the collateral it sought. When the Bank's prognostications failed to materialize due to the foreseeable problems, the Bank set out on a course to improve its own position to the serious detriment of the unsecured creditors.[62]

An important case decided in Pennsylvania,[63] *In re M. Paolella & Sons. Inc.*,[64] relates to the actions of a lender to its customer, a tobacco products wholesaler. MNC Commercial had been lending operating capital to M. Paolella & Sons, Inc., the largest tobacco wholesale distributor in the Delaware Valley. MNC was a secured asset creditor.[65] Paolella was, in fact, liquidating its assets and going out of business. At the time of filing of any involuntary petition in bankruptcy, the debtor owed MNC approximately $11 million (after payments received by MNC resulting from Paolella's sale of its assets prior to the bankruptcy proceedings).[66] In addition to MNC, Paolella's major creditors included The American Cigar Company, The American Tobacco Company, Lorillard, Inc., Phillip Morris, Inc., and R.J. Reynolds Tobacco

Company. The claims of the tobacco companies totaled approximately $4.5 million, of which $1.8 million were reclamation claims against goods recently delivered to the debtor.[67]

As a result of the liquidation of the assets of the debtor by the trustee, MNC received approximately $6.6 million. Nothing was paid to the unsecured creditors of the debtor.[68] The trustee's action against MNC was one to subordinate MNC's claims against the debtor to all unsecured creditors and recover back the proceeds of the sale of the debtor's assets from MNC.[69] The gravamen of the trustee's suit lies in equitable subordination of a secured party's claim. In essence, MNC was alleged to have cut off credit to the debtor under circumstances which knowingly violated the rights of three tobacco manufacturers who were the suppliers to the debtor.[70] The debtor took advantage of special buying programs offered by the three suppliers to buy in volume beyond its ordinary purchases in order to take advantage of reduced prices. This caused the debtor's inventory to increase substantially by reason of the additional credit advanced by the three companies: Lorillard, Phillip Morris, and R.J. Reynolds.[71]

However, because the reclamation claims and the subordination claims were based upon the same facts they were deemed duplicative. The Bankruptcy Court held that the trustee could recover for the benefit of the three tobacco companies involved the money received as interim distributions made by the trustee to MNC.[72]

The basis position taken by the court was that the bankruptcy liquidation was directly caused by the cut-off of credit by MNC during a time that it knew of the increased inventory held by Paolella because of the special deal made to it by the tobacco companies, and for which there was no valid reason at that particular time to cut off credit to Paolella.[73] The court noted:

> The law should not permit what happened here. Lenders should not be able to encourage their borrowers to purchase goods in excess of normal requirements with the intention of refusing to permit the borrower to pay for them after they have been delivered. ... In sum, as to the tobacco company plaintiffs, there is no basis to subordinate MNC's claim to theirs to the extent they had extended the debtor a normal amount of unsecured credit. They understood for some time the risk of nonpayment of their outstanding invoices but continued making unsecured loans because the debtor was the largest wholesaler in the region. ... For three plaintiffs, additional credit was provided in the form of special buying programs, of which MNC was aware. These programs enabled the debtor to obtain additional inventory in two ways. First, two firms allowed it to purchase greater than normal quantities at lower prices. Second, three firms reduced their prices; had they not done so, the amount of inventory purchased by the

> debtor would decrease, since there was no evidence that its credit lines with these suppliers was increased. To the extent of this additional credit only equitable subordination is appropriate.[74]

The entire question of insiders within a bankrupt and equitable subordination of their security interest in the assets of the bankrupt was the subject of a recent case in the U.S. Court of Appeals for the Ninth Circuit,[75] *Stouqmos v. Kilimnik*. Kilimnik, the secured creditor, founded American Alloy Metals ("AAM") in 1965.[76] In 1982, Kilimnik, who was the sole shareholder of AAM, sold the assets of AAM to a new corporation called AAM owned by Peter Suriano, AAM's general manager.[77] Kilimnik changed the name of AAM to WNK Enterprises, Inc. ("WNK"). WNK sold its assets to the new AAM for a down payment of $50,000 and the new AAM's assumption of WNK's trade payables of $365,000 and a promissory note executed by Suriano and the new AAM for $3.95 million. On May 1, 1982, the parties executed a purchase agreement for the sale of WNK's assets to the new AAM and Suriano. After the sale, Kilimnik became president of the new AAM and Suriano, general manager, the same positions each held in the first AAM.[78]

