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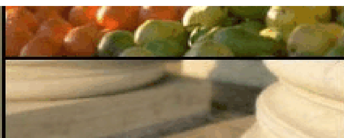

University of Arkansas
System Division of Agriculture
NatAgLaw@uark.edu | (479) 575-7646

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The Fox Takes Over the Chicken House: Creditor Interference with Farm Management

by

Phillip L. Kunkel

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THE FOX TAKES OVER THE CHICKEN HOUSE: CREDITOR INTERFERENCE WITH FARM MANAGEMENT

PHILLIP L. KUNKEL*

I. INTRODUCTION

Within the last several years, many Midwestern farmers have found themselves under financial pressure brought on by low commodity prices, high interest rates, declining land values, and various other factors. These factors have forced agricultural lenders who made operating loans to these farmers to take drastic actions such as foreclosures, repossessions, and liquidations in order to collect their problem loans.[1]

Oftentimes, lenders do not initiate these collection efforts immediately upon the onset of the farmer's financial difficulties. It may not be possible for the lender to commence collection procedures immediately and when finally begun, these procedures will require some amount of time to complete. As a result, the lender will be forced to live with his loan.[2] During this phase in the life of a loan — after the lender recognizes that the loan is a problem loan, but before initiation of collection procedures — each

*B.A., St. John's University, Collegeville, Minnesota, 1974; J.D., University of Minnesota, 1977; partner in Moratzka, Dillon & Kunkel, Hastings, Minnesota.

1. T. FREY & R. BEHRENS, LENDING TO AGRICULTURE ENTERPRISES 219-24 (1981) [hereinafter cited as FREY & BEHRENS]. The authors indicate that "[a]ction to collect the loan ordinarily is taken only after all [other] measures have proved ineffective." *Id.* at 222.

2. *Id.* at 218, 222. Lenders usually initiate collection efforts only after "lengthy negotiations with the debtor, attempts to improve the creditor's position. . ., and efforts to institute a program of correction." *Id.* at 222.

party will be guided by what he determines is in his best interest. The lender will do all it can to improve its position in order to enhance its chances of collection including: Attempting to acquire additional collateral, strongly encouraging the borrower to sell certain assets, or extending payment dates. The farmer, however, in most cases, will do all he can to prevent a total liquidation. If this means succumbing to the pressures placed upon him by the lender, he will often do so.

In an effort to collect without resorting to legal process, a lender will often exert considerable "leverage" on the borrower. One person's leverage, however, may well be another's "control." In fact, during this period, "the debtor may lose full control of his business affairs temporarily."[3]

This Article will examine the possible consequences to the lender who takes control of the farming operation in an effort to collect its loan. The Article will concentrate on the lender who makes an "operating loan"[4] to a farming operation, since the potential for creditor interference with farm management would appear to be greatest with these loans.

II. THE AGRICULTURAL OPERATING LOAN

The agricultural operating loan is a special purpose loan. It is structured to coincide with the production cycle of the commodity or commodities that will serve as the basis of repayment. In most instances, the operating loan will be of relatively short duration. In the case of a Midwestern crop loan, the loan will be payable in full in the fall of the year, following the harvest. The farmer will typically require a new loan in the spring of the following year to provide the necessary funding for that year's crop.[5]

The lender will generally secure an agricultural operating loan with very broad security agreements that cover all commodities owned at the time the loan is made as well as all after-acquired commodities.[6] The lender must necessarily secure an operating

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3. *Id.* at 218. While programs designed to correct problem loans involve hardships, lenders and farm-debtors often achieve viable solutions to the problem. *Id.* at 218-19. *See* Rome, *The Business Workout — A Primer for Participating Creditors*, 11 U.C.C. L.J. 183, 201-02 (1979) (discusses the relationship between control and leverage in the debtor-creditor relationship).

4. An "operating loan" for purposes of this Article is a seasonal loan for the payment of operating and living expenses during the course of a growing season or production cycle. Generally, these loans are repaid in full at harvest or at the end of the cycle from the sales proceeds of the commodity produced. The process is repeated during the next production cycle. FREY & BEHRENS, *supra* note 1, at 67. The operating loan is "[p]robably the most common form of agricultural loan." *Id.*

5. FREY & BEHRENS, *supra* note 1, at 67.

6. *See In re* Sunberg, 35 Bankr. 777 (Bankr. S.D. Ia. 1983), *aff'd*, 729 F.2d 561 (8th Cir. 1984). The security agreement in *Sunberg* covered "existing or hereafter acquired. . . general intangibles." 35 Bankr. at 561.

loan with extensive collateral because the value of the collateral at the start of the production cycle is typically low.[7] In addition, the collateral position of the lender may change dramatically during the term of the loan due to factors totally beyond the control of either lender or borrower. The market value of the commodities may fluctuate during the term of the loan. Wind, hail, rain, or drought may destroy or severely damage the crop, which is the security for the loan. If a livestock loan is involved, the herd may be subject to disease or breeding difficulties. Finally, the farmer may consume part of the collateral in the normal operation of the farming enterprise. The farmer may feed his livestock with harvested crops that are on hand at the beginning of the production cycle while the new crop is growing in the fields. In short, because of numerous contigencies, "most lenders will require collateral valued at 20 to 50 percent in excess of the amount of the loan."[8]

Perhaps in part because of the nature and breadth of the security interest required by an operating lender, the typical farmer will generally obtain all of his production money from one lender. Lenders do not want to be in a position in which they must look to a portion of the growing crop or livestock herd for security. If another creditor has an interest in similar crops or livestock, difficult problems of identification, control, and division of the sales proceeds exist for both parties. If there is no other creditor, the difficulties for the lender are not necessarily diminished because the farmer may still intermingle the secured commodities with unsecured commodities. Thus, most agricultural operating lenders prefer to have the sole blanket security interest covering all of the farmer's livestock and crops. As a result, the farmer must generally look to a single lender for his vital operating funds.

Although an operating loan is traditionally conceived as being a device for obtaining the necessary funds to acquire and feed livestock or to plant and harvest crops, or both, it is not unusual for a lender to use the operating loan to finance the acquisition of equipment, implements, or machinery. Rather than make a separate loan for these acquisitions, the lender considers the costs as an operating expense for the production cycle involved in the loan.[9] Oftentimes, when the costs are considered in this manner, the

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7. *See* FREY & BEHRENS, *supra* note 1, at 166-67. While livestock has a market value at all stages of maturity, the value of a growing crop is minimal until it approaches maturity since an immature crop cannot be converted to cash prior to harvest. *Id.* at 167.

8. Id. at 167. The authors note, however, that the prudent creditor may protect himself by purchasing insurance or requiring that the debtor do so. *Id.* at 215.

9. *Id.* at 67. Under an operating loan lenders "periodically [advance] funds for payment of operating and living expenses during the course of the growing season or livestock production cycle." *Id.*

normal cash flow of the farming operation is incapable, at the inception of the loan, of repaying the annual operating expenses, interest, and equipment acquisition costs. In these situations, the loan arrangement implicitly contemplates at least a partial liquidation in the event of repayment difficulties. To secure the equipment loans, the lender commonly obtains a security interest in all equipment either owned at the time of the loan or acquired later.[10] Thus, a single lender may have a security interest in virtually all of the farmer's personal property.[11]

In addition to having a blanket security interest in virtually all of the farmer's personal property, the agricultural lender enjoys a significant preference when his borrower disposes of the collateral without either obtaining the consent of the lender or paying the sales proceeds to the lender. Section 9-307(1) of the Uniform Commercial Code provides that a buyer of farm products[12] from a person engaged in farming operations[13] obtains the commodity with the operating lender's security interest firmly attached.[14] This rule is in contrast to the general rule of section 9-307(1), which provides that a buyer in the ordinary course of business takes free of a security interest created by his seller.[15] This statutory protection, combined with the almost universal restrictions upon disposition of collateral contained in the security agreement, provides the operating lender with a substantial amount of protection against unauthorized dispositions of livestock or crops.[16] Buyers of secured farm products must either obtain the

10. *See id.* at 65. Using equipment as collateral is not necessarily limited to the lender who finances the acquisition of the equipment. *Id.* An operating lender may well use the equipment as collateral for a normal operating loan. *Id.*

11. For a case acknowledging a single lender's security interest in virtually all of the farmer's personal property, see *In re* Sunberg, 35 Bankr. 777 (Bankr. S.D. Ia. 1983), *aff'd*, 729 F.2d 561 (8th Cir. 1984).

12. *See* U.C.C. § 9-109(3) (1978). Section 9-109(3) defines farm products as follows:

> [C]rops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool-clip, maple syrup, milk and eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations. If goods are farm products they are neither equipment nor inventory. . . .

Id.

13. Courts have construed "farming operations" very broadly. *See, e.g., In re* K. L. Smith Enter., 28 U.C.C. Rep. Serv. (Callaghan) 534, 539 (Bankr. D. Colo. 1980) (egg production held to be a farming operation); *In re* Blease, 24 U.C.C. Rep. Serv. (Callaghan) 450, 451-54 (Bankr. D.N.J. 1978) (veterinarian who bred and raised horses and raised corn was involved in farming operations).

14. U.C.C. § 9-307(1) (1978). Section 9-307(1) provides:

> "A buyer in ordinary course of business (subsection (9) of Section 1-201) other than a person buying farm products from a person engaged in farming operations takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence."

Id. Thus, a person who has a security interest in farm products has a special status as a secured creditor.

15. *Id.*

16. *See* Wabasso State Bank v. Caldwell Packing Co., 251 N.W.2d 321 (Minn. 1977). In *Caldwell Packing* a farmer sold cattle that were covered by a security agreement. Because the farmer

consent of the lender, issue checks jointly payable to the farmer and lender, or run the risk of being held liable to the lender in a subsequent conversion action.[17]

The lender is further protected in many operating loan situations by the nature of the farming operation itself. If the borrower is a cash grain farmer, with minimal livestock, he will generally market his crops only once per year. The reason for this, of course, is that there is only one growing season which results in a single crop for the year.

While this single marketing period offers the lender additional protection against the unauthorized disposition of collateral, it also presents the lender with a loan monitoring problem. If the lender makes the operating loan in the early spring, with no possibility of repayment until late autumn, the lender must closely monitor its disbursements, the farmer's use of the funds under the loan, and the extent, location, and value of the collateral. The lender's ability to closely monitor the progress of the loan is crucial to the success of the loan from the lender's point of view. Thus, these lenders must follow the course of the borrower's business more closely than a lender who is receiving payments on a regular basis. The lender may achieve this monitoring in any of several ways. The lender, or an affiliate, may keep the borrower's books and records and thus be able to monitor all disbursements and income.[18] The lender may require that the farmer make all disbursements by a draft that requires the lender's approval.[19] Also, the lender may require that the farmer remit all sales proceeds to the lender who will apply them to the loan. The lender then commonly will make a living allowance in the form of a disbursement on the loan.[20]

If the lender determines that a particular loan is likely to cause collection difficulties, he may classify it as a "problem loan." A problem loan is defined as "one in which there is a major breakdown in the repayment agreement resulting in an undue delay in collection, in which it appears that legal action may be required to effect collection, or in which there appears to be a potential loss."[21] If the lender classifies a loan as a problem loan,

had previously sold cattle without objection by the secured creditor, the buyer of the cattle claimed that the security interest did not survive the sale. *Id.* at 322. The Supreme Court of Minnesota held that the express terms of the security agreement could not be circumvented by a prior course of dealing and, therefore, the security interest was not extinguished by the sale. *Id.* at 325.

17. *Id.* at 324.

18. *See* FREY & BEHRENS, *supra* note 1, at 172-73. The authors suggest that lenders closely monitor their debtor's finances. *Id.*

19. *See id.* Bank-lenders can easily examine checks that clear their borrower's accounts. *Id.*

20. *See id.* at 67. The authors note that under operating loans lenders periodically advance funds for living expenses. *Id.*

21. *Id.* at 210-11. The authors implore lenders to constantly scrutinize delinquent loans to determine whether they are problem loans. *Id.* at 211.

the monitoring activities of the lender will increase. The lender may impose additional restrictions upon the borrower that may require that the borrower reduce his living expenses, provide additional collateral, or dispose of certain assets. There is no doubt that the lender's primary concern will be the protection of his interest.[22] The lender may strive to avoid expressing concerns to other creditors for fear that concern may trigger collection efforts on the part of the other creditors that could have an adverse effect upon the operating lender.[23] If the borrower is cooperative, he will generally consent to the actions suggested by the lender.[24]

As a general rule, a creditor may use his bargaining position, including his ability to refuse to make additional loans, to improve his position and the collectibility of his loan.[25] The creditor may call a loan when due, refuse to extend a loan with or without cause, and lawfully enforce collection.[26] However, when 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."[27]

III. LENDER CONTROL OVER THE DEBTOR

In response to a creditor's attempts to improve his position, several commentators have strongly advised creditors to avoid becoming overly involved in the debtor's management.[28] While it is possible that a creditor may be classified as a fiduciary as a result of

22. *Id.* at 219. The authors acknowledge that "[p]rotection of the creditor's interest must be the prime consideration in the formulation of any plan for correction." *Id.*

23. *Id.* at 217. The authors recognize, however, that lenders may contact the debtor's other creditors in an effort to determine the interests of each. *Id.*

24. *Id.* at 218. Truly cooperative borrowers will often consent to the often unpleasant conditions of correction programs. *Id.* These borrowers apparently recognize that they will benefit if the correction program is successful. *Id.* at 219.

25. *See, e.g., In re* Grant Co., 699 F.2d 599, 610 (2d Cir. 1983) (bank-creditors increased money lent to debtor for which they took additional security interests in an attempt to prevent debtor's rumored intention to file bankruptcy petition); Weinberger v. Kendrick, 698 F.2d 61, 78-79 (2d Cir. 1982) (no fraud existed when bank and its corporate borrower entered into arm's length transaction); *In re* Prima Co., 98 F.2d 952, 965 (7th Cir. 1938) (debtor's acquiescence to creditor's recommendations was not sufficient to constitute creditor's domination of debtor's will even when debtor was financially unable to meet its obligations without creditor's assistance); *In re* Teltronics Servs., Inc., 29 Bankr. 139, 172 (Bankr. E.D.N.Y. 1983) (arm's length agreement required debtor to purchase various equipment from the creditor and limited the debtor's ability to obtain additional secured financing at a level predetermined by the creditor).

26. *See In re* Teltronics Servs., Inc., 29 Bankr. at 170 (creditor lawfully restricted debtor's ability to obtain additional secured financing).

