An Agricultural Law Research Article

Liability of a Creditor in a Control Relationship with Its Debtor

by

K. Thor Lundgren

Originally published in MARQUETTE LAW REVIEW
67 MARQUETTE L. REV. 523 (1984)

LIABILITY OF A CREDITOR IN A CONTROL RELATIONSHIP WITH ITS DEBTOR

K. THOR LUNDGREN*

I. INTRODUCTION

A creditor who, by virtue of loan agreements or the acquiescence of its debtor, exercises substantial influence and authority over the business affairs of the debtor risks potential liability for all the debtor's debts. Most of the leading cases which illustrate this principle are not widely known or discussed. Therefore, this article will analyze these cases in the hope that it will provide creditors and their counsel with the means to assure recovery of debts without incurring the inordinate risk that the creditor — in the clear and unerring perspective of judicial hindsight — will be held liable to others for improperly exercising such control. The discussion will also assist counsel by isolating factors which courts have found important in determining whether liability will be imposed.

Potential liability arising out of a control relationship transcends the typical institutional lender-borrower loan arrangement. Thus, the term "creditor" includes any person to whom a debt is owed, whether through a loan of money, sale of goods or otherwise and who, by virtue of the creditor-debtor relationship, is in a position to exert control over the business affairs of a borrower.[1]

There are a variety of theories under which "control liability" may arise. First, under the instrumentality or alter

---

* B.A., University of Michigan, 1969; J.D., University of Minnesota, 1974; partner, Michael, Best & Friedrich, Milwaukee, Wisconsin.

1. For example, loan covenants often grant lenders the right to call a loan upon changes in management, a merger of the company, a sale of substantial portions of the business or a decline in net worth or other measures of performance; to appoint positions on the debtor's board of directors; and to require that the borrower continue its present business. Moreover, the right to call a loan by virtue of any real or imagined default (including the elusive "deems itself insecure" clause) vests a considerable amount of control in a lender. *See* H. PROCHNOW, BANK CREDIT (1981).

ego rule,[2] liability for the obligations of the debtor is imposed where a creditor's control over a debtor's business and financial affairs is so dominant that either the creditor has become the alter ego of the debtor or the debtor has become the creditor's "instrument."[3] Second, employing a conceptually similar analysis, other courts use agency law principles to impose liability.[4] Still other courts use a third method: a creditor found to be in a position to exert control over payments to other creditors may incur liability for the debtor's failure to pay so-called "trust fund taxes" due the government.[5] Fourth, in cases involving companies that have issued publicly held securities, plaintiffs have sought to impose liability on creditors by alleging that they were controlling persons within the meaning of section 15 of the Securities Act of 1933 and section 20 of the Securities Exchange Act of 1934.[6] Fifth, a creditor who endeavors to assist a debtor in operating its business may find that such efforts expose the creditor to a negligence claim under the

2. The instrumentality or alter ego rule has long been employed by courts in imposing liability upon stockholders and parent companies for the obligations of the corporations they are deemed to control, and also to subordinate the claims of such persons to other creditors if the company or its stockholders are found to have abused their position of control for an improper purpose which proximately causes injury to other creditors. There is a considerable body of decisions and articles which address such questions in detail and it is not the purpose of this article to again discuss such issues. To pursue this topic, see 1 W. FLETCHER, CYCLOPEDIA OF THE LAWS OF PRIVATE CORPORATIONS §§ 41-45 (rev. perm. ed. 1983); Clark, *The Duties of the Corporation Debtor to its Creditors*, 90 HARV. L. REV. 505 (1977); Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83 (1961); Landers, *Another Word on Parents, Subsidiaries and Affiliates in Bankruptcy*, 43 U. CHI. L. REV. 527 (1976); Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975); Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976). *See also* Comstock v. Group of Institutional Investors, 335 U.S. 211 (1948); Pepper v. Litton, 308 U.S. 295 (1939); Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939); *In re* Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977); *In re* Branding Iron Steak House, 536 F.2d 299 (9th Cir. 1976); *In re* Brunner Air Compressor Corp., 287 F. Supp. 256 (N.D.N.Y. 1968); *In re* Process-Manz Press, Inc., 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); *In re* Typhoon Indus., Inc., 6 Bankr. 886 (Bankr. E.D.N.Y. 1980); Gelatt v. De Dakis, 77 Wis. 2d 578, 254 N.W.2d 171 (1977).