Kilimnik was supposed to receive periodic payments under terms of the $3.95 million note, but no payments were made between September 1982 and August 1985.[79]

Suriano and Kilimnik split in the spring of 1985. The break-up agreement between the two called for Suriano to leave AAM. The agreement provided for Suriano's granting Kilimnik an irrevocable proxy to vote all his stock in AAM, and for AAM to repay the $50,000 down payment made by Suriano in the original purchase agreement and for Suriano to be released from all personal liability on the $3.95 million note to WNK. Kilimnik assumed complete control of AAM as president and proxy holder of all the shares of AAM.[80]

In August 1985, AAM made a $75,000 payment on the note. Kilimnik also received $2,000 for redemption of his preferred stock in the new AAM. On August 29, 1985, Kilimnik gave notice to AAM of his intention to declare the note in default as of September 9, 1985.[81] On September 13, 1985, Kilimnik filed suit in the Washington state court to enforce his security interest in the assets of AAM created by the purchase agreement of May 1, 1982. In the period immediately prior to the bankruptcy petition, AAM had placed unusually large orders with its suppliers. While some payments were made to these suppliers, they continued to press AAM for payment and even threatened legal action to collect payment.[82]

In September 1985, Kilimnik incorporated AAM Aerospace Corrosion International, Inc. ("Aerospace").[83] Immediately thereafter, Kilimnik started to transfer AAM's business and assets to the new corporation. Aerospace took over AAM's facilities, and all AAM's employees became Aerospace employees. AAM moved to a small office away from its earlier facilities and had its phone lines connected to the new address. All of this had been arranged in July 1985.

A temporary employee hired by AAM would take AAM orders and then deliver these orders to Aerospace for completion.[84]

On September 30, 1985, Kilimnik formally resigned as chairman and president of AAM effective October 1, 1985.[85] At a special meeting of shareholders of AAM on October 1, 1985, at which a resolution was adopted directing AAM to waive its rights in its inventory, equipment and receivables and surrender them to Kilimnik in exchange for Kilimnik's agreement to forego a deficiency judgment against AAM. AAM's assets were then formally turned over to Kilimnik. On October 2, 1985, Kilimnik withdrew $104,600 from an AAM deposit account.[86]

An involuntary Chapter 7 petition in bankruptcy was filed against AAM by some of its creditors on October 11, 1985.[87] In February 1986, an action was brought by the trustee in bankruptcy against Kilimnik seeking, among other things, to recover the value of AAM's assets surrendered to Kilimnik's claim in bankruptcy, to equitably subordinate and to impose successor liability on Aerospace.[88] The Bankruptcy Court granted summary judgment to Kilimnik on his claim to enforce his security interest in AAM's assets, held that Kilimnik had received a preferential payment in August 1985, but dismissed the trustee's remaining claims.[89] The District Court affirmed the Bankruptcy Court's decision without discussion. On appeal, the Court of Appeals reversed the District Court in part and sustained it in part.[90] It held that the Bankruptcy Court's refusal to equitably subordinate Kilimnik's claims was an abuse of discretion. The Appeals Court concluded that the Bankruptcy Court's conclusion that Kilimnik was merely a secured creditor, and as such, owed no fiduciary duty to AAM was in error.[91]

The Court of Appeals focused in on the issue of the fiduciary nature of Kilimnik's relationship to AAM. It held that under bankruptcy law, Kilimnik was an insider of the debtor, AAM.[92] The opinion quoted the Bankruptcy Judge:

> In May of 1985, Mr. Kilimnik came back into control of [AAM]; and from that date until the involuntary bankruptcy petition, he did control the corporation, either as president of AAM from the moment it acquired the assets from WNK.[93]