27. *Id.*

28. *See* Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor,* 31 BUS. LAW. 343 (1975). The commentator concludes "that whenever a creditor interferes in the business affairs of a financially troubled corporate debtor, it risks the possibility that such interference may provide a basis for the equitable adjustment of its claims against the debtor, the imposition of statutory liability or the imposition of liabilities at common law." *Id.* at 365.

excessive control of the debtor, no court or commentator has yet been able to put forth a precise definition of "control." Rather, it appears that no simple rule or formula of what constitutes control exists because the existence of a control relationship "necessarily depends on the cumulative impact of the facts and circumstances of the particular case."[29] As a result, one can only speculate concerning the factors that a court, when faced with a challenge to the actions of an agricultural operating lender, will consider determinative.

There appears to be no reason why a court could not look to other areas of the law for guidance in defining the parameters of a control relationship.[30] Control has been an issue in cases under the Interstate Commerce Act,[31] the Federal Aviation Act,[32] and the Internal Revenue Code.[33] In addition, there is a substantial body of securities case law concerning the question of control,[34] even though the Securities Act of 1933[35] and the Securities Exchange Act of 1934[36] do not contain definitions of "control." However, the Securities Exchange Commission has promulgated a rule under the 1934 Act that defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting

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For discussions of creditor involvement with debtor management, see Koch, *Bankruptcy Planning for the Secured Lender*, 99 BANKING L.J. 788 (1982); Committee on Dev. in Bus. Fin., *Structuring and Documenting Business Financing Transactions Under the Federal Bankruptcy Code of 1978*, 35 BUS. LAW. 1645 (1980); Bartlett & Lapatin, *The Status of a Creditor as a 'Controlling Person,'* 28 MERCER L. REV. 639 (1977).

29. Koch, *supra* note 28, at 798.

30. *See* Enstam & Kamen, *Control and the Institutional Investor*, 23 BUS. LAW. 289 (1968). The commentators discuss "many federal statutes in which control is mentioned and in which its existence brings into play various legal consequences." *Id.* at 291, 291-97. They also discuss non-statutory applications of the statutory control concepts. *Id.* at 297-301.

31. 49 U.S.C. § 5(4) (1982). *See* Gilbertville Trucking Co. v. United States, 371 U.S. 115 (1962). In *Gilbertville* the Court noted that § 1(3)(b) of the Transportation Act of 1940 defined control " 'to include actual as well as legal control, whether maintained or exercised through or by reason of the method of or circumstances surrounding organization or operation. . . .' " *Id.* at 125. *See* Transportation Act of 1940 § 1(3)(b), 49 U.S.C. 10102(6) (1976 & Supp. V).

32. 49 U.S.C. § 1378 (1982). *See* Toolco-Northeast Control Case, 42 C.A.B. 822 (1965). In *Toolco* the Civil Aeronautics Board indicated that control "is a question of fact to be determined by weighing the evidence in each case, and drawing reasonable inferences and conclusions therefrom in the light of the objectives and purposes of the Act." *Id.* at 825.

33. *See* Fidelity Bank, N.A. v. United States, 616 F.2d 1181, 1185-86 (10th Cir. 1980). In *Fidelity Bank* the court discussed the degree of control that a lender must exercise over a borrower before the court would find liability under the I.R.C. § 6672. *Id.* at 1185-86. *See* I.R.C. § 6672 (West 1983) (penalty for willfully failing to collect and account for withholding taxes).

34. *See, e.g.,* Ayers v. Wolfinbarger, 491 F.2d 8, 14 (5th Cir. 1974) (control does not exist in securities context when "stock is simply pledged as security for deferred payments, and particularly where the reinstatement provision after default is so favorable to the purchaser"); Koppers United Co. v. SEC, 138 F.2d 577, 580 (D.C. Cir. 1943) (facts indicated that control did not exist when the parties arrived at a business agreement by bargaining at arm's length); *In re* Clearfield Bituminous Coal Corp., 1 S.E.C. 374 (1936) (applicant that owned all the securities of a public utility company did not control the utility because the applicant had effectively assigned its power to control). For a discussion of securities cases and creditor control see Douglas-Hamilton, *supra* note 28, at 352-63.

35. Securities Act of 1933, 15 U.S.C. § 77a (1982).

36. Securities Exchange Act of 1934, 15 U.S.C. § 78a (1982).

securities, by contract, *or otherwise.*"[37] Thus, it would appear that a court which must rule on the issue of control can benefit greatly from examining cases in these other areas for purposes of analogy.[38]

While it may be very difficult for a court to determine if, in fact, a creditor has so dominated a debtor as to control him, there is support for the proposition that a court may find creditor control in the mere *ability* to dominate.[39] The rationale for the concept of "latent control" is that:

> the prudent debtor can be expected to act with considerable deference toward a potentially dominant lender, even though that lender may not have actually pounded the debtor into submission. If the . . . courts endorse the latent control theory, a lender must consider the possibility that loan agreements containing *excessively* restrictive and oppressive conditions may evidence lender control. Moreover, because the exercise of *actual* control is difficult to prove, the existence of such an oppressive loan agreement could tip the scale in a close case.[40]

Two recent bankruptcy court opinions appear to have adopted this latent control theory. In *In re T.E. Mercer Trucking Co.*[41] the court considered a creditor's motion for summary judgment. In denying the motion for summary judgment, the court considered the "remarkable loan contracts" involved and concluded that "the extensive creditor control evidenced by the loan agreement suggests that the debtor corporations were mere instrumentalities or the alter ego" of the creditor.[42]

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37. 17 C.F.R. § 240.12b (1983) (emphasis added).

38. *See* Koch, *supra* note 28, at 798-99. *See also* Queenan, *The Preference Provisions of the Pending Bankruptcy Law*, 82 COM. L.J. 465, 470 (1977). Queenan notes that conversations with the members of the staff of the House of Representatives indicated that the concept of control in the context of debtor-creditor relations was to be as broad as that which "is employed in the securities laws." *Id.* *But see* Committee on Dev. in Bus. Fin., *supra* note 28, at 1663 & n.90. The article warns "bankruptcy courts [to] resist the temptation to look to securities law cases for guidance in construing [control] because of the different policy considerations and concerns underlying. . . the Code as compared with the securities laws." *Id.* at 1663.

39. *See* Gilbertville Trucking Co. v. United States, 371 U.S. 115, 125 (1962) (control includes power to control regardless of whether exercised); Detroit Edison Co. v. SEC, 119 F.2d 730, 739 (6th Cir. 1941) (control may exist based upon latent power to resume actual control); *In re* M.A. Hanna Co., 10 S.E.C. 581, 588 (1941) (control is "less than absolute and complete domination of company").

40. Koch, *supra* note 28, at 799 (emphasis in original).

41. 16 Bankr. 176 (Bankr. N.D. Tex. 1981).

42. *In re* T.E. Mercer Trucking Co., 16 Bankr. 176, 190 (Bankr. N.D. Tex. 1981). In *Mercer Trucking* the creditor required the debtors to "recognize, admit and affirm all of [their] foregoing indebtedness owing by them, individually, jointly or severally to [the creditor]." *Id.* at 184. The debtors also allowed the creditor to undertake and order liquidation of the debtors' corporation as a part of the loan agreement. *Id.*

Similarly, in *In re Teltronics Services, Inc.*,[43] the court carefully analyzed several creditor control cases and concluded:

> 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 market place.[44]

Courts, and parties in their arguments to the court, have cited several factors indicating that a lender was in control of a debtor.[45] While no single factor is determinative, consideration of the combined effect of these factors will assist courts in determining whether a creditor has assumed control of the financially distressed debtor.

A. FINANCIAL DEPENDENCE

The mere fact that a financially troubled debtor is dependent upon a lender is not, generally, sufficient alone to find that the lender is exercising control over the debtor.[46] In *In re Jefferson Mortgage Co.*,[47] a trustee in bankruptcy alleged that a lender exerted control over the debtor and was therefore an "insider" within the meaning of the Bankruptcy Code.[48] In addressing the trustee's argument, the court stated that the lender:

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43. 29 Bankr. 139 (Bankr. E.D.N.Y. 1983).

44. *In re* Teltronics Servs., Inc., 29 Bankr. 139, 171 (Bankr. E.D.N.Y. 1983) (emphasis added). In *Teltronics* the bankruptcy trustee contended that a creditor of the bankrupt induced it to default under a loan agreement thereby enabling the creditor to seize its collateral and take over the business of the bankrupt. *Id.* at 143. The creditor responded that its conduct was not only lawful but also a reasonable commercial practice. *Id.*

45. For a court's discussion of factors indicative of lender control of its debtor, see *In re* Jefferson Mortgage Co., 25 Bankr. 963 (Bankr. D.N.J. 1982). The court in *Jefferson Mortgage* considered the 90-day preference period, the concept of "insider," whether the parties' debtor-creditor relationship was at arm's length, and the terms of the agreement before making its decision. *Id.* at 964-72.

While most creditor control cases involve corporate debtors, individual debtors have recently utilized the creditor control challenge as well. *See, e.g.*, Denison State Bank v. Madeira, 230 Kan. 684, ___, 640 P.2d 1235, 1237-40 (1982) (debtor-depositor challenged creditor-bank); Umbaugh Pole Bldg. Co. v. Scott, 50 Ohio St. 2d 282, ___, 390 N.E.2d 320, 321-23 (1979) (debtor-farmers challenged creditor-farmers' cooperative).

46. *See* Koch, *supra* note 28, at 798. The commentator notes that the existence of a control relationship depends on the cumulative factors of each case. *Id.*

47. 25 Bankr. 963 (Bankr. D.N.J. 1982).

48. *In re* Jefferson Mortgage Co., 25 Bankr. 963, 965 (Bankr. D.N.J. 1982). Section 101(25) of the Bankruptcy Code provides as follows:

> "[I]nsider" includes—
> (A) if the debtor is an individual—
> (i) relative of the debtor or of a general partner of the debtor;

> may have exercised some measure of control over the debtor financially in order to protect its collateral. However, this control was merely incident to their creditor-debtor relationship. The creditor had only financial power over the debtor, and the debtor could have terminated the relationship at any time and looked for another creditor.[49]

As a result, the court held as a matter of law that the parties' relationship was one of an arms' length debtor-creditor relationship.[50]

Similarly, in *In re Yonkers Hamilton Sanitarium, Inc.*[51] a trustee in bankruptcy sought to recover allegedly preferential transfers made by the debtor to the federal government under the Medicare program. The trustee contended that the court should regard the government and its fiscal intermediary, Blue Cross-Blue Shield, as a person in control of the debtor based upon the debtor's financial dependence on the revenues the debtor expected to be paid by the government through Blue Cross.[52] The court concluded that, while a debtor may be influenced by the demands of its major customers or creditors, the influence was not the type of control contemplated by the Bankruptcy Code.[53]

(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 in 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
(F) managing agent of the debtor.

11 U.S.C. § 101(25) (1976).

49. 25 Bankr. at 970.

50. *Id.*

51. 22 Bankr. 427 (Bankr. S.D.N.Y. 1982).

52. *In re* Yonkers Hamilton Sanitarium, Inc., 22 Bankr. 427, 428-29 (Bankr. S.D.N.Y. 1982).

53. *Id.* at 430. The court rather woodenly applied the "definition" of "insider" contained in 11 U.S.C. § 101(25)(B) to conclude that voting control was required to control a corporate debtor. *Id.* *See also In re* Castillo, 7 Bankr. 135, 137 (Bankr. S.D.N.Y. 1980) (the same court that decided *Yonkers*

When a lender is the sole available source of financing to a financially troubled debtor, however, courts should be more conscious of the potential for creditor control.[54] If the lender is the debtor's only source of financial aid, one may infer that the prudent debtor will be submissive to the lender's wishes.[55] Several courts, in a variety of contexts, have found that the monopolistic control of a debtor's sources of financing may be significant in finding that a creditor has control of its debtor. In *In re American Lumber Co.*[56] the court noted that because the lender was a debtor's "sole source of credit," the debtor was "within the coercive power" of the lender.[57] The court recognized that the lender foreclosed on its security interest in the debtor's accounts receivable, thereby depriving the debtor of the only source of ready cash with which to conduct its business.[58] Prior to making any expenditures, therefore, the debtor had to request and obtain a "loan" from the lender. Thus, the court determined that the lender had "sought to perpetrate a fraud upon the general unsecured creditors of [the debtor]."[59]

Similarly, in *A. Gay Jenson Farms Co. v. Cargill, Inc.*[60] the court indicated that since a creditor provided all of the financing for a rural elevator, the creditor had de facto control over the conduct of the debtor.[61] While the court cited several factors in support of its finding, it emphasized that the rural elevator "was financially dependent on Cargill's continual infusion of capital."[62]

Finally, in *Toolco-Northeast Control Case*[63] the Civil Aeronautics Board considered the financial distress of the debtor as well as the

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applied a mechanical test in determining that the creditor was not an insider, ignoring that 11 U.S.C. § 101(25) is a nonexclusive list of insiders).

54. Koch, *supra* note 28, at 801 (citing *In re* American Lumber Co., 5 Bankr. 470 (Bankr. D. Minn. 1980)).

55. Koch, *supra* note 28, at 801.

56. 5 Bankr. 470 (Bankr. D. Minn. 1980).

57. *In re* American Lumber Co., 5 Bankr. 470, 478 (Bankr. D. Minn. 1980).

58. *Id.* In *American Lumber* the defendant bank loaned money to the bankrupt taking a security interest in the bankrupt's accounts and contract rights, stock of the bankrupt, and real estate. *Id.* at 473. Upon default by the bankrupt, the bank foreclosed on the accounts receivable and contract rights. The bank scrutinized each check drawn by the bankrupt and paid only those that would enhance the value of the accounts receivable. The bank also forced the termination of most of the bankrupt's employees and undertook to liquidate the bankrupt. *Id.* at 474.

59. *Id.* at 479. The bankruptcy court found that the bank's plan of liquidation was designed to enhance the value of the property secured by the bank to the detriment of general unsecured creditors. *Id.* at 477.

60. 309 N.W.2d 285 (Minn. 1981).

61. A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 291 (Minn. 1981). In *Jenson Farms* a grain elevator, Warren Grain & Seed Co. (Warren), defaulted on payments due to farmers for the purchase of grain. Warren had secured financing from Cargill, Inc. for working capital. *Id.* at 288.

62. *Id.* at 292. Among the factors considered by the court were that Cargill's name was imprinted on Warren's checks and drafts, Cargill financed all of Warren's purchases and operating expenses, and Cargill had the power to discontinue financing of Warren's operations. *Id.* at 291.