3. *See infra* text accompanying notes 11-50.

4. *See infra* text accompanying notes 51-80.

5. *See infra* text accompanying notes 81-104.

6. 15 U.S.C. §§ 77o, 78t (1982), respectively. *See also infra* text accompanying notes 105-21.

traditional tort theory of assumption of duty.[7] Finally, section 547(b)(4)(B) of the Bankruptcy Code,[8] while not imposing liability, may extend the reach of the preference period from ninety days to one year for creditors who are held to be insiders by virtue of their control over a debtor.[9]

When a debtor defaults on a loan agreement or when it owes money to a creditor beyond the agreed payment period, concern about repayment often will lead its creditors to demand drastic concessions as the price of forbearance. Without another source of financing, the debtor may accede to a number of creditor demands and grant a right of consultation and veto power over expenditure of funds. The debtor may also give the creditor significant authority over decisions such as which creditors will be paid and when payments will be made, the manner in which the debtor will conduct its business, whom the debtor will retain and hire, which assets will be held and which sold, and which contracts will be accepted.[10]

With increasing frequency, lenders and trade creditors are also given equity in the debtor's company in exchange for the debt. This accommodation dramatically increases the ability of creditors to exercise substantial control over their debtors. With these factors in mind, an examination of the decisions defining the boundaries of creditor liability begins.

II. Theories of Liability

A. The Instrumentality or Alter Ego Theory

An early case considering the extent of control necessary to impose liability on lenders is *Harris Trust & Savings Bank v. Keig (In re Prima Co.)*.[11] Certain banks that had lent Prima Company large sums of money became dissatisfied with its management when the company was operating un-

7. *See infra* text accompanying notes 122-31.
8. 11 U.S.C. § 547(b)(4)(B) (1982).
9. *See infra* text accompanying notes 132-40.
10. *See, e.g.*, Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973), *modified and petition for reh'g denied*, 490 F.2d 916 (5th Cir. 1974). See also J. Kusnet & J. Antopol, Modern Banking Forms (1981), for a compilation of standard forms and agreements.
11. 98 F.2d 952 (7th Cir. 1938), *cert. denied*, 305 U.S. 658 (1939).

profitably. One of the banks suggested that the debtor employ an outsider as manager of the company. Soon thereafter, Prima reluctantly employed the recommended manager and executed a contract granting him complete control over the business. His decisions were subject only to the two lenders' approval.[12] The trial court found the following: Prima had reasonable grounds to believe that the banks would call their loans if the company did not employ the manager; the banks exercised undue influence and took advantage of the debtor's situation in order to force the manager and his contract upon it; and the contract resulted in the elimination of responsibilities of the company's officers. Finally, the trial court found that under the employment contract, the banks exclusively controlled the business of the debtor, and the manager, therefore, had become the instrument of the banks. Finding that the banks controlled and directed the debtor's business through their recommended manager, the trial court decided that the banks were liable to the bankruptcy trustee for losses sustained by the debtor during the time the manager operated the business.[13]

On appeal, the Court of Appeals for the Seventh Circuit recognized that the debtor acquiesced in the bank's recommendation that a new manager be hired. In support of its finding, the court found that: the debtor was unable to meet its financial obligations to the banks, it feared the banks would call their loans, and the stockholders were concerned about their personal guarantees. Nevertheless, the court reversed, ruling this acquiescence was "not sufficient to constitute domination of [the debtor's] will."[14] Central to the court's ruling was the absence of a factual basis demonstrating that the banks had made any threats to induce the debtor to enter into the employment contract. Other factors deemed significant by the court were the lack of evidence to indicate that the lenders attempted to manipulate the debtor's business affairs through the manager.[15] The debtor's failure to complain about the manager's conduct in