The Court of Appeals noted that a person in control of a corporation is an insider, and where the trustee seeks to subordinate a claim arising from the dealings between a debtor and an insider, the court will give the insider's actions rigorous scrutiny.[94] Here, the Bankruptcy Court's decision suggested that Kilimnik's actions could not withstand this rigorous scrutiny. Kilimnik's self-dealing from 1982 caused injury to competing claimant's or an unfair advantage to Kilimnik individually. After Kilimnik assumed complete control of AAM in 1985, AAM made larger than normal purchases from certain suppliers, suggesting that Kilimnik was building inventory in preparation for his foreclosure on his secured interest.[95]

An earlier case in the Fifth Circuit of the U.S. Court of Appeals, *In the Matter of Clark Pipe and Supply Co., Inc.*, raised in all three of the previously discussed cases, held against equitably subordinating the claims of the secured creditor after having previously granted equitable subordination.[96] The court vacated its earlier opinion and denied equitable subordination to the unsecured creditors.[97] Clark, an oil field supplier, financed its accounts receivable and inventory through a revolving credit arrangement with Associates Commercial Corporation ("Associates").[98] The agreement between Clark and Associates established a line of credit varying between $2.2 million to $2.7 million.[99] The amount of money that Associates would loan to Clark was based upon a formula of 85 percent of the eligible accounts receivable and 60 percent of the cost of Clark's inventory.[100]

Clark was required, as well, to deposit all payments made to it for account receivables in a deposit account belonging to Associates which would advance money to Clark from the same account based upon the agreed formula.[101] The agreement allowed Associates to reduce the percentage used to determine advances in its discretion at any time.[102] Clark's business started to decline and Associates advised Clark that the percentage used would be reduced by 5% beginning January 1982.[103] Thereafter, Clark stopped buying new inventory and its sales revenue declined to about one-fifth of its outstanding accounts payable.[104]

Associates then requested that Clark prepare a budget which detailed Clark's disbursements necessary to keep Clark operational. The budget prepared did not provide for payment to any of Clark's vendors for previously shipped goods (accounts payable).[105] Clark's comptroller operated on the theory that if any money became available, it would be funnelled to Associates.[106] A former loan officer of Associates testified at the Bankruptcy hearing:

> Clark would continue to operate, sell the inventory, turn it into receivables, collect the cash, and reduce my loans ... to get in the best position I can prior to the bankruptcy, i.e., I want to get the absolute amount of dollars as low as I can by hook or crook.[107]

The court's opinion distinguished between a case in which it approved equitable subordination, and upon which it had relied in its earlier opinion granting equitable subordination, i.e., *In re American Lumber Co.* ("American Lumber").[108] Equitable subordination was warranted in *American Lumber* and not *Clark*, the court held, because of dissimilarities in facts. In *American Lumber*, the "bank" controlled the debtor through its right to a controlling interest in the debtor's stock.[109] The bank forced the debtor to convey security interest in its remaining unencumbered assets to the bank after the borrower defaulted on an existing debt.[110] Immediately thereafter, the bank foreclosed on the borrower's accounts receivable, terminated the borrower's employees, hired its own skeleton crew to conduct a liquidation, and selectively honored the debtor's payables to improve its own position.[111] The bank began receiving and opening all incoming mail at the borrower's office and it established a bank account into which it placed all amounts received by the borrower and over which the bank had sole control.[112]

The opinion stressed the absence of direct evidence to support a finding that Associates misled other Clark creditors to their detriment.[113] The earlier opinion granting equitable subordination against Associates relied in part upon a finding that Associates knew that Clark was selling pipe (as part of a liquidation) to which suppliers had a first lien.[114] On rehearing *Clark*, the court decided that the issue of the priority suppliers' first lien had not been decided by the Court of Appeals until after the reputed sales.[115] Another basis for reversal, related to the question of whether Associates encouraged Clark to remove the suppliers' "decals from pipes in its inventory." The court emphasized that the "... lender did not represent to third parties that additional financing was in place or that the debtor was solvent, when the opposite was true."[116]

Agreeing with *Clark*, the U.S. Court of Appeals, *In re Castletons Inc.*, 990 F.2d 551 (10th Cir. 1993), held that the secured party "took appropriate, justifiable actions to protect its security interest ... " was under no fiduciary obligation to its debtor ... to other creditors of the debtor in the collection of its claims'" even though the debtor, after default, was required to deposit all its revenue in a control account maintained by the secured party. In fact, during the ninety days preceding the bankruptcy, the debtor paid off a substantial amount of its $3.6 million line of credit note to the secured creditor.