63. 42 C.A.B. 822 (1965).

contributions of the lender in deciding that Hughes Tool Company had retained control of Northeast Airlines, Inc.[64] In addition, in the context of an agricultural operating loan, a lender who has a security interest in all existing and after-acquired crops, livestock, implements, tools, and equipment, and who provides all of the farm operator's production money, may well possess the latent power to control the farm debtor.[65]

B. RESTRICTIVE COVENANTS

As a routine matter, an agricultural operating lender will require that the borrower agree not to incur additional secured debts or suffer any involuntary liens against the collateral.[66] Generally, the purpose of these restrictive covenants is to maintain or improve the ratio between the debt and the assets that exist at the time of the financing.[67] These restrictions, of course, restrict the management of the farming operation and remove a certain amount of freedom from the operator. It seems clear, however, that a lender has a right to impose proper conditions upon the debtor to enhance its security and increase the likelihood that it will be repaid.[68]

For example, in *Canadair Ltd. v. Seaboard World Airlines, Inc.*[69] an aircraft manufacturer, Canadair Ltd. (Canadair), attempted to enforce a restrictive covenant in the mortgages it held on the aircraft it sold to an air carrier, Seaboard World Airlines (Seaboard).[70] Canadair sought to enforce a restriction limiting capital investments and rent obligations in order to enjoin a lease purchase agreement that Seaboard entered into with another aircraft manufacturer.[71] The issue before the court was whether the restriction was invalid because it gave the manufacturer control

64. Toolco-Northeast Control Case, 42 C.A.B. 822, 827 (1965). The Civil Aeronautics Board noted that Hughes Tool Co. (Toolco) was an essential source of financial aid to Northeast Airlines. *Id.* Northeast Airlines, therefore, "necessarily continue[d] to rely upon Toolco for assistance." *Id.* Thus, the Board concluded that Northeast had no choice but to "defer to Toolco's wishes." *Id.*

65. *See* Douglas-Hamilton, *supra* note 28, at 361 (discussion of liability for creditor control under federal securities law).

66. *See* FREY & BEHRENS, *supra* note 1, at 65-66. The authors indicate that lenders should avoid having partial security interests in collateral in which creditors also have partial interests. *Id.* at 65.

67. Koch, *supra* note 28, at 799.

68. *Id.*

69. 43 Misc. 2d 320, 250 N.Y.S.2d 723 (Sup. Ct. 1964).

70. Canadair Ltd. v. Seaboard World Airlines, Inc., 43 Misc. 2d 320, ___, 250 N.Y.S.2d 723, 725-26 (Sup. Ct. 1964). In *Canadair* the court indicated that agreements between the parties "[e]ssentially. . . [constitued] chattel mortgage and equipment trust agreements." *Id.* at 725.

71. *Id.* Seaboard entered into a lease agreement with Douglas for the acquisition of an airplane. The agreement provided that Seaboard would pay rent of $1,072,071 yearly for ten years. *Id.* Seaboard's agreement with Canadair contained a provision prohibiting Seaboard from making commitments in excess of $1,500,000 in any one year. *Id.* at 728-29.

over the carrier without prior approval as required under section 408 of the Federal Aviation Act.[72] Canadair argued that these agreements merely provided for ordinary debtor-creditor protection and that the court should construe control to mean the directing and running of a business. The court concluded that administrative approval was not necessary, and that the restrictions did not place Canadair in a position of control.[73]

Under the securities laws, courts have held that the power to veto the creation of liens and extraordinary debt does not amount to control.[74] Likewise, the power to veto other extraordinary corporate action is not control.[75] Should a court, however, find a creditor in control of a debtor, any restrictive covenants, particularly if they involve restrictions on management, personnel, or production, may well provide evidence of the creditor's control.[76]

C. CONTROL OVER DISBURSEMENTS

It may be particularly risky for a creditor to insist upon control over its borrower's disbursements. Cases have addressed the lender's liability when the lender has control over disbursements of the borrower and have generally found that the lender was in control of the debtor.[77] In *In re Process-Manz Press, Inc.*,[78] the bankrupt debtor assigned all of its receivables to a creditor. The creditor collected all proceeds and supplied all necessary funds for the debtor's payroll and other expenses.[79] The court found that the control the creditor exercised over the debtor was so pervasive that the creditor was "in substance the owner" of the debtor.[80]

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72. *Id.* at 726. Section 408 of the Federal Aviation Act prohibits the acquisition of "control of any air carrier in any manner whatsoever" without approval of the Civil Aeronautics Board. Federal Aviation Act § 408(a), 49 U.S.C. § 1378(a) (1958).

73. 43 Misc. 2d at ____, 250 N.Y.S.2d at 727. Subsection (b) of § 1378 provides that a party seeking to acquire control must obtain the approval of the Board. *Id.* at ____, 250 N.Y.S.2d at 727. *See* 49 U.S.C. § 1378(b). The parties did not show that the control represented by the agreements required the Board to entertain jurisdiction. *Id.* at ____, 250 N.Y.S.2d at 727.

74. For a discussion of voting and management control under corporate law, see Douglas-Hamilton, *supra* note 28, at 344-45.

75. Allied Chemical & Dye Corp., 5 S.E.C. 151 (1939) (company's veto power did not constitute control under Public Utility Holding Company Act of 1935).

76. *See* A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 288-89 (Minn. 1981) (debtor-creditor agreements contained several substantial restrictions). *But see In re* Prima Co., 98 F.2d 952, 968 (7th Cir. 1938) (restrictive agreement insufficient to find control).

77. *See* Koch, *supra* note 28, at 805 (citing *American Lumber*).

78. 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on other grounds,* 369 F.2d 513 (7th Cir. 1966), *cert. denied,* 386 U.S. 957 (1967).

79. *In re* Process-Manz Press, Inc., 236 F. Supp. 333, 337 (N.D. Ill. 1964), *rev'd on other grounds,* 369 F.2d 513 (7th Cir. 1966), *cert. denied,* 386 U.S. 957 (1967). In *Process-Manz Press* the claimant, A.J. Armstrong Co. (Armstrong), loaned money to the bankrupt taking a security interest in 100% of the stock of the bankrupt and an assignment of the receivables of the bankrupt. Armstrong received all the income of the bankrupt and made advances to the bankrupt. *Id.* The bankrupt was thus "dependent solely on Armstrong for its financial needs." 236 F. Supp. at 339.

80. *Id.* at 348. The court referred to Armstrong as the "alter ego" of the bankrupt. *Id.*

Likewise, in *In re American Lumber Co.*,[81] the court found that a lender's foreclosure of its security interests in accounts receivable and contract rights deprived the debtor of the only source of ready cash with which to conduct its business. "Loans," therefore, were necessary for every expenditure made by the debtor.[82] The lender determined which of the debtor's other creditors would be paid. The creditor made sure that the only accounts paid were those that the lender felt would improve its own position. Thus, the court found that the lender was in control of the debtor.[83]

If a lender feels that it must have this type of control, a mere veto power over irregular expenditures would seem preferable.[84] Recently, in *Fidelity Bank, N.A. v. United States*,[85] the IRS alleged lender control when a bank honored checks drawn in excess of the borrower's line of credit and retained authority to veto the borrower's expenditures. In exercising this authority, a bank officer examined all checks drawn on the borrower's account prior to payment and honored any checks that appeared valid.[86] Until it declared the borrower in default and foreclosed its security interest, the bank honored all checks drawn on the overdraft line of credit.[87] On these facts, the court determined that the bank was not in control of the debtor because it had not initiated payment decisions or decided which creditors to pay.[88] Even though the lender had control of all the taxpayer's income and the taxpayer was totally dependent upon the lender, the court was unwilling to find that the lender had intruded into the financial operations aspect of the debtor's business.[89]

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81. 5 Bankr. 470 (Bankr. D. Minn. 1980).

82. *In re* American Lumber Co., 5 Bankr. 470, 478 (Bankr. D. Minn. 1980). The court in *American Lumber* specifically noted that the creditor was the debtor's sole source of credit. *Id.* See *supra* notes 56-59 and accompanying text for the facts of *American Lumber*.

83. *Id.* at 479. The court concluded that "[t]his kind of conduct cannot be allowed to prevail." *Id.*

84. Koch, *supra* note 28, at 805.

85. 616 F.2d 1181 (10th Cir. 1980).

86. Fidelity Bank, N.A. v. United States, 616 F.2d 1181, 1183 (10th Cir. 1980). In *Fidelity Bank* a construction company secured a revolving line of credit of $1,000,000 from a bank. After the company had exceeded its $1,000,000 credit limit, the bank allowed the company to overdraw its account to meet working capital needs under a construction contract with the Kiowa Housing Authority (KHA). The bank would approve overdraft payments only if the payee was connected with the KHA contracts. *Id.*

87. *Id.* Upon default by the borrower, the bank dishonored or returned all the borrower's checks. *Id.* Among the dishonored and returned checks were checks the borrower issued to the IRS for withheld payroll taxes. *Id.* at 1184. The IRS assessed a 100% penalty for the unpaid taxes against the bank under § 6672 of the Internal Revenue Code, which imposes liability for unpaid taxes on any person who is responsible for the collection and payment of payroll taxes but willfully fails to perform these acts. *Id.* at 1185. *See* I.R.C. § 6672 (West 1983).

88. 616 F.2d at 1186. The court concluded that the jury could find that the bank was not a "responsible person" within the meaning of § 6672. *Id.* The court, therefore, remanded the case on this issue. *Id.*

89. *Id.* The court determined that the bank's actions were no more than arrangements by which the bank made a series of loans to the debtor for specific purposes. *Id.* at 1185-86.

It would be difficult to distinguish the case of an agricultural operating lender who requires the borrower to remit all net proceeds from the sales of agricultural commodities to the lender for application to the outstanding balance of the loan from the situation in *American Lumber* and *Process-Manz*. This would be particularly true if the lender issued drafts or required its approval for the payment of other creditors. The agricultural lender who insists upon these provisions in a loan agreement would thus appear to incur a great deal of risk. An agreement of this type would seem to result in the intrusion of the lender into the financial and operational aspects of the debtor.

D. OTHER RESTRICTIONS INDICATIVE OF CONTROL

When a debtor is experiencing financial pressure, it is not uncommon for him to look to a lender for guidance. Debtors often cite their subsequent following of the lender's recommendations as evidence of a fiduciary relationship or lender control of the business operation.[90] This may be particularly true in the case of an agricultural operating loan in which a lender has made strong suggestions or recommendations concerning crop selection, marketing plans, or other management decisions in an effort to work out a problem loan. In *Umbaugh Pole Building Co. v. Scott*[91] the farm debtor operated a hog farm. His major operating lender was a local Production Credit Association. As part of its regular servicing of the loan, the Association gave advice and counseling to its debtors relative to their farming operation.[92] When the debtor, the Association, and other lien creditors became embroiled in a dispute, the debtor argued that the advice and counseling that he received from the Association was indicative of a fiduciary relationship.[93] The court rejected this argument, holding that "[w]hile the advice was given in a congenial atmosphere and in a sincere effort to help the [debtor] prosper, nevertheless, the advice was given by an institutional lender in a commercial context in which the parties dealt at arms

90. *See* Umbaugh Pole Bldg. Co. v. Scott, 58 Ohio St. 2d 282, 390 N.E.2d 320 (1979). While the court indicated that debtor reliance upon the advice of his creditor may establish a fiduciary relationship, the facts in the case before it "were insufficient to create a fiduciary relationship." *Id.* at ___, 390 N.E.2d at 323.

91. 58 Ohio St. 2d 282, 390 N.E.2d 320 (1979).

92. Umbaugh Pole Bldg. Co. v. Scott, 58 Ohio St.2d 282, ___, 390 N.E.2d 320, 321 (1979).

93. 390 N.E.2d at 322. *Scott* arose out of a mechanic's lien against the debtor for improvements to his property. The lienor sued to foreclose on the lien. The debtor cross-complained against the Association, alleging that the Association had wrongfully refused to advance funds to pay for the improvements. Although the initial action involved a third-party lienor, the appeal concerned only the rights of the debtor and the Association. *Id.*

length, each protecting his own interest.''[94]

In *In re W.T. Grant Co.*[95] certain debenture holders objected to a proposed settlement by a trustee in bankruptcy. The debenture holders contended that certain lenders had improperly used their influence with the failing company to improve their own position.[96] Among the allegations by the debenture holders was that the banks were running the company.[97] In response to this allegation the court observed that:

> There is no doubt that, at least from March of 1974, the banks kept careful watch on what was going on at Grant; they would have been derelict in their duty to their own creditors and stockholders if they had not. It is not uncommon in such situations for officers whose companies have been brought to the verge of disaster to think that they still have better answers than do the outsiders. In order to establish their claims the appellants must show not simply that the banks proffered advice to Grant that was unpalatable to management, even advice gloved with an implicit threat that, unless it were taken, further loans would not be forthcoming. They must show at least that the banks acted solely for their own benefit. . . .[98]

If a lender, such as an agricultural operating lender, is providing all of the debtor's operating capital, a provision in a note or loan agreement that renders the obligation payable on demand or payable upon the lender's determination that it is ''insecure'' would seem to be a factor that courts should consider in

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94. *Id.* at 323. For additional cases in which courts have found that there was not a fiduciary relationship between a lender and its borrowers, see Snow v. Merchants Nat'l Bank, 309 Mass. 354, 35 N.E.2d 231 (1941) (no fiduciary relationship existed when plaintiff relied on bank president's financial advice because plaintiff knew that bank would receive a profit from the advice); Stenberg v. Northwestern Nat'l Bank, 307 Minn. 487, 238 N.W.2d 218 (1976) (bank that encouraged debtor to expand its business and offered it an open line of credit was not a fiduciary).

95. 699 F.2d 599 (2d Cir.), *cert. denied,* 104 S. Ct. 89 (1983).

96. *In re* W. T. Grant Co., 699 F.2d 599, 603-04 (2d Cir.), *cert. denied,* 104 S. Ct. 89 (1983). In *Grant* the debenture holders claimed that the bank lenders compelled the bankrupt to enter into security agreements to secure payments due to the lenders, which adversely affected the bankrupt's revenues. The banks also directed the bankrupt not to sell its receivables. *Id.* at 605. The creditors claimed that the actions of the banks resulted in weakening the bankrupt to the creditors' detriment. *Id.*

97. *Id.* at 610. The Second Circuit noted that the bankruptcy court made detailed findings that included that '' '[t]he bank claimants used their position of control over Grant's management to prevent Grant from promptly seeking relief under the Bankruptcy Act. . . .' '' *Id.* at 605 (quoting *In re* W.T. Grant Co., 4 Bankr. 53, 61 (Bankr. S.D.N.Y. 1980)).