12. 98 F.2d at 961-62.
13. *Id.* at 956, 962-64.
14. *Id.* at 965.
15. The court opined that the amount of their loans "certainly warranted" their involvement in the debtor's financial affairs. *Id.* at 966.

running the business was also significant.[16] The court also noted that some time after execution of the original contract, the debtor and the manager entered into another employment contract without the lenders' knowledge.[17]

Implicit in the Seventh Circuit's ruling is the notion that pressure perceived by a debtor from its financial predicament which results in a weakening of a debtor's will without concomitant wrongful or overbearing conduct by a creditor is insufficient to render a creditor liable for exercising some managerial control. Additionally, the lack of creditor involvement in the debtor's daily business affairs and the debtor's apparent independent acquiescence in the manager's recommendations influenced the circuit court's decision to reverse.

Ford v. C.E. Wilson & Co.[18] is another decision which approved strong measures taken by the creditor to protect its loan. In *Ford*, a borrower having an outstanding loan secured by a chattel mortgage and accounts receivable requested an additional loan from its bank. As a condition of this loan, the debtor agreed to execute additional security agreements pledging personal property and accounts receivable and to lease warehouse space to the bank.[19] Additionally, the debtor agreed to deposit all proceeds of its accounts in a special account. The counter signature of the bank's agent was required on all checks drawn against this account. Some time later, the business failed and the bank liquidated its collateral. A trade creditor brought suit against the bank for the unpaid purchase price of goods it sold to the debtor; however, the trial court granted the bank's motion for a directed verdict. On appeal, the trade creditor contended that the bank was liable for the debtor's contracts because it assumed such control of the debtor's business as to become a coprincipal or partner.[20] Finding for the bank, the Court of Appeals for the Second Circuit noted that the debtor continued to conduct its own business and that the bank's actions were necessary to protect the security for repayment of its

16. *Id.*
17. *Id.*
18. 129 F.2d 614 (2d Cir. 1942).
19. *Id.* at 615.
20. *Id.* at 617.

loans. Relying on *Prima*, the court summarily dismissed the plaintiff's contention, stating: "What was done here was entirely insufficient to render the Bank a co-principal or partner."[21]

In *Chicago Mill & Lumber Co. v. Boatmen's Bank*,[22] the plaintiff also failed to convince the Court of Appeals for the Eighth Circuit that a lender should be held liable as an alter ego for the liabilities of a debtor corporation. There the bank lent a sum of money to the debtor which was secured by a pledge of all the company's stock. After making an additional loan to the company, the bank arranged to have its assistant cashier elected president of the company in order to protect its interests as a creditor.[23] The cashier was given one-third of the company's stock by its sole shareholder, subject to the pledge to the bank, and the evidence showed that the general manager of the debtor company received his directions from the cashier. The court recognized that "when one corporation owns or controls the entire property of another, and operates its plant and conducts its business as a department of its own business, or as its alter ego, it is responsible for its obligations incurred in so doing."[24] However, the court held that the bank's conduct was the product of a legitimate and customary practice of a substantial creditor in overseeing the business of a debtor which was in financial trouble and it did not constitute sufficient control to render the bank liable for the debts of the company to a trade creditor.[25]

These decisions should be compared to *Credit Managers Association of Southern California v. Superior Court*.[26] There the plaintiff's[27] complaint alleged that the debtor, Jer Merai Lingerie Company, was solvent and that its assets had a fair

---

21. *Id.*
22. 234 F. 41 (8th Cir. 1916).
23. *Id.* at 43-44.
24. *Id.* at 45.
25. *Id.* at 46.
26. 51 Cal. App. 3d 352, 124 Cal. Rptr. 242 (1975). In this case the California Court of Appeal was asked to decide whether the trial court committed reversible error in ruling that the plaintiff had not alleged sufficient facts to state a cause of action which would entitle the plaintiff to recovery.
27. The plaintiff was an assignee for the benefit of creditors of a corporation which had borrowed money from the defendant bank.