A major case, *In re Aluminum Mills*,[117] distinguished Clark, if not outrightly rejecting it. The case dealt with perfected security interests held by Citicorp in 85 percent of the common stock of the debtor.[118] Citicorp quoted from *Clark* as follows:

> The crucial distinction between what is inequitable and what a lender can reasonably and legitimately do to protect its interest is the distinction between the existence of 'control' and the exercise of that control to direct the activities of the Debtor.[119]

Citicorp also relied upon the alleged similarity to *In re Badaer Freiqhtways*, 106 Bankr. 971 (Bankr. N.D. Ill. 1989), in which the lender recommended that the debtor employ two men with whom the lender had a close relationship.[120] These two were to be the debtor's chief financial officer and chief operating officer.[121] The lender also recommended that day-to-day authority over management decisions be delegated by the debtor to these appointees.[122] After the dismissal of one and the resignation of the other, the lender demanded repayment of the loan.[123] In *Badaer*, the lender was successful in defending against an equitable subordination action because the court found that debtor's theory failed to allege facts establishing any agency relationship between the two and the lender establish influence but not control.[124]

In *Aluminum Mills*, however, the court found against Citicorp because it had overreached by inducing fiduciaries of the debtor to breach their fiduciary duty to the debtor in order to benefit Citicorp.[125] In essence, the court held that the action for equitable subordination was maintainable against Citicorp. The court noted that Citicorp misread *Badger* (and inferentially *Clark*), because Citicorp insisted that control was equated to day-to-day control.[126] The court stated:

> Control means 'operating control of the debtor's business,' because only then does the lender assume the fiduciary duty owed by corporate insiders. ... The guiding principle is that the lender is liable as a fiduciary if it assumes the power of a fiduciary. Therefore, operating control does not necessarily mean day-to-day control, but may simply be control over the decision that a corporate fiduciary is expected to make. Decisions concerning the termination and replacement of executives, the release of claims, and the filing of a bankruptcy petition are certainly issues which could be decided by fiduciaries.[127]

The Court of Appeals for the Sixth Circuit conceded that equitable subordination no longer required a finding of inequitable conduct as a prerequisite and that a finding of 'gross misconduct' would suffice.[128] However, the court in *In re Baker*[129] appeared not to allow that a new test is

> [A] new standard of overall fairness to be applied on a case-by-case basis, which would allow equitable subordination even in circumstances where no 'gross misconduct' has occurred.[130]

In *Virtual Network*,[131] the Seventh Circuit found that in the legislative history of Section 510(c) of the Bankruptcy Code, that "equitable subordination no longer requires, in all circumstances, some inequitable conduct on the part of the creditor." The *Virtual Network* decision applied a fairness standard and "upheld the equitable subordination of IRS tax penalty claims to other unsecured creditors on the grounds that punitive, non-pecuniary claims of the IRS should be subordinate to actual loss claims."[132]

In *Baker*, the court refused to extend the rule of *Virtual Network* to a case not involving punitive damages, holding, "we see no cause to expand a fairness standard involving punitive damages to a case such as this one, which involves actual loss claims by all parties."[133]

In attempting to reconcile the varying positions on equitable subordination, it appears that while some of the courts, specifically the First, Third, Seventh, and Ninth Circuit Courts of

Appeals have expanded upon the basic principles of *Mobile Steel*, the Fifth, Sixth, and Tenth Circuits have held the line.

Obviously, the extension of the control theory to include any act which is inclusive of an act of a fiduciary nature goes beyond the essential nature of the *Mobile* doctrine. While *Clark* protected the self-interested protective measures taken by the lender under its security agreement, similar measures taken by the lender in *Paolella* were construed unfavorably. Control, in *Clark*, meant day-to-day, while in *Aluminum Mills*, control and breach of fiduciary duty were broadly construed.

Arguably, the Supreme Court may ultimately have to take an interest in discussing the direction that equitable subordination is taking in the Bankruptcy Courts. Its current output has not defined the limits imposed by *Mobile Steel*, which recinded the wide variations between the circuit courts.