98. 699 F.2d at 610. The debenture holders also contended that, because of the banks' alleged misconduct, the banks' claims should have been subordinated to the debenture holders' claims. *Id.* at 603-04. See *infra* notes 269-72 for a discussion of the subordination issue in *Grant.*

determining whether a lender is in control.[99] A prudent debtor will more readily comply with the demands of a lender because of the creditor's power to call the loan virtually at will.[100] The debtor will be particularly willing to comply if the loan is secured by virtually all of the debtor's personal property.[101]

Similarly, if a corporate debtor's principal officer or shareholder has personally guaranteed the debt owed to a lender, the lender may well be in a position of controlling the corporate debtor through the guarantor. It would seem that the guarantor's agreement creates a community of interest between the guarantor and the lender, assuring that the guarantor will exercise his control over the debtor for the lender's benefit.[102] This would appear to be particularly true in the case of a secured guarantee, in which a lender has obtained personally owned property of the guarantor to secure the corporate obligation. These provisions are not uncommon in the case of closely held family farm corporations in which the major asset of the farming operation, the land, is held by the shareholders of the operating corporation.[103]

Requiring a corporate debtor to pledge its stock to the lender is one more indication that the lender may be controlling the debtor.[104] This is particularly true if the loan agreement contains a liberal default provision that would allow the lender to declare a default and replace the debtor's management at will.[105] In *American Lumber* the court appeared to indicate that a lender may be in control of the debtor, even though the lender has not actually exercised his default remedies, so long as the pledge agreement grants the lender a right to declare a default.[106] In addition, the Civil Aeronautics Board in *Toolco-Northeast Control Case*[107] held that the debtor did not relinquish control merely because it gave up its right to vote the debtor's stock in favor of an independent

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99. *See* Koch, *supra* note 28, at 806-07.

100. Koch, *supra* note 28, at 806-07. *See also* Queenan, *supra* note 38, at 470. For a court's discussion of facts and circumstances establishing that a creditor's power to call in its debtor's loans at will prompted the debtor to comply with the creditor's demands, see A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 291-93 (Minn. 1981).

101. Queenan, *supra* note 38, at 470. The commentator suggests that the more collateral a creditor has as security the more likely a debtor will succumb to the demands of the creditor. *Id.*

102. *See* Koch, *supra* note 28, at 803-04; Queenan, *supra* note 38, at 470.

103. *See* FREY & BEHRENS, *supra* note 1, at 196. The authors acknowledge that "[e]xperience indicates that the best co-obligor is one who has a personal interest in the success of the borrower's venture. . . ." *Id.*

104. Koch, *supra* note 28, at 802-03.

105. *Id.* The commentator notes, however, that "[t]he bankruptcy risks inherent in stock pledges will, in most cases, outweigh the benefits to be derived therefrom." *Id.* at 803.

106. *In re* American Lumber Co., 5 Bankr. 470, 478 (Bankr. D. Minn. 1980). For a discussion of the pledge agreement in *American Lumber* see Koch, *supra* note 28, at 803.

107. 42 C.A.B. 822 (1965).

trustee.[108] These cases suggest that the mere taking of a stock pledge to secure the repayment of a loan, by itself, does not create a control relationship. If any of the other factors discussed above are also present, however, especially if the same lender is the debtor's sole source of financial support, a stock pledge may well prove persuasive to a court called upon to address the control issue.[109]

In summary, a court may find any combination of factors significant in determining whether an agricultural lender has taken control of the farm. A court, therefore, should not base its decision upon any single factor, but rather, on the cumulative effect of such matters. In addition, the context in which a debtor or other party raises the creditor control issue may well be significant in determining whether the lender is subject to liability.

IV. CHALLENGES TO CREDITOR CONTROL

The issue of creditor control of a debtor may arise in a variety of situations. The debtor himself may challenge the creditor either by means of using creditor control as a defense in a suit to collect the loan made by the lender or as the basis for a complaint in a suit initiated by the borrower.[110] In addition to the lender and debtor, third parties, principally other creditors, may raise the issue of creditor control in an attempt to collect the amount that a financially distressed borrower owes them. Finally, the issue of creditor control may be raised if the borrower has filed a bankruptcy petition.

Two challenges to creditor control are likely in bankruptcy cases. The trustee may allege that as a result of control, the lender has become an "insider" within the meaning of the Code,[112] and as a result, has received preferential transfers within the one year period immediately preceding the filing of the bankruptcy petition.[113] The creditor's claim, which it has filed in the bankruptcy proceedings, may also be challenged by the trustee or

108. Toolco-Northeast Control Case, 42 C.A.B. 822, 830. In *Toolco-Northeast* Hughes Tool Co. attempted to divest itself of control of Northeast Airlines by transferring its interest in Northeast to a trust. For a discussion of the pledge agreement in *Toolco,* see Koch, *supra* note 28, at 802-03.

109. *See* Koch, *supra* note 28, at 803.

110. *See generally* Koch, *supra* note 28; Queenan, *supra* note 38.

111. *See generally* Koch, *supra* note 28; Queenan, *supra* note 38. Section 548 of the Bankruptcy Code, which prohibits fraudulent transfers by debtors, provides an additional attack on the propriety of creditor actions. *See* 11 U.S.C. § 548 (1982).

112. Section 101(25) of the Bankruptcy Code defines "insider." See *supra* note 48 for the text of § 101(25).

113. *See* 11 U.S.C. § 547(b)(2)(B) (1982). Section 547(b)(2)(B) prohibits preferential transfers by the debtor within one year preceding the filing of bankruptcy. *Id.*

other creditors due to the creditor's control under section 510(c) of the Code. Section 510(c) provides that the bankruptcy court may, "under principles of equitable subordination," subordinate all or any part of an allowed claim.[114] The context in which a party raises the issue will likely be very important in determining if the lender is subject to liability.

A. BORROWER v. LENDER

In numerous cases, a lender's customer has challenged the lender on grounds of negligence, fraud, or contract alleging that a fiduciary relationship existed between the parties based upon the actions of the lender. As a general rule, however, the relationship between a lender and its borrower is that of creditor-debtor and not of a fiduciary.[115] Thus, a lender has no special duty to counsel the borrower or to inform the borrower of material facts relating to the transaction unless special circumstances exist.

In *Klein v. First Edina National Bank*,[116] a bank customer brought suit to recover stock that she had pledged as security for a loan by the bank to a third party. The customer claimed that a loan officer concealed certain facts which, if brought to her attention, may have kept her from pledging the stock. According to the customer's testimony, she was unaware at the time of the loan that the third party, her employer, already owed the bank a significant sum of money that was secured by an assignment of a particular account owed the employer.[117] Apparently, the bank's intention was to release that account as a result of the new loan and to rely entirely upon the plaintiff's stock for security.[118] The customer, according to her testimony, relied upon the loan officer to look after her interests "as she would trust a doctor or lawyer."[119] The court found that the customer did not show that the bank stood in a confidential relationship to her. The record contained no evidence

114. 11 U.S.C. § 510(c)(1) (1982).

115. *See* Umbaugh Pole Bldg. Co. v. Scott, 58 Ohio St.2d 282, ____, 390 N.E.2d 320, 323 (1979) (debtor-creditor relationship is not a fiduciary relationship).

116. 293 Minn. 418 196 N.W.2d 619 (1972).

117. Klein v. First Edina Nat'l Bank, 293 Minn. 418, 420, 196 N.W.2d 619, 620-21 (1972).

118. *Id.*, 196 N.W.2d at 621. The bank applied part of the loan proceeds to retire a previous loan to the employer, which was secured by a receivable. *Id.* The bank officer assumed that the employer would use the proceeds from the receivable to repay the later loan. By 1966 the bank learned that the receivable had been paid in full, but did not call the loan until 1968. Because the loan was secured, the bank "considered itself under no obligation to keep tabs on. . . the account." *Id.*, 196 N.W.2d at 622.

119. *Id.* at 421, 196 N.W.2d at 622. The bank customer claimed that the bank committed fraud in taking the customer's stock as security. The customer was an alcoholic, had marital problems, and, at the time of the loan transactions, was in a highly emotional state. *Id.* at 420-21, 196 N.W.2d at 621-22. The customer testified that she would not have signed the loan instruments if someone other than the banker had put the papers before her to sign. *Id.* at 421, 196 N.W.2d at 622.

to indicate that the bank should have known that its customer was placing her trust and confidence in it and was depending upon it to look out for her interest.[120] Since no confidential relationship existed, the court affirmed a directed verdict in favor of the bank.[121]

Similarly, in *Denison State Bank v. Madeira*,[122] the buyer of an automobile dealership defended an action for collection of certain promissory notes executed and delivered to a bank on the ground that the lender had breached its fiduciary duty in failing to disclose certain financial matters of the seller prior to the sale.[123] The court held that the bank was not under a duty to disclose the financial information since the bank did not use the information to its own benefit at the expense of the buyer. Also, the allegedly concealed information was either a matter of public record or was otherwise readily available if the buyer had utilized some effort to discover the information.[124] While the buyer testified that he trusted and relied upon the bank to furnish him with complete, honest information, this was not enough to establish a fiduciary relationship.[125]

This is not to say that a customer can never establish a fiduciary relationship with the lender, but only that to do so may be extremely difficult. A borrower successfully established a fiduciary relationship in *Richfield Bank & Trust Co. v. Sjogren*.[126] In *Richfield Bank* a borrower purchased air purification units from National Pollution Eliminators, Inc. (National Pollution).[127] The president of National Pollution suggested that financing for the purchase could be arranged through the Richfield Bank. The borrower obtained the funding from the Richfield Bank.[128]

120. *Id.* 421-22, 196 N.W. 2d at 623. The plaintiff had been a customer of the defendant-bank for nearly 20 years before the date she pledged her stock. *Id.* The court held that this fact alone could not place the bank in a confidential relationship with the customer. *Id.*

121. *Id.* at 423, 196 N.W.2d. at 623.

122. 230 Kan. 684, 640 P.2d 1235 (1982).

123. Denison State Bank v. Madeira, 239 Kan. 684, ___, 640 P.2d 1235, 1237 (1982). In *Denison State Bank* the defendant invested in an automobile dealership. The defendant borrowed the necessary funding and executed promissory notes to a bank. The dealership was heavily indebted to the bank. *Id.* at ___, 640 P.2d at 1238. The dealership had an overdraft of $5,000 in its account with the bank and had outstanding $15,000 in drafts due to the bank. *Id.* The dealership also pledged General Motors Corporation rebates to a third party. *Id.* at ___, 640 P.2d at 1238-39. The defendant expected to receive the rebates as part of the return of his initial investment. *Id.* at ___, 640 P.2d at 1239.

124. *Id.* at ___, 640 P.2d at 1243. The court noted that the overdraft, the drafts, and the pledge of the rebates would probably be reflected in an examination of the dealership's records. *Id.* at ___, 640 P.2d at 1239. The defendant testified that he had full access to the dealership's financial records. *Id.* at ___, 640 P.2d at 1238.

125. *Id.* at ___, 640 P.2d at 1243. The court noted that "[i]n the instant case, we are not faced with a situation where a party with superior knowledge used that knowledge to its own benefit. . . . [The defendant] is fully competent and able to protect his own interests." *Id.* at ___, 640 P.2d at 1243-44.

126. 309 Minn. 362, 244 N.W.2d 648 (1976).

127. Richfield Bank & Trust Co. v. Sjogren, 309 Minn. 362, 363, 244 N.W.2d 648, 649 (1976). The purchase contract in *Richfield Bank* provided that National Pollution would install the units in various business establishments and the borrower would collect rents and service the units. The borrower was satisfied with the results of the transaction and decided to expand the business by purchasing additional units. *Id.*

128. *Id.* The borrower decided to make the purchase and obtained the necessary funds from the

National Pollution was insolvent and unable to deliver the purification units. Both the officers of National Pollution and the loan officer of the bank knew that the units were not available at the time of the loan. More significantly, however, the loan officer with whom the borrower dealt was also the only bank officer who handled the National Pollution account, was listed by National Pollution as its credit reference, had personally loaned National Pollution "$7,000 or $8,000," and had received fringe benefits from National Pollution.[129] The court found that the loan officer was an active participant in the daily affairs of the company.[130] Based upon these facts, the court found that the bank was under a duty to inform its customer of the "fraudulent activities" of National Pollution before it made a loan that "furthered the fraud."[131]

The *Klein* and *Madeira* cases illustrate the reluctance of the courts to impose a fiduciary relationship upon a transaction when the parties neither intended nor anticipated one. Whether a relationship exists depends upon the facts and circumstances of each individual case. If a borrower seeks to establish a fiduciary relationship between his lender and himself, he will have a very heavy burden in overcoming the strong presumption that appears to exist in favor of characterizing transactions between a lender and its customers as arm's length transactions.

B. CREDITORS v. LENDER

In addition to facing challenges from its borrowers, a lender who assumes control of a debtor's business runs the additional risk of answering to the debtor's other creditors. In addressing the creditor control issue in this context, it is helpful to carefully examine two cases, with differing results, for the purpose of analyzing the creditors' actions.

In *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*,[132] ten creditors of a specialized machine products company brought an action against the major creditor of the machine

Richfield Bank, giving the bank a security interest in real estate and in the units. The borrower had never before done business with the Richfield Bank and did not inquire into the financial condition of National Pollution. *Id.* at 364, 244 N.W.2d at 649.

129. *Id.* at 364-65, 244 N.W.2d at 650.

130. *Id.* The court found that the loan officer "was described by one of the employees of National Pollution as calling all the shots for National Pollution from February or March, 1972, onward, as being involved in just about everything that happened on a day-to-day basis in that company." *Id.* at 365, 244 N.W.2d at 650.

131. *Id.* at 369, 244 N.W.2d at 652. The court limited its holding to "the unique and narrow 'special circumstances' of this case, in which the bank had *actual knowledge* of the fraudulent activities of one of its depositors. . . ." *Id.* (emphasis supplied by court).