market value of approximately one million dollars when its promissory note to the Security Pacific National Bank came due, and that the bank then demanded the debtor employ Mordy and Company as its business consultant or else the bank "would foreclose the . . . note and close down"[28] the debtor's operation. It also alleged that Mordy was so employed over the objection of the debtor, and that Mordy and the other defendants "implemented or caused to be implemented strict and oppressive credit policies, sales procedures, and inventory policies toward the distributions [sic] of the products of said corporation."[29] Finally, the complaint alleged that they acted without regard to the wishes or appproval of the directors and stockholders and were negligent in the management of the debtor's business.[30] On these allegations, the California Court of Appeal overturned the trial court, declaring:

> Credit Managers' first amended complaint directly or indirectly alleged, in effect, that Jer Merai, against its will, was compelled by Bank to employ Mordy as business consultant and that it was compelled to surrender to Mordy complete management control of Jer Merai to such an extent that Mordy was able to overrule and supplant the board of directors and shareholders in its operation of the business. Under such circumstances in our view a trial court could properly conclude that Mordy had the same fiduciary obligation to Jer Merai and its creditors and to the stockholders of Jer Merai that the officers and directors of Jer Merai would have had to such creditors and such shareholders. . . . Directors of a corporation are trustees of the stockholders and indirectly for the creditors.[31]

---

28. *Credit Managers*, 51 Cal App. 3d at 355, 124 Cal. Rptr. at 244.

29. *Id.*

30. *Id.* at 358, 124 Cal. Rptr. at 244.

31. *Id.* at 359-60, 124 Cal. Rptr. at 247 (citations omitted). Regarding this last statement, see McGivern v. Amasa Lumber Co., 77 Wis. 2d 241, 252, 252 N.W.2d 371, 377 (1977). See also Commons v. Schine, 35 Cal. App. 3d 141, 145, 110 Cal. Rptr. 606, 608 (1973), where the court stated:

> One who dominates and controls an insolvent corporation may not, however, assert the general immunity of creditor preferences from attack. He may not use his power to secure for himself an advantage over other creditors of the corporation. The corporate controller-dominator is treated in the same manner as a director of an insolvent corporation and thus occupies a fiduciary relationship to its creditors.

(Citations omitted.)

Because the court ruled on the sufficiency of allegations in the complaint, it could be argued that the court's decision reflects a modern or more enlightened view of the law, particularly when the trend to expand liability in "progressive" jurisdictions, such as California, is considered. However, this case can be distinguished from those previously discussed. In *Credit Managers* it was alleged that the consultant took actions over the objection of the debtor.[32] This threat of immediate creditor action to foreclose unless a business consultant was hired appeared to be more direct than the "threat" in *Prima* and could have formed the basis for the opinion. Unfortunately, the court in *Credit Managers* did not discuss *Prima* or other decisions in this area, nor did it analyze the degree of creditor action or control which would be considered legally permissible.

Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.[33] provides an excellent history of the law in this area and demonstrates the latitude courts grant creditors who exercise control over their debtor in seeking to protect repayment of their debt. The plaintiffs were ten creditors of an insolvent corporation who sued National Distillers to recovery money owed them from the debtor, Brad's Machine Products, Inc. Brad's previously was awarded a contract to supply fuses to the government. Brass was a principal component of the fuses. Bridgeport Brass Company, a subsidiary of National Distillers, was the principal supplier of brass to Brad's. By March 1969, Brad's owed Bridgeport approximately one million dollars. At the request of Brad's, Bridgeport converted this obligation to a promissory note secured by a real estate mortgage.[34] The parties also entered into an agreement whereby Brad's would continue to receive brass as long as it paid promptly for new shipments. Notwithstanding this agreement, by July 1969, Brad's owed another $600,000 to Bridgeport for its brass purchases. By then the government had threatened to cancel Brad's contract due to its deteriorating financial condition. Not surprisingly, a

32. *See Credit Managers*, 51 Cal. App. 3d at 355, 124 Cal. Rptr. at 244.

33. 483 F.2d 1098 (5th Cir. 1973), *modified and petition for reh'g denied*, 490 F.2d 916 (5th Cir. 1