## ENDNOTES

1. U.C.C. (1989) The American Law Institute and the National Commissioners on Uniform State Laws.
2. U.C.C. Section 9-102 (1989).
3. 11 U.S.C. Section 547(b).
4. 11 U.S.C. Section 547(c).
5. Ibid.
6. U.S. Constitution, art. V, cl. 2.
7. *In re Hamilton*, 892 F.2d 1230 (5th Cir. 1990).
8. Ibid., p. 1232.
9. Ibid., p. 1234.
10. Ibid., p. 1232.
11. Ibid., p. 1231.
12. Ibid., p. 1233.
13. Ibid., p. 1232.
14. Ibid., p. 1235.
15. *Davis, Gower v. Ford Motor Credit Corp.*, 784 F.2d 604, 607 (11th Cir. 1984).
16. *In the Matter of Mobile Steel Company*, 5636 F.2d 692, 699 (5th Cir. 1977). Ibid., p. 699.
17. Ibid., p. 699.
18. Ibid., p. 692.
19. Ibid., p. 699.
20. Ibid.
21. Ibid.
22. Ibid.
23. Ibid., p. 701.
24. Ibid., p. 699.
25. Ibid.
27. *In re The O'Day Corporation*, 126 Bankr. 370 (Bankr. Ct. District Mass. 1991).
28. Ibid., p. 374.
29. Ibid., p. 373.
30. Ibid.
31. Ibid.
32. Ibid.
33. Ibid., p. 374.
34. Ibid.
35. Ibid.
36. Ibid.
37. Ibid.

38. Ibid.
39. Ibid.
40. Ibid.
41. Ibid.
42. Ibid., p. 375.
43. Ibid.
44. Ibid.
45. Ibid.
46. Ibid., p. 376.
47. Ibid., p. 377.
48. Ibid.
49. Ibid., p. 384.
50. Ibid.
51. Ibid.
52. Ibid., p. 372.
53. Ibid.
54. Ibid.
55. Ibid.
56. Ibid.
57. Ibid., p. 373.
58. Ibid., p. 412, 413.
59. Section 510(c) of the Bankruptcy Code represents a general codification of provisions which enable a bankruptcy court to subordinate claims, a power which had existed under the former Bankruptcy Act of 1898.
60. *In re O'Day, op.cit.*, p. 413.
61. Ibid., p. 412.
62. Ibid.
63. Ibid.
64. *In re M. Paolella Y Sons, Inc.*,1991 Bankr. Lexis 1181 (U.S. Bankr. Ct. E.D. Pennsylvania 1991).
65. Ibid., p. 1.
66. Ibid., p. 2.
67. Ibid., p. 24.
68. Ibid., p. 1.
69. Ibid., p. 4.
70. Ibid., p. 1.
71. Ibid., p. 13.
72. Ibid., p. 96.
73. Ibid.
74. Ibid.
75. *Stouqmos v. Kilimnik*, 1993, U.S. App. Lexis 4221 (9th Cir. 1993).

76. Ibid., p. 1.
77. Ibid., p. 2.
78. Ibid., p. 3.
79. Ibid., p. 2.
80. Ibid., p. 3.
81. Ibid., p. 4.
82. Ibid., p. 3.
83. Ibid., p. 4.
84. Ibid., p. 3.
85. Ibid.
86. Ibid., p. 4.
87. Ibid.
88. Ibid., p. 4.
89. Ibid.
90. Ibid., p. 5.
91. Ibid., p. 33.
92. Ibid., p. 26.
93. Ibid.
94. Ibid.
95. Ibid., p. 27.
96. *In the Matter of Clark Pipe and Supply Co., Inc.*, 893 F.2d 693 (5th Cir. 1990).
97. Ibid., p. 695.
98. Ibid.
99. Ibid., p. 700.
100. Ibid.
101. Ibid.
102. Ibid.
103. Ibid.
104. Ibid.
105. Ibid.
106. Ibid.
107. Ibid.
108. *In re American Lumber Co.*, 5 N.R. 470 (D. Minn. 1980).
109. *Clark, op.cit.*, p. 701.
110. Ibid.
111. Ibid.
112. Ibid.
113. Ibid., p. 702.
114. Ibid., p. 703.
115. Ibid.
116. Ibid.