132. 483 F.2d 1098 (5th Cir. 1973).

company for the amount the company owed them. The alleged liability of the creditor, National Distillers & Chemical Corp. (National Distillers), was predicated upon the rule that when one corporation controls and dominates another corporation to the extent that the second corporation becomes the "mere instrumentality" of the first, the dominant corporation becomes liable for the debts of the subservient corporation attributable to an abuse of that control.[133]

In setting forth the "instrumentality" theory, the court began with the general rule that "the mere loan of money by one corporation to another does not automatically make the lender liable for the acts and omissions of the borrower."[134] If the rule were contrary, no lender would be willing to extend credit since the risks and liabilities would be too great. However, "[i]f a lender becomes so involved with its debtor that it is in fact actively managing the debtor's affairs, then the quantum of control necessary to support liability under the 'instrumentality' theory may be achieved."[135] To establish the requisite control, a party must show that the creditor assumed actual, participatory, and total control of the debtor.[136] In addition, for a court to find liability based upon the "instrumentality" theory, a party must show that the dominant corporation was using the subservient corporation to further the purpose of the dominant corporation and that the subservient corporation in reality had no separate, independent existence of its own.[137] Finally, the instrumentality rule requires that fraud or injustice proximately result from a misuse of control by the dominant corporation.[138]

Having established this as its test, the court turned to the facts. Brad's Machine Products, Inc. (Brad's) was a California corporation that began as a machine shop. It was owned by John Bradford and his wife Nola. His machinery operation in California proved profitable and he saw potential further profits in the munitions industry. In the mid-1960's Brad's obtained a government contract for the production of fuses.[139] Bradford's skills

133. Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098, 1101 (5th Cir. 1973). The court in *Krivo* noted that courts will disregard the corporate form "to affix liability where it justly belongs." *Id.* at 1103. *See* W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 43 (1983 rev. ed.). A growing class of cases disregard the corporate entity when another corporation conducts its affairs as though the entity is a mere conduit or instrumentality. *Id.*

134. 483 F.2d at 1104.

135. *Id.* at 1105.

136. *Id. See also* Baker v. Raymond Int'l, Inc., 656 F.2d 173 (5th Cir. 1981) (to pierce corporate veil, parent's control must be actual, participatory, and total).

137. 483 F.2d at 1105-06.

138. *Id.* at 1106. The court emphasized that liability under the instrumentality rule did not depend upon an intent to defraud. *Id.*

139. *Id.* at 1107. Brad's obtained a $2.7 million contract from the government for the production of fuses. *Id.*

as a machinist enabled him to develop a very efficient and unique system for manufacturing the fuse bodies. The new technique apparently revolutionized the manufacture of that particular fuse body.[140]

Following the acquisition of the government contract, Brad's appeared to prosper. Bradford's other investments, however, soon became a severe drain on Brad's operation.[141] By the late 1960's Brad's was experiencing financial distress. As a result of this distress, Brad's turned to its principal source of supply, Bridgeport Brass Co. (Bridgeport), a division of National Distillers for help.[142] Bridgeport, at the request of Brad's, agreed to convert an arrearage of approximately $1,000,000 to a promissory note, which was secured by certain real estate as well as the personal guarantees of Bradford and his wife. Despite the conversion of Bridgeport's open account balance into an installment payment obligation, Brad's continued to experience financial difficulties. In an effort to once again shore up his company, Bradford met with National Distillers. National Distillers agreed to loan Brad's additional money, defer payment on accounts receivable, help Brad's and Bradford liquidate unprofitable holdings to provide more capital, provide "internal financial management assistance," and intervene with the government to prevent cancellation of the existing fuse contract.[143] As security, National Distillers obtained a real estate mortgage on Brad's plant and a security agreement covering the plant's furniture and fixtures. In addition, Brad's and Bradford personally assigned various other assets to National Distillers for purposes of liquidation.[144] To help the financial management, National Distillers sent one of its internal auditors to Brad's plant to establish control procedures for managing cash and investments. Finally, National Distillers worked with Brad's to dispose of the assets assigned to National Distillers and other assets not so assigned. National Distillers agreed that any income or proceeds from the unassigned assets would be used for purposes of aiding Brad's other creditors first.[145] Despite the efforts of Brad's Bradford, and National Distillers, Brad's ceased its operations in

140. *Id.*

141. *Id.* Bradford's investments included a quarter horse, racing boats, airplanes, a bar, a motel, orange groves, oil wells, and a motion picture company. *Id.* One of Brad's subsidiaries lost over a million dollars in the late 1960's. *Id.*

142. *Id.* By 1969 Bridgeport was shipping $400,000 to $500,000 worth of brass rods to Brad's every month. *Id.*

143. *Id.* The Defense Contract Administration threatened to cancel its contract with Brad's if Brad's financial condition worsened. *Id.* at 1108.

144. *Id.* at 1108. Brad's and Bradford assigned captial stock in other corporations, oil and gas leases, and all the stock of Bradford's motion picture company to National Distillers. *Id.*

145. *Id.* at 1108-09. If the proceeds were more than Brad's other creditors required, they "either would revert to Brad's or to Bradford or would belong to National Distillers outright." *Id.* at 1109.

1970. Brad's creditors brought suit against National Distillers seeking payment of Brad's unpaid debts.[146]

Brad's creditors argued that National Distillers had in fact assumed control of Brad's.[147] The court, however, found that National Distillers' activities were "narrowly restricted to safeguarding its interests as a major creditor" and that it participated in the corporate decision-making only to a limited degree.[148] With regard to the auditor supplied by National Distillers, the court noted that his powers were essentially "negative in character."[149] Only those decisions having immediate effect on Brad's financial position were subject to the auditor's attention. In that regard, the auditor had merely a veto power even though all checks from Brad's account required his signature. The court found that the auditor was never substantially involved in personnel or production decisions.[150]

With regard to the creditors' argument that control existed by virtue of National Distillers' supervision of the liquidation of various assets, the court found that National Distillers made the final decision with regard to the disposition of the assets. The assets, however, had been assigned to National Distillers for just that purpose.[151]

The court found that, although National Distillers had the power to exert great influence on Brad's, the power was insufficient to constitute control. The court concluded that Brad's was not an instrumentality of National Distillers.[152]

In contrast to *Krivo* is *A. Gay Jenson Farms Co. v. Cargill, Inc.*,[153] which arose following the financial collapse of a Minnesota grain elevator. Eighty-six farmers brought the action seeking to recover losses sustained when the elevator, Warren Seed & Grain Co.

146. *Id.*

147. *Id.* The plaintiff-creditors alleged that National Distillers' majority ownership of Brad's stock constituted the control requisite for a finding of liability. *Id.*

148. *Id.* at 1110.

149. *Id.* at 1111. The court noted that the auditor merely monitored finances and helped "fend off aggressive, unhappy creditors." *Id.*

150. *Id.* at 1112.

151. *Id.*

152. *Id.* at 1114. The court concluded, finding that:

> Although National Distillers' position as a major creditor undoubtedly vested it with the capacity to exert great pressure and influence, we agree with the District Court that such a power is inherent in any creditor-debtor relationship and that the existence and exercise of such a power, alone, does not constitute control for the purpose of the "instrumentality" rule. . . . Plaintiffs had to show the exercise of that control in the actual operation of the debtor corporation.

Id.

153. 309 N.W.2d 285 (Minn. 1981).

(Warren), defaulted on the contracts it made with the farmers for the sale of grain.[154] The farmers premised the action upon an agency theory.

Section 14 O of the Restatement (Second) of Agency provides that a creditor who assumes control of the debtor's business may become liable for the debtor's business transactions.[155] In addition, comment a to section 14 O provides that when a security holder takes over the management of the debtor's business either in person or through an agent, he becomes liable as a principal for the obligations incurred by the business after the take over.[156] The plaintiffs also relied upon section 14 K, which provides that one who contracts to acquire property from a third person and convey it to another is the agent of the other "if it is agreed that he is to act primarily for the benefit of the other and not for himself."[157] The court concluded that Cargill was, in fact, the principal responsible to the farmers for the breached grain contracts.[158] In reaching this conclusion, the court carefully reviewed the historic relationship between Warren and Cargill.

The relationship began in 1964 when Cargill agreed to lend money to Warren on an "open account" basis up to a maximum of $175,000. Under this original contract Warren received funds and paid its expenses by issuing drafts drawn on Cargill through Minneapolis banks. Warren deposited its sale proceeds with Cargill and Cargill credited Warren's account. In return for this financing, Warren appointed Cargill as its grain agent for transactions with the Commodity Credit Corporation. Cargill also received the right of first refusal to purchase market grain sold by Warren to the terminal market. The parties negotiated a new contract in 1967 that extended Warren's credit line to $300,000. This later contract specified that Warren would provide Cargill with annual financial statements and that either Cargill would keep the books for Warren or an independent firm would conduct the audit. Cargill received the right of access to Warren's books for inspection. In addition, the agreement provided that Warren was not to make capital improvements or repairs in excess of a specified amount without Cargill's prior consent and was not to become liable as a guarantor or encumber its assets except with Cargill's

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154. A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 287-88 (Minn. 1981).

155. *See* RESTATEMENT (SECOND) OF AGENCY § 14 O (1958). Section 14 O provides, "A creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business." *Id.*

156. *Id.* comment a.

157. *Id.* § 14 K.

158. 309 N.W.2d at 294.

permission, Finally, Warren had to obtain Cargill's consent before declaring a dividend or selling and purchasing stock.[159]

For the next several years, Cargill continued to review Warren's operation and expenses and make recommendations with respect to the improvement of the Warren operation.[160] Cargill increased the credit line in 1972 to $750,000 and in 1976 to $1,250,000. At that time, Warren was shipping Cargill ninety percent of its cash grain. In addition, approximately twenty-five percent of Warren's total sales was seed grain that Warren sold as Cargill's agent under separate agreements.[161]

As Warren's indebtedness continued to exceed its credit line, Cargill began to contact Warren daily regarding its financial affairs. Cargill's headquarters informed its regional office in 1973 that, since Warren was using Cargill money, Cargill had the right to make some of the critical decisions regarding the use of the funds.[162] When it became evident that Warren had serious financial problems, Cargill assured several farmers who heard that Warren's checks were not being paid that "there would be no problem with payment."[163] In the final days of Warren's operation, Cargill sent an official to supervise the elevator operations, including the disbursement of funds and income generated by the elevator.[164]

After Warren ceased operations, it owed Cargill $3.6 million. Wrren also owed the plaintiff-farmers $2 million.[165] Cargill contended that an agency relationship did not exist between Warren and itself because it had not consented to the agency, Warren did not act on behalf of Cargill, and Cargill did not exercise control over Warren. The court, however, found that Cargill assumed de facto control of Warren and was, in fact, Warren's principal.[166]

In support of its finding that Cargill had assumed de facto

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159. *Id.* at 288.

160. *Id.* at 288-89. A Cargill official characterized the Warren operation as an organization that "needs *very strong* paternal guidance." *Id.* at 289 (emphasis supplied by court).

161. *Id.* at 289.

162. *Id.*

163. *Id.* at 289, 291.

164. *Id.* at 289. By April of 1977 Warren was $4 million in debt. *Id.*

165. *Id.* at 289-90.

166. *Id.* at 290-91. In finding that Cargill was Warren's principal, the court noted:

> By directing Warren to implement its recommendations, Cargill manifested its consent that Warren would be its agent. Warren acted on Cargill's behalf in procuring grain for Cargill as the part of its normal operations which were totally financed by Cargill. Further, an agency relationship was established by Cargill's interference with the internal affairs of Warren, which constituted de facto control of the elevator.

Id. at 291.

control of the elevator, the court recited the following: Cargill made "constant recommendations to Warren by telephone;" Cargill had a right of first refusal on Warren's grain; Cargill imposed restrictive covenants upon Warren and restricted its ability to enter into mortgages, purchase stock, or pay dividends without its approval; Cargill had a right of entry onto Warren's premises to carry on periodic checks and audits; Cargill criticized Warren's finances, officer's salaries, and inventory; Cargill determined that Warren needed "strong paternal guidance;" Cargill provided drafts and forms to Warren upon which Cargill's name was imprinted and which were used in the operation of the Warren business; Cargill financed *all* of Warren's grain purchases and operating expenses; and Cargill had the power to discontinue the financing of Warren's operation.[167]

While the *Cargill* court found that Cargill was in control of Warren, and established itself as Warren's principal under the Restatement standard, it is significant that the court also found that Cargill "kept Warren in existence" for its own purposes.[168] This was not the case in *Krivo.* In *Krivo* the creditor merely used its influence to maintain its position and protect its interests rather than engage in further profit taking, gain an unfair advantage, or do harm to other creditors. On the contrary, the creditor in *Krivo* assisted the debtor with liquidation plans designed to benefit other creditors.[169]

V. BANKRUPTCY CHALLENGES TO CREDITOR CONTROL

Should the debtor file a bankruptcy petition, the risks to a creditor who is exerting a significant amount of "leverage" over the debtor significantly increase. As a result of filing the bankruptcy petition, there may well be a trustee who will be very interested in the conduct of the lender. If a debtor filed a chapter 11 petition a creditor's committee may likewise be interested in the lender's conduct.[170] The two principal challenges to creditor

167. *Id.* at 291. Concerning Cargill's contention that Warren was merely a supplier, the court noted that a party must show that he is an independent business to establish that he is a supplier. *Id.* *See* RESTATEMENT (SECOND) OF AGENCY § 14 K comment a. Again, the court found that the decisions made by Warren were not independent of Cargill's interest or its control. 309 N.W.2d at 292. The court concluded that "the relationship that existed between the parties was not merely that of buyer and supplier." *Id.*

168. 309 N.W.2d at 293.

169. 483 F.2d at 1108-09.

170. *See* 11 U.S.C. § 1102(a) (1982). Section 1102(a) authorizes a bankruptcy court to appoint "a committee of creditors." *Id.*

control under the Bankruptcy Code will be under the "insider" preference rule of section 547(b)(4)(B) and the "equitable subordination" doctrine of section 510(c).

A. INSIDER PREFERENCES

Under section 547(b) of the Bankruptcy Code, a preference is a transfer of the debtor's property to or for the benefit of a creditor for or on account of an antecedent debt.[171] The transfer must have been made while the debtor was insolvent or within ninety days (one year for "insiders") before filing the bankruptcy petition.[172] The effect of the transfer must be to enable the creditor to receive more then it would receive in a chapter 7 bankruptcy if the debtor had not made the transfer.[173]

Congress made an important change in the law with regard to preferences when it enacted section 547(b). The "insider" concept did not exist in the Bankruptcy Act of 1898.[174] Under prior law, payments made to a controlling lender, relative, or other insider more than four months prior to the filing of the bankruptcy, could not be attacked by a creditor as a preference, but only as fraudulent conveyances.[175] The insider preference provisions of section 547(b) allow the trustee in bankruptcy or a debtor-in-possession to challenge transactions between a debtor and an insider that the debtor made up to one year before he filed a petition in bankruptcy.[176]

According to one commentator, section 547 is designed to promote two goals: to discourage creditors from racing to dismember the debtor during his "slide into bankruptcy" and to promote equality among creditors by not allowing a debtor to favor any one creditor.[177] Of these two, equality among creditors is the

171. *Id.* § 547 (b)(1), (2).
172. *Id.* § 547 (b)(4).
173. *Id.* § 547 (b)(5).
174. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544.
175. *See* 4 W. COLLIER, COLLIER ON BANKRUPTCY ¶ 547.01 (L. King 15th ed. 1979).
176. *See* 11 U.S.C. § 547 (b)(4) (1982). Section 547 (b)(4) provides that the trustee may avoid any transfer of property of the debtor made:

> (A) on or within 90 days before the date of filing of the petition; or
> (B) between 90 days and one year before the date of filing of the petition, if such creditor, at the time of such transfer—
> (i) was an insider; and
> (ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer. . . .

Id. Section 101(25) defines "insider." See *supra* note 48 for the text of § 101(25).
177. Note, *The Term Insider Within Section 547 (b)(4)(B) of the Bankruptcy Code*, 57 NOTRE DAME L. REV. 726, 727-28 (1982).

overriding goal.[178] Congress enacted the insider preference provisions of section 547 to foster the stated goals of the section.[179]

Under the Code, an insider is one "who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor."[180] Thus, the true test of whether one is an insider is whether he has a relationship with the debtor that courts cannot characterize as an arm's length transaction.[181]

The insider concept is not capable of precise definition; the Code's definition is open ended and merely lists examples of insider relationships.[182] Thus, who will qualify as an insider under the Code is a question of fact that a court must decide upon a review of all the facts and circumstances in each case.[183] For example, in *In re Montanino*,[184] the court, after carefully reviewing all the facts behind the transfer of property, concluded that the parents of a woman with whom the debtor was living were insiders within the meaning of section 547(b)(4)(B). The court found that the relationship between the woman's mother and the debtor "was more than sufficiently close to eliminate any finding of an arms-length transaction."[185]

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178. *See* H.R. Rep. No. 595, 95th Cong., 2d Sess. 177-78, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6138.

179. *See* Note, *supra* note 177, at 729-30. The commentator explains the rationale for the insider preference provision as follows:

> The primary reason for such exacting scrutiny of insiders is that persons with a close relationship to the debtor naturally have access to more information. Thus, insiders can exert greater influence on the debtor, which causes insider transactions to be less vulnerable to the market pressures that help control arm's length transactions. Exacting scrutiny is also warranted because the insider's close relationship to the debtor may veil a potentially preferential transfer, or may even deliberately conceal the preference.

Id.

180. H.R. Rep. No. 595, 95th Cong., 2d Sess. 312, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6269.

181. *See, e.g.*, *In re* Taylor, 29 Bankr. 5, 7 (Bankr. W.D. Ky. 1983) (an insider must have a "close relationship with the debtor"); *In re* Montanino, 15 Bankr. 307, 310 (Bankr. D.N.J. 1981) ("an 'insider' is one who has such a relationship with the debtor that their dealing with one another cannot be characterized as an arm's-length transaction").

182. Section 101(25) of the Bankruptcy Code provides a definition of insider. See *supra* note 48 for the text of § 101(25). Section 101(25) provides that an "insider *includes* [list of categories]." 11 U.S.C. § 101(25) (1976) (emphasis added). In addition, 11 U.S.C. § 102(3) provides that " 'includes' and 'including' are not limiting." *Id.* § 102(3) (1982). Thus, § 101(25) apparently provides only a partial list of those who are insiders under the Code.

For two decisions that have narrowly construed "insider" to constitute only those listed in § 101(25), see *In re* Yonkers Hamilton Sanitarium, Inc., 22 Bankr. 427, 430 (Bankr. S.D.N.Y. 1982) (government and its agent not insiders); *In re* Castillo, 7 Bankr. 135, 137 (Bankr. S.D.N.Y. 1980) (defendant bank that was not a relative, partner, director, office or person in control of the debtor was not an "insider").

183. *In re* Taylor, 29 Bankr. at 7 (citing 2 COLLIER ON BANKRUPTCY ¶ 101.25 (15th ed. 1979)).

184. 15 Bankr. 307 (Bankr. D.N.J. 1981).

185. *In re* Montanino, 15 Bankr. 307, 310-11 (Bankr. D.N.J. 1981). In *Montanino* the debtor purchased realty with funds borrowed from the defendant. The parties did not execute a promissory note or provide for interest or repayment terms. *Id.* at 308. In repayment of the loan, the debtor

When the debtor is a corporation or partnership, the insider definition contained in section 101(25) includes a "person in control of the debtor."[186] The Code does not define "person in control" or "control." According to at least one commentator, Congress intended the same broad concept of control as exists in the securities law.[187] If this is Congress' intent, given the dual policies of section 547, "[t]here is no reason why a bank providing necessary financing to an insolvent enterprise could not be considered to be in control and therefore an insider."[188] This would particularly be true in situations in which the bank could declare the loan in default at any time and held either the personal guarantees of the principals or collateral that is vital to the operation of the business.[189] In addition, given the expansive concept of insider, no reason exists why the control concept embodied in section 101(25) should necessarily be limited to control over legal entities such as partnerships or corporations. If it is possible for a lender to be in control of a corporate debtor for purposes of section 547, no reason exists why a lender cannot be in control of the individual debtor. The twin goals of section 547 prohibiting debtor dismemberment at the hands of creditors and preventing unequal treatment of creditors, are not necessarily limited to cases involving pervasive lender control of nonindividual debtors. Therefore, the prohibited control practices should not depend upon the character of the debtor.

This is not to say that all agricultural operating lenders are necessarily insiders. Depending upon the facts and circumstances of a particular case, an agricultural operating lender may well possess enough badges of control to render its relationship with the debtor sufficiently close to subject its transactions with the debtor to close scrutiny in order to determine whether those dealings are at arm's length.[190] Nothing in the Code or in the legislative history appears to prohibit this exacting scrutiny.

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transferred the realty to the defendants. *Id.* at 309. The court noted that the deed to the defendants recited that "this is a conveyance between relatives." *Id.* at 310. The court also found it significant that the debtor cohabitated with the defendant's daughter for a period of five years before the transfer. *Id.*

186. 11 U.S.C. § 101(25)(B)(iii) (1982).

187. *See* Queenan, *supra* note 38, at 470. The regulations issued under the Securities Exchange Act of 1934 provide that control is "possession, direct or indirect, of the power to direct or cause the direction of management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 240.12b-2 (1983).

188. Queenan, *supra* note 38, at 470.

189. *Id.*

190. *See In re* Jefferson Mortgage Co., 25 Bankr. 963 (Bankr. D.N.J. 1982). In *Jefferson Mortgage* the court found that the lender was not an insider because "not a scintilla of evidence" existed indicating that the concessions the lender obtained "rose to the level of a special relationship that would characterize the Bank as an 'insider' for purposes of § 547." *Id.* at 970.

Even if a court finds that a lender is an insider, however, the trustee or debtor-in-possession must prove two additional elements. First, they must show that the insider had reasonable cause to believe that the debtor was insolvent.[191] They must also show that the debtor was actually insolvent on the date of the transfer.[192] The standard for reasonable cause to believe that the debtor is insolvent is whether the creditor has sufficient actual information respecting the debtor's financial condition so that an ordinary prudent person would be put on notice and inquiry as to his financial status.[193] This standard requires neither actual knowledge nor actual belief of the debtor's insolvency.[194] Whether a creditor had reasonable cause to believe the debtor was insolvent is a question of fact that courts must resolve on a case by case basis.[195] Due to this heavy burden of proof, however, the reasonable cause standard may result in sheltering transfers that have benefited the insider at the expense of other creditors.

In addition to proving that the creditor had reasonable cause to believe that the debtor was insolvent on the date of the transfer, the trustee or debtor-in-possession must also prove that the debtor was actually insolvent when he made the transfer for insider preferences falling outside the ninety day period.[196] The Bankruptcy Act's balance sheet test of insolvency still applies under the Code.[197] They must show, therefore, that on the transfer date the debtor's debts were greater than its assets, which are valued at their fair market value. Proving actual insolvency on a date up to one year prior to the filing of a bankruptcy petition may be difficult.[198] Presumably, however, a debtor-in-possession would have an easier time proving this than a trustee since the debtor will be relying upon his own records.

Should a court find that an agricultural operating lender is an insider, application of section 547(c)(5) could be disastrous for the

191. 11 U.S.C. § 547 (b)(4)(B)(ii) (1982).

192. *Id.* § 547 (b)(3). The presumption of insolvency is not applicable beyond the 90-day "non-insider" preference period of § 547(b)(4). *Id.* § 547(f) (1982).

193. *Montanino,* 15 Bankr. at 311.

194. *Id.*

195. *In re* Gruber Bottling Works, Inc., 16 Bankr. 348, 352 (Bankr. E.D. Pa. 1982). On the facts in *Gruber Bottling* the court found that the creditor "had no reasonable cause to believe that the debtor was insolvent." *Id.* at 354.

196. 4 COLLIER ON BANKRUPTCY *supra* note 175, ¶ 547.26.

197. *See* 11 U.S.C. § 101(26) (A) (1982). Section 101(26)(A) provides that one is insolvent "when the sum of his debts is greater than all of [his] property." *Id.* Thus, insolvency reflects one's balance sheet.

198. *See* Queenan, *supra* note 38, at 470. The commentator notes, however, that courts may be "fairly liberal in permitting the trustee to link up the debtor's condition on the filing date with any time during the prior year though evidence indicating that what transpired during the year consisted only of an insolvent enterprise going further downhill." *Id.*

lender.[199] Section 547(c)(5) considers transfers that improve a creditor's position or result in a reduction in the secured party's security interest during the preference period.[200] If the creditor is not undersecured during this period, he will escape difficulty. The focus of the section is on the improvement of the secured party's position caused by the enhancement of the collateral's value during the preference period. If the lender's position is improved, it has realized a preference.

Section 547(c)(5) applies only to inventory and receivables; inventory for the purpose of section 547 includes "farm products such as crops or livestock, held for sale or lease."[201] In addition, section 547(e)(3) provides that a preferential transfer does not exist "until the debtor has acquired rights in the property transferred."[202] These provisions appear to be very significant for the agricultural operating lender.

It would appear that under section 547(c)(5) two situations exist by which an agricultural creditor may be at risk. If a lender makes a loan before the farmer-borrower plants the crops and if the planting occurs within the preference period, the crop lender whose lien on the crops is dependent upon an after-acquired property clause may have obtained a preferential transfer. Since a debtor has no rights in growing crops until he plants them, the section 547 transfer occurs at the time of planting and the earlier loan is an antecedent debt.[203] If he plants the crops prior to the preference period, the planting itself would not seem to be a preferential transfer. To the extent that the crop increases in value during the preferential period, however, a corresponding preference challenge

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199. 11 U.S.C. § 547(c)(5) (1982). Section 547(c)(5) provides that § 547(b) does not apply to a transfer of the following:

> [A] perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of—
> (A)(i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or
> (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; and
> (B) the date on which new value was first given under the security agreement creating such security interest. . . .

Id.

200. *Id.*

201. *Id.* § 547(a)(1).

202. *Id.* § 547(e)(3).

203. Reiley, *Farming Failures and Drafting Failures: The Uncertain Posture of Crop Financing Under Article 9 and § 547 of the Bankruptcy Code*, ANN. SURV. BANKR. L. 29, 39 (1983).

may result.[204] While the creditor will argue that no "transfer" exists that would result in the enhancement of value of the collateral subject to section 547, the broad definition of "transfer" contained in the Code[205] may well provide a trustee or debtor-in-possession with a claim for conversion of property by the debtor for the enhanced value of the collateral subject to a security interest.[206]

Courts, however, have been reluctant to apply section 547 to the enhancement of value of collateral during the preference period; therefore, the agricultural operating lender who may potentially be classified as an insider by the court must be very conscious of the risks of the extended preference period applicable to insiders. For example, in *In re Nivens* [207] the court, in dicta, indicated that section 547 was not applicable to a mere increase in crop value during the preference period.[208] And in *Fairchild v. Lebanon Production Credit Association*[209] the court indicated that the mere increase in the value of existing collateral, without a transfer, was not a preferential transfer under the Code.[210] Thus, a lender should be aware of the potential challenge to his security interest in crops that the debtor plants or livestock he acquires during the preference period.

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204. *Id.* at 40. Professor Reiley contends that the value enhancement in growing crops should not be viewed as a transfer because no assets of the debtor are diverted to the crops. *Id.*

205. *See* 11 U.S.C. § 101(41) (1982). Section 101(42) provides: " 'Transfer' means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest." *Id.*

206. *See* Reiley, *supra* note 203, at 41. Professor Reiley states:

> Cultivation, fertilization and irrigation within the preference period require the expenditure of dollars or incurring debt for materials and labor and the use of the debtor's equipment and the debtor's labor. The cost of these activities would seem to be a transfer. To the extent that cost is paid from assets otherwise available to unsecured creditors there is a transfer to the prejudice of creditors within the meaning of Section 547(c)(5).

Id. Therefore, he appears to suggest that additional costs incurred by a debtor in the furtherance of his farming operation within the preference period constitutes a voidable preference under the Code.

207. 22 Bankr. 287 (Bankr. N.D. Tex. 1982). In *Nivens* creditors of the bankrupt debtor claimed that they had liens to disaster payments and government support payments by virtue of their security interests in crops and the proceeds of crops. *In re* Nivens, 22 Bankr. 287, 289 (Bankr. N.D. Tex. 1982).

208. *Id.* at 293. The court noted that when the volume of inventory increases during the preference period, the lien that affixes against the increase becomes voidable. When only the value of inventory increases, however, the increase in value does not constitute an avoidable preference. *Id.*

209. 31 Bankr. 789 (Bankr. S.D. Ohio 1983). In *Fairchild* the defendant had a security interest in the debtor's "feeder" hogs. The debtor subsequently converted his business to a hog "breeder" operation. Fairchild v. Lebanon Prod. Credit Ass'n, 31 Bankr. 789, 791 (Bankr. S.D. Ohio 1983). The court held that the subsequently acquired "breeder" hogs were covered by the defendant's security interest. *Id.* at 793.