117. *In re Aluminum Mills Corp.*, 132 Bankr. 869 (U.S. Bankr. Ct. N.D. Illinois, E.D. 1991).
118. Ibid., p. 895.
119. Ibid., p. 894.
120. Ibid.
121. Ibid.
122. Ibid., p. 891
123. Ibid., p. 891.
124. Ibid., p. 894.
125. Ibid., p. 895.
126. Ibid., p. 896.
127. Ibid.
128. Ibid.
129. *In re Baker & Getty Financial Services, Inc.*, 974 F.2d 712 (6th Cir. 1992).
130. Ibid., p. 719.
131. *Matter of Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990).
132. Ibid., p. 1250.
133. *Baker, op.cit.*, p. 719.

Listed below are some of the most recent publications issued by the Center for Applied Research. Apply to the Director, Center for Applied Research, for single copies. Associate Membership in the Center is also available ($25 annually) which entitles the subscriber to free copies of all new Center publications.

## WORKING PAPERS

116 Robert Isaak
*Developing Country Recipes for Collective Learning, Economic Development & Global Environmental Responsibility*: November 1993

117 William C. Freund
*Two Anachronistic SEC Rules in an Era of Global Equities Trading*: November 1993

118 Stephen Blank, Stephen Krajewski, and Henry S. Yu
*Corporate Response to an Emerging North American Economic Space*: November 1993

119 Suren K. Kaushik and Raymond H. Lopez
*The Structure and Growth of the Credit Union Industry in the United States: Meeting Challenges of the Market*: December 1993

120 Pelis Thottathil
*Reverse Mortgage: An Alternative to the Assumption Option*: February 1994

121 Barnard Seligman
*A History of the Practice and Theory of Indexation*: March 1994

122 Rosario J. Girasa
*Protection of Intellectual Property Rights in the People's Republic of China*: April 1994

123 Robert Isaak and Lawrence Bridwell
*Partnerships for Educational Competitiveness*: May 1994

124 Hubert Roosma
*Predicting Mutual Fund Performance: An Application of Modern Portfolio Theory*: May 1994

125 Samir M. El-Gazzar and Alexander J. Sannella
*The Effects of the Airline Deregulation on Shareholders' Wealth*: June 1994

126 Robert Weill
*The Teaching of Critical Thinking Skills in Business and Law Classes: A Research Project*: June 1994

127 Surendra K. Kaushik and Raymond H. Lopez
*Profitability of Credit Unions, Commercial Banks, and Savings Banks: A Comparative Analysis*: October 1994

128 Joseph A. Russo
*Problem Solving Behavior in Novice Auditors: An Iterative Model, Methodology, and Early Findings*: November 1994

129 Walter G. Antognini and Mitchell J. Kassoff
*Deferring Gain on the Sale of Publicly Traded Securities by Investing the Proceeds into a Specialized Small Business Investment Company:* December 1994

130 Walter E. Joyce
*Ironic Justice: The Reagan and Bush Appointments to the Supreme Court -- Five Degrees of Separation*: December 1994

131 Joseph J. Gross
*A Creditor's Dilemma - Equitable Subordination of Security Interests in Bankruptcy Courts*: December 1994

132 Richard Lynn and Hubert Dwyer
*Fama and French's Tests of the Capital Asset Pricing Model and the Modigliani and Miller Models of Capital Structure: The Consequences of Interdependence*: December 1994

133 Hubert Roosma
*Prediction of Market Turning Points: An Application of P/E Ratios, D/P Ratios and Federal Funds Rates*: December 1994

134 Samir M. El-Gazzar and Philip Finn
*Economic Implications of Proposed Accounting for Stock-based Compensation*: December 1994

135 Melvyn E. Fisher
*The Informational Content of Comparative Network Television Commercials*: December 1994

136 Karen A. Berger and Harlan P. Wallingford
*Developing Advertising and Promotion Strategies for Higher Education*: December 1994