210. *Id.* at 794. The debtors contended that the defendant's interest in the hogs that were born within 90 days of the filing of the petition did not attach until the hogs were born. *Id.* at 793. The court concluded that the defendant's rights attached to the entire herd and that the increase in the herd was merely an increase in value. *Id.* at 794. The court indicated that had new hogs been *acquired*, they would have been subject to a preference. *Id.*

B. EQUITABLE SUBORDINATION

As previously discussed, equality of distribution among creditors is a fundamental theme of the Bankruptcy Code.[211] The fundamental purpose behind section 547 is to allow a trustee or debtor-in-possession to recapture a debtor's preferential transfers that benefit one creditor at the expense of others.[212] In addition to authorizing the avoidance of preferential transfers, the Bankruptcy Code allows a bankruptcy court, sitting as a court of equity, "under principles of equitable subordination," to subordinate all or part of a claim to all or part of any other allowed claim.[213] Courts have long viewed this power as merely an exercise of broad equitable powers of the bankruptcy court to correct abuses, fraud, and inequity that would otherwise result from a strict application of the equal distribution principle of the bankruptcy laws.[214]

The Bankruptcy Code, rather than providing guidance to the courts in administering the doctrine of subordination, merely provides that courts should invoke the doctrine "under principles of equitable subordination."[215] The Code's legislative history indicates that courts should apply equitable subordination according to existing case law, leaving the development of the concept to the courts.[216] Because of this dependence upon prior case law, it is necessary to briefly review the development of equitable subordination.

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211. 4 COLLIER ON BANKRUPTCY *supra* note 175, ¶ 547.03[1].

212. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 177-78, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6138. The House Report states that the purpose of § 547 is "to deter 'the race of diligence' of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section — that of equality of distribution." *Id.* at 178, 1978 U.S. CODE CONG. & AD. NEWS at 6138.

213. 11 U.S.C. § 510(c)(1) (1982). Section 510(c) provides:

> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to 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.

214. *See In re* Multiponics, Inc., 622 F.2d 709, 721 (5th Cir. 1980) (bankruptcy court is authorized to prevent fraudulent, abusive, or unfair course of conduct through equitable subordination). *See also In re* Kansas City Journal-Post Co., 144 F.2d 791, 800 (8th Cir. 1944). In *Kansas City Journal-Post* the court described equitable subordination as:

> a means of regulating distribution results in bankruptcy by adjusting the order of creditors' payments to the equitable levels of their comparative claim positions. . . . [I]ts fundamental aim is to undo or to offset any inequity in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results.

Id. at 800.

215. 11 U.S.C. 510(c)(1) (1982).

216. *See* H.R. Rep. No. 598, 95th Cong., 2d Sess. 359, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS, 6307, 6315. The House Report states that the court's power to subordinate claims is "broader than the general doctrine of equitable subordination, and encompasses subordination on any equitable grounds." *Id.*

One of the earliest Supreme Court cases addressing the power of equitable subordination is *Taylor v. Standard Gas & Electric Co.*[217] In *Taylor,* the Court held that since Standard Gas & Electric Co., the controlling stockholder of the debtor, contributed to the debtor's financial distress through mismanagement, the Court must subordinate Standard's claims for loans made to the debtor to those of the preferred stockholders.[218] Shortly after Taylor, the Supreme Court decided *Pepper v. Litton,*[219] in which a corporation's dominant and controlling shareholder caused the company to confess a judgment for salary claims prior to the corporation's bankruptcy. After the corporation commenced bankruptcy proceedings the shareholder attempted to enforce the judgment.[220] The Court held that the shareholder abused his fiduciary position and violated the "rules of fair play and good conscience."[221] The Fifth Circuit has clarified this vague standard of fair play and good conscience more recently in *In re Mobile Steel Co.*[222]

In *Mobile Steel* the claimants were the organizers, officers, and directors of a corporation controlled by one of the claimants.[223] The claimants presented two classes of claims during the bankruptcy proceedings. They based the first upon debentures issued to the claimants by the company's predecessor.[224] They based the second claim upon promissory notes issued to three of the claimants in exchange for commercial property.[225] The bankruptcy court determined that the consideration which the claimants gave for the

217. 306 U.S. 307 (1939).

218. Taylor v. Standard Gas & Elec. Co., 306 U.S. 307, 323 (1939). In *Taylor* the Court found that Standard completely controlled the debtor, Deep Rock, since Standard owned nearly all of Deep Rock's common stock, a majority of Deep Rock's directors were Standard officers, directors, or agents, and Standard controlled the fiscal affairs of Deep Rock as its only creditor. *Id.*

219. 308 U.S. 295 (1939).

220. Pepper v. Litton, 308 U.S. 295, 298 (1939). In *Pepper v. Litton* the petitioner brought suit against a corporation and its controlling shareholder for unpaid royalties. *Id.* at 297. While the suit was pending, the controlling shareholder of the corporation caused the corporation to confess a judgment for past salary claims. *Id.* The shareholder acquired the corporation's property through an execution sale and transferred it to a new wholly owned corporation. *Id.* at 298. The corporation then filed a voluntary petition in bankruptcy. *Id.*

221. *Id.* at 310. The Court found that the actions of the controlling shareholder revealed a scheme to defraud the petitioner. *Id.* at 296.

222. 563 F.2d 692 (5th Cir. 1977).

223. *In re* Mobile Steel Co., 563 F.2d 692, 695 (5th Cir. 1977). In *Mobile Steel* a group of investors formed E.B.F. Co., Inc., and purchased the assets of a corporation. *Id.* at 696. The purchase was financed by a secured bank loan, the proceeds of the capital contributions of the investors, and the proceeds of the issuance of debentures to the investors. *Id.* The corporation then changed its name to Mobile Steel Co., Inc. (Mobile Steel). *Id.* at 697.

224. *Id.* at 695.

225. *Id.* Mobile Steel purchased realty from a partnership. *Id.* at 697-98. Two of the three partners of the partnership were directors and shareholders of Mobile Steel. *Id.* at 697. Mobile Steel financed the transaction by assuming the mortgage debt on the property and issuing promissory notes to the partnership for the balance of the purchase price. *Id.* at 698. Mobile Steel then sold the property. *Id.* As part of the sales agreement, the partnership released its security interest in the property and surrendered the promissory notes. *Id.* Mobile Steel then issued new promissory notes to the partners individually. *Id.*

debentures constituted a contribution to capital rather than a loan. Thus, the bankruptcy court disallowed their first claim.[226] The second group of claims was subordinated to the claims of the other secured creditors on the ground that the claimants failed to establish affirmatively the proper performance of their fiduciary obligations, which supported their claims.[227] The district court affirmed this decision. On appeal, the court of appeals held that both the disallowance and the subordination of the claims were improper.[228] According to the court, the following three conditions must be satisfied before a bankruptcy court may exercise the power of equitable subordination: "[1] The claimant must have engaged in some type of inequitable conduct. . . . [2] The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant. . . . [3] Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act."[229] In addition to these three conditions to the exercise of the power of equitable subordination, the court indicated that three "principles" must be considered. First, the inequitable conduct need not relate to the acquisition or assertion of the claim.[230] Second, a court should subordinate a claim only to the extent necessary to offset the harm that the debtor and its creditors suffered because of the inequitable conduct.[231] Third, it is up to the objecting trustee to come forward with enough substantiation to overcome the claimant's prima facie case that exists as a result of the filing and proving of a claim. Once he has filed his claim, the claimant must prove its validity and honesty.[232]

While the equitable subordination of a creditor's claim may often be the most appropriate and effective means to prevent a

226. *Id.* at 702. The bankruptcy judge determined that the debentures were really preferred stock and not entitled to treatment as debt. *Id.*

227. *Id.* at 704. The bankruptcy judge concluded that because of the poor financial position of Mobile Steel, purchase of the property constituted culpable mismanagement by the directors. *Id.* The bankruptcy judge also noted that the directors personally benefited from the purchase from their partnership. *Id.*

228. 563 F.2d at 706.

229. *Id.* at 700 (citations omitted).

230. *Id. See In re* Kansas City Journal-Post Co., 144 F.2d 791 (8th Cir. 1944). The Eighth Circuit Court of Appeals in *Kansas City Journal-Post* noted that inequitable conduct warranting subordination "need not . . . be specifically related to the creditor's claim, either in its origin or acquisition. . . ." *Id.* at 804.

231. 563 F.2d at 701. The court noted that, since the subordination power is remedial rather than penal, subordination of a creditor's claim in an amount greater than the injury he has caused to the bankrupt would be improper. *Id.*

232. *Id.* The court stated that a trustee's objection must contain a "substantial factual basis to support its allegation of impropriety." *Id.* To not require a substantial factual basis would place an unwarranted burden on the fiduciary to prove the fairness of all of their transactions with the bankrupt. *Id.* The court noted, however, that once the initial presumption of validity is overcome, fiduciaries' claims demand a "large measure of watchful care." *Id.* at 702. (citing Washburn v. Green, 133 U.S. 30, 43 (1890)).

creditor from realizing the benefits of an inequitable course of conduct, courts should recognize that equitable subordination provides a basis for correcting inequities caused as a result of a creditor's own actions.[233] Thus, the court's equitable powers should not enhance one creditor's rights to the detriment of another's legitimate rights.

Generally, inequitable conduct refers to conduct that would make it unfair to allow a creditor his claim or, if his claim is allowed, to permit him to pursue his claim on a parity with other similarly situated creditors. Oftentimes, therefore, courts order subordination upon findings of fraud, illegality, undercapitalization of the debtor, or a claimant's use of the debtor as a mere "instrumentality."[234] The fraud and instrumentality grounds are most applicable to the case of an agricultural operating lender who may be exposed to an equitable subordination charge.

In the context of equitable subordination, "fraud" is much broader than the traditional common law concept.[235] For example, fraud may involve the misuse of a judgment claim to the detriment of other creditors.[236] Fraud may also involve the misrepresentation of a debtor's financial status.[237] Finally, fraud may consist of the breach of a fiduciary relationship, typically the duty owed by a shareholder to a corporation.[238] Courts, however, have never limited the subordination doctrine to fiduciaries alone.[239] If the

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233. *See In re* Kansas City Journal-Post Co., 144 F.2d at 800-01. The court in *Kansas City Journal-Post* stated that:

> the power of subordination . . . should not operate to take away anything punitively to which one creditor is justly entitled in view of the liquidation finality, and bestow it upon others, who in the relative situation have no fair right to it. It can therefore ordinarily go no farther than to level off actual inequitable disparities on the bankruptcy terrain for which a creditor is responsible, to the point where they will not create unjust disadvantages in claim positions and liquidation results.

Id.

234. Note, *Deep Rock in the Deep South — Equitable Subordination of Claims in Fifth Circuit Bankruptcy Proceedings*, 11 CUM. L. REV. 619, 626 (1981); Herzog & Zweibel, *The Equitable Subordination Claims in Bankruptcy*, 15 VAND. L. REV. 83, 83 (1961).

235. Herzog & Zweibel, *supra* note 234, at 98-99. The commentators note that fraudulent conduct requiring equitable subordination need not "fit into the classic common law concept of fraud." *Id.* at 99. Section 548 of the Code allows a trustee to totally avoid a fraudulent transfer of an interest of the debtor. *See* 11 U.S.C. § 548(a)(1) (1982).

236. *See* Pepper v. Litton, 308 U.S. 295, 312 (1939) (confession of judgment in favor of controlling shareholder to defraud creditors); *In re* Lockwood, 14 Bankr. 374, 381 (Bankr. E.D. N.Y. 1981) (judgment obtained against debtor through fraud).

237. *See, e.g.*, L & M Realty Corp. v. Leo, 249 F.2d 668, 672 (4th Cir. 1957) (when stockholder fraudulently obtained loan, his claim subordinated to repayment of loan in bankruptcy of corporation); *In re* Bowman Hardware & Elec. Co., 67 F.2d 792, 795 (7th Cir. 1934) (when claimant's loan to bankrupt not disclosed to creditors at claimant's request, claimant's loan subordinated to creditors' claims).

238. *See* Pepper v. Litton, 308 U.S. 295, 312 (1939) (controlling shareholder caused bankrupt corporation to confess judgment in his favor to defraud creditor).

239. *See In re* Teltronics Servs., Inc., 29 Bankr. 139, 169 (Bankr. E.D. N.Y. 1983). In *Teltronics* the court noted that while "the overwhelming majority of subordination cases involve the claims of fiduciaries . . . the subordination doctrine has never been strictly limited to fiduciaries." *Id.*

claimant is a fiduciary, the court will subject his dealings with the debtor to more exacting scrutiny.[240] If the claimant is a non-fiduciary, "egregious conduct must be proven with particularity. . . . [I]t is insufficient for the objectant in such cases merely to establish sharp dealings; rather he must prove that the claimant is guilty of gross misconduct tantamount to 'fraud, overreaching or spoliation to the detriment of others.' "[241] For purposes of equitable subordination, a court may well find a creditor exercising control over a debtor to be a fiduciary.[242] That one is a fiduciary is not of itself sufficient to result in subordination of the fiduciary's claim; inequitable conduct must have occurred.[243]

The second type of inequitable conduct that may give rise to the equitable subordination of a creditor's claim is the self-serving domination of a debtor by a creditor to the detriment of other creditors or the debtor himself. This conduct generally arises in the context of a relationship between a corporation and a claimant in which the self interest of the claimant is the motivating force behind the debtor corporation's transactions. These transactions are indicative of the "instrumentality" or alter-ego cases.[244] As discussed previously under the instrumentality theory, the mere domination of a debtor by another is not sufficient to establish inequitable conduct. Rather, it is the use of that domination to the advantage of the dominating corporation resulting in injury to the subsidiary that brings subordination into play.[245]

The presence of inequitable conduct, without more, does not warrant the subordination of a claim under the *Mobile Steel* test.[246] The misconduct must result in injury to the creditors of the debtor

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240. *Id.* (citing Pepper v. Litton, 308 U.S. 295, 306-08 (1939)).

241. *In re* Teltronics Servs., Inc., 29 Bankr. at 169 (quoting *In re* W.T. Grant Co., 4 Bankr. 53, 75 (Bankr. S.D.N.Y. 1980), *aff'd*, 699 F.2d 599 (2d Cir. 1983)).

242. 29 Bankr. at 170 (creditor may be held to fiduciary standard if he exerts control amounting to domination of will).

243. *See, e.g.*, *In re* Featherworks Corp., 25 Bankr. 634, 648 (Bankr. E.D. N.Y. 1982) (creditor must show that claimant's conduct was inequitable and resulted in injury to creditor or unfair advantage to claimant); *In re* De Feo Fruit Co., 24 Bankr. 220, 226 (Bankr. W.D. Mo. 1982) (some misconduct related to claim necessary to subordinate claim).

244. *See* Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939). In *Taylor* a parent mismanaged and dominated its bankrupt subsidiary, Deep Rock Oil Corp. (Deep Rock). *Id.* at 320. The Court recognized the instrumentality rule, which would treat Deep Rock as an agent of the parent and preclude the parent's claim. *Id.* at 322. The Court held that because the parent had mismanaged and dominated Deep Rock, its claim was subordinate to the claims of preferred shareholders. *Id.* at 324. From *Taylor* equitable subordination has come to be known as "the Deep Rock doctrine." See Note, *supra* note 234, at 621 for a discussion of the Deep Rock doctrine.

245. Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098, 1103 (5th Cir. 1973). The court in *Krivo* noted that liability under the instrumentality rule requires that the dominant corporation must have proximately caused harm to the plaintiff. *Id.* See *supra* notes 132-52 for a discussion of *Krivo*.

246. *See In re* Mobile Steel Co., 563 F.2d 692, 699-702. In *Mobile Steel* the court stated that inequitable conduct was only one of three conditions that must exist before a court may properly exercise equitable subordination. *Id.* at 699-700. See *supra* text accompanying note 229 for the *Mobile Steel* test.

or confer an unfair advantage on the claimant.[247] It is not necessary under this test, however, for the claimant to both obtain an advantage and cause injury to other creditors.[248] The third requirement in the *Mobile Steel* test is that the subordination must be consistent with the provisions of the Bankruptcy Code.[249] Thus, a bankruptcy court cannot grant equitable relief that overrides congressional directives concerning the manner in which courts should marshal or protect priorities.[250] The bankruptcy court's power to subordinate is, therefore, not unlimited.

Because the equitable subordination power is remedial and not punitive, the intended beneficiaries of a subordination are the other creditors, not the debtor.[251] The proper party to seek equitable subordination, therefore, is generally the trustee in bankruptcy or the creditors.[252] Although a debtor-in-possession in a chapter 11 reorganization has all the powers of a trustee,[253] at least one court has held that the debtor has no standing to raise the doctrine.[254]

In addressing the issue of whether a creditor's claim should be equitably subordinated, one must again begin with the proposition that a creditor is not a fiduciary of his debtor. However, as discussed above, when a creditor exercises pervasive control, a court may hold the creditor accountable under a fiduciary standard. Several cases are helpful in analyzing this issue.

In *In re American Lumber Co.*,[255] the Federal District Court for the District of Minnesota found "overwhelming" evidence that a lender purposefully manipulated a debtor's operations in a manner detrimental to the debtor's unsecured creditors.[256] Among the indicia of control the court found sufficient to establish a complete domination of will were the following:

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247. *Id.* at 700.

248. *Id.* at 700-02. *See also In re* Multiponics, Inc., 622 F.2d 709 (5th Cir. 1980). In *Multiponics* the court noted that equitable subordination was appropriate when "the misconduct resulted in injury 'to the *creditors* of the bankrupt,' not necessarily directly to the bankrupt." *Id.* at 721 (emphasis supplied by court).

249. 563 F.2d at 700.

250. *In re* Dade County Dairies, Inc., 474 F. Supp. 438 (S.D. Fla. 1979). In *Dade County Dairies* the court noted that equitable subordination of a claim cannot be inconsistent with the Bankruptcy Act and, therefore, held that the bankruptcy court was without equitable powers to subordinate an administrative expense claim to which the Act gave priority. *Id.* at 440.

251. *In re* Multiponics, Inc., 622 F.2d at 721. The court in *Multiponics* noted that injury resulting from misconduct must be shown to have resulted " 'to the *creditors* of the bankrupt,' not necessarily directly to the bankrupt itself." *Id.* (emphasis by the court).

252. *In re* Weeks, 28 Bankr. 958, 960 (Bankr. W.D. Okla. 1983) (proper party to seek equitable subordination is creditor or trustee); *In re* Lockwood, 14 Bankr. 374, 381 (Bankr. E.D. N.Y. 1981) (proper party to seek equitable subordination is trustee).

253. 11 U.S.C. § 1107(a) (1982).

254. *See In re* Weeks, 28 Bankr. at 960. The court stated that "debtors have no standing to raise the doctrine [of equitable subordination]." *Id.*

255. 5 Bankr. 470 (Bankr. D. Minn. 1980).

256. *In re* American Lumber Co., 5 Bankr. 470, 478 (Bankr. D. Minn. 1980). See *supra* notes 56-59 and accompanying text for the facts of *American Lumber*.

(1) The bank had the right to a controlling interest in the debtor's stock pledged as collateral in the event of a default in the loan obligation;

(2)The bank, which was the debtor's sole source of credit, placed the debtor within its coercive powers by refusing to honor the debtor's payroll checks, and by foreclosing on its security interests in the debtor's only source of ready cash; and

(3) The bank forced compliance with its wishes by imposing such harsh measures on the debtor as forcing the termination of most employees, requiring drastic reductions in officers' salaries, coercing execution of security agreements on the debtor's only remaining assets, and determining which creditors were to be paid by the debtor.[257]

Another case in which the court held a non-insider creditor to a fiduciary standard is *In re Process-Manz Press, Inc.*[258] In *Process-Manz* the claimant held a possessory pledge of substantially all the bankrupt debtor's common stock, endorsed in blank. The debtor assigned all of its receivables to the claimant, and the claimant collected the proceeds and supplied funds for the bankrupt's payroll and other expenses.[259] In addition, the creditor participated in a stock redemption that adversely affected other creditors.[260] The court found that the control that the creditor exercised over the bankrupt was so pervasive that the claimant was "in substance the owner" of the debtor, and therefore a fiduciary.[261] Since the court found that the creditor engaged in unfair and fraudulent conduct to the detriment of the debtor, its claims were equitably subordinated.[262]

In *In re Prima*,[263] the court determined that a bankrupt debtor's acquiescence in a bank's recommendation to hire a particular general manager was insufficient to constitute a domination of its will.[264] The bank provided all the debtor's financial support through one year of continuing losses and the debtor and its three

257. 5 Bankr. at 473-74.

258. 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967).

259. *In re* Process-Manz Press, Inc., 236 F. Supp. 333, 336-37 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967). See *supra* notes 78-81 and accompanying text for a discussion of the facts of *Process-Manz*.

260. *Id.* at 338-39. The court found that Armstrong caused the bankrupt to redeem its preferred stock at a time when the bankrupt was unable to pay its debts as they matured. *Id.* at 348.

261. *Id.* at 348. The bankruptcy referee found that Armstrong, holding over 90% of the stock of the bankrupt and controlling all its income, was not an ordinary secured creditor but the "alter ego" of the bankrupt. *Id.*

262. *Id.* at 348-50. The court found that Armstrong's actions towards the bankrupt's creditors were "unfair, inequitable and unconscionable." *Id.* at 348.

263. 98 F.2d 952 (7th Cir. 1938).

264. *In re* Prima Co., 98 F.2d 952, 964 (7th Cir. 1938).

principals, who had guaranteed the debts with the bank, believed that if the debtor did not enter into the contract with the bank's general manager, the bank would call the loan.[265] The court held that because the bank was a nonfiduciary, its threat to call the outstanding loans did not constitute overreaching but rather was the lawful exercise of its legal rights.[266] In arriving at its holding the court noted that the debtor voluntarily entered into a second contract with the manager without the knowledge or consent of the bank involved.[267] In addition, the debtor never communicated with the bank regarding any of the acts of alleged mismanagement later raised.[268]

Finally, in *In re W.T. Grant Co.*,[269] the court considered whether creditor-banks influenced several of the debtor's key financial decisions in the period of time immediately preceding the commencement of bankruptcy proceedings.[270] Several of Grant's creditors sought to have the claims of the banks subordinated.[271] The bankruptcy court recognized that courts have denied the application of equitable subordination in several cases, even when a creditor exercised a significant degree of daily monitoring of its debtor.[272] As a result, the bankruptcy court rejected the argument on the theory that the actions taken by the debtor "reflected independent policy decisions and not rigid submission to the dictates of the bank claimants."[273] On appeal, the Court of Appeals for the Second Circuit found nothing improper about the bank's "careful watch" of the debtor's activities, and suggested that the

265. *Id.* at 964. In *Prima* the debtor was a beer manufacturer. *Id.* at 959. The debtor incurred losses for almost a year before borrowing money from the Harris Trust and Savings Bank (Harris). Harris, believing that the debtor's troubles were largely due to mismanagement, recommended that the debtor discharge their old manager and hire Garnett Skinner. *Id.* at 961.

266. *Id.* at 965. The debtor believed that if it did not acquiesce in Harris's suggested change of management, Harris would enforce collection of its loan. *Id.* at 964. The court noted that the bank had not threatened to call its loan and the evidence did not establish a domination of the debtor's will. *Id.* at 964-65.

267. *Id.* at 966. Since the debtor entered into a later employment contract with Skinner without the knowledge or consent of the bank, the court did not consider Skinner to be an agent of the bank. *Id.*

268. *Id.* The court noted that if the debtor had considered Skinner an agent of the bank, it would have notified the bank of any mismanagement by Skinner. *Id.*

269. 4 Bankr. 53 (Bankr. S.D.N.Y. 1980), *aff'd,* 699 F.2d 599 (2d Cir.), *cert denied,* 104 S. Ct. 89 (1983).

270. *In re* W. T. Grant Co., 4 Bankr. 53, 60 (Bankr. S.D.N.Y. 1980), *aff'd,* 699 F.2d 599, 602-03 (2d Cir.), *cert. denied,* 104 S. Ct. 89 (1983). *Grant* involved the approval of a chapter 11 offer of compromise and settlement of claims against a bankrupt by holders of the bankrupt's debentures. 4 Bankr. at 56. The debenture holders contended that the bank claimants should be equitably subordinated to their claims. 4 Bankr. at 60.

271. 4 Bankr. at 61.

272. *Id.* at 75. The court noted that, to establish an equitable subordination claim, a claimant must show "fraud, overreaching or spoliation to the detriment of others." *Id.*

273. *Id.* at 77. The court concluded that the transactions between the banks and the bankrupt were "the result of arm's-length negotiations conducted in good faith and governed by the dictates of sound business judgment." *Id.* at 76.

banks would have been derelict in their duty to their own creditors and equity holders had they not done so.[274]

In reviewing these cases, it seems apparent that the creditors in *American Lumber* and *Process-Manz* exercised rights beyond those necessary to protect their position. They engaged in affirmative conduct in which they were active participants in schemes designed to adversely affect other creditors. In *American Lumber* the bank obtained, through coercion, an eleventh-hour security interest in previously unencumbered collateral.[275] In addition, it paid only those creditors' claims that would benefit itself.[276] In *Process-Manz* the claimant participated in a stock redemption that resulted in the debtor being left with an unreasonably small amount of capital for the continuation of its business.[277] The deprivation of working capital that resulted, in the eyes of the court, "could have no other result than to create a belief that the debtor would incur debts beyond its ability to pay as they matured."[278] In addition, both claimants exercised complete control over the debtor's income. In both cases, the claimant, by virtue of stock pledges, controlled the voting stock of the debtor. In summary, this *offensive* use of the creditor's control over the debtor resulted in liability and subordination of the creditor's claim.

In contrast, the creditors in *Prima* and *W. T. Grant* merely used their position and influence to maintain the status quo. They took no actions that resulted in harm to creditors or smacked of fraud, overreaching, or other inequitable conduct. They merely expected payment according to the terms of their loan agreements. This *defensive* use of influence resulted in findings that no subordination of their claims existed. In the context of the *Mobile Steel* standard, in neither case was the objecting party able to sufficiently prove the second element, namely, that the inequitable conduct of the claimant resulted in "injury to the creditors of the bankrupt" or the conferring of "an unfair advantage on the claimant."[279]

274. 699 F.2d at 610-11. On appeal the Court of Appeals for the Second Circuit noted that equitable subordination requires that the claimant show "at least that the banks acted solely for their own benefit . . . and adversely to the interest of others." 699 F.2d at 610-11. See *supra* notes 95-97 for a discussion of the court of appeals' decision in *Grant*.

275. *In re* American Lumber Co., 5 Bankr. 470, 474 (Bankr. D. Minn. 1980).

276. *Id.* The court determined that "[t]he injury which occurred to [American Lumber's] general unsecured creditors is obvious." *Id.* at 478. The court noted that the bank "sought to perpetuate a fraud upon the general unsecured creditors." *Id.* at 479.

277. *In re* Process-Manz Press, Inc., 236 F. Supp. 333, 339-40. Prior to its dealings with the creditor, Process-Manz had no mortgages on its property except for balances due on sales contracts for specific items of property. *Id.* at 339. After dealing with the creditor, Process-Manz's financial condition grew progressively worse. *Id.*

278. *Id.* at 346. In addition, the court noted that the creditor's conduct could only result in hindering and delaying the other creditors' claims. *Id.* at 347.

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

VI. CONCLUSION

The creditor who advances funds pursuant to an agricultural operating loan is in a unique position. The collateral securing the loan may be worth little at the time the creditor makes the loan, the debtor may use or consume some of the collateral in the normal operations of the business, or no possibility of repayment may exist for several months. Because of these concerns, the agricultural operating lender will engage in more loan monitoring activities than his urban counterpart. When the lender determines that a particular loan is a potential problem loan, the monitoring activities may well increase.

An agricultural loan agreement in and of itself may be sufficient to characterize the lender as an insider within the meaning of section 547 of the Bankruptcy Code, for such an agreement on its face indicates that the lender has the ability to control the debtor. In addition, if the lender has used the powers granted to it by the loan agreement to obtain an unfair advantage for itself, to do harm to other creditors, or to adversely affect the debtor, it may also be exposing itself to liability under section 510(c) of the Code. If the lender uses the loan agreement for the defensive purpose of purely maintaining its position, however, no liability should attach under section 510(c).

If the debtor has avoided bankruptcy, abuse of a loan agreement may also be the basis for liability in an action brought by creditors who have been damaged by the abuse. In the action the creditors will not have the benefit of the policies of the Bankruptcy Code or the automatic consequences that follow upon the establishment of an insider preference action. Thus, it may well be much more difficult for creditors to obtain relief outside of a bankruptcy court. In either context, however, the court should consider the factors discussed above in analyzing whether a lender is in control of the debtor or is in a position vis-a-vis the debtor to warrant further inquiry.