## CASE STUDIES

14 Leon Winer
*Forest & Forest Motor and Control Company*: May 1993

15 Leon Winer
*The Strategic Creative Analysis (Scan) Process*: September 1993

16 Leon Winer
*Business Equipment Division*: October 1993

17 Robert R. Cangemi and Raymond H. Lopez
*Euro Disney (A) (1987)*: May 1994

## MONOGRAPHS

Peter M. Edelstein
*Faculty Guide to Cheating*: May 1994

## REPRINTS

81 Robert Isaak
*Germany: Economic Powerhouse or Stalemate?*: January 1993
(*Challenge, The Magazine of Economic Affairs*, vol. 35, no. 5, Fall 1992)

82 Donald C. Streever
*Textile Rental Weathers Recession Lows*: January 1993
(*Textile Rental*, vol. 75, no. 12, August 1992)

83 Vincent R. Barrella
*Curbing IRS Efforts to Circumvent Tax Court Discovery Limitations - The District Court as the Proper Forum*: April 1993
(*TAXES, The Tax Magazine*, November 1991)

84 Peter Allan and Eugene H. Nellen
*The Motivation to Manage: Differences Between College Students of Business According to Race*: May 1993
(*The Mid-Atlantic Journal of Business*, vol. 28, no. 3, December 1992)

85 Martin T. Topol and Myron Gable
*Building Retail Stores Through Direct Response Advertising: A Field Study*: May 1993
(*The Journal of Euromarketing*, vol. 2, no. 2, 1992)

86 Samir M. El-Gazzar
*Stock Market Effects of the Closeness to Debt Covenant Restrictions Resulting from Capitalization of Leases*: September 1993
(*The Accounting Review*, vol. 68, no. 2, April 1993)

87 Joy A. Schneer and Frieda Reitman
*Effects of Alternate Family Structures on Managerial Career Paths*: October 1993
(*Academy of Management Journal*, vol. 36, no. 4, 1993)

88 Roy J. Girasa
*Legal Aspects of Doing Business in China*: May 1994
(*Westchester Bar Journal*, vol. 20, no. 4, Fall 1993)

89 Christian N. Madu and Chu-Hua Kuei
*Dimensions of Quality Teaching in Higher Institutions*: May 1994
(*Total Quality Management*, vol. 4, no. 3, 1993)

90 Michael Szenberg
*Philosophical Pattern Comparisons Among Eminent Economists*: May 1994
(*The American Economist*, vol. 37, no. 1, Spring 1993)

91 Martin T. Topol and Elaine Sherman
*Trends and Challenges of Expanding Internationally via Direct Marketing*: June 1994
(*Journal of Direct Marketing*, vol. 8, no. 1, Winter 1994)

92 Kwang-Hyun Chung, Dimitrios Ghicas, and Victor Pastena
*Lenders' Use of Accounting Information in the Oil and Gas Industry*: October 1994
(*The Accounting Review*, vol. 68, no. 4, October 1993)

93 Martin H. Zern
*A Tough Tax Assessment - The Penalty for Failure to Remit Withheld Taxes: Moderation by the IRS?*: January 1995
(Academy of Legal Studies in Business *National Proceedings*, vol. 23:539-557, 1994)

94 Surendra K. Kaushik and Leonard Silk
*India's Evolving Economic Model*: February 1995
(*Economic Policy, The Journal of the Committee on Developing American Capitalism*, Fall 1994)

## REPRINT CLASSICS

3 Leon Winer
*Teaching Marketing Skills and Content with Negotiation Role Play: A Case History*: December 1994
(*Proceedings of the 1990 Atlantic Marketing Association*, vol. VI, October 1990; *Great Ideas for Teaching Marketing* [Cincinnati: South-Western Publishing Co., 1994])

## CENTER FOR INTERNATIONAL BUSINESS STUDIES

### Working Papers

2 Yan Fu
*The Chinese Way of Doing Business*: April 1993

3 Nikolai Wasilewski and Roger L. M. Dunbar
*Dimensions of Environmental Scanning Systems in Multinational Enterprises*: May 1993

4 Dietfried Günter Liesegang
*Environmentally-Oriented Directives for Market Economies:* January 1994

## MBA PAPERS OF DISTINCTION

Luiz Maia de Mello Massa
*IBM's Changing Organizational Structure*
vol. XII, no. 1: May 1993

Patt Terris
*Fun with Recycling*
vol. XIII, no. 1: October 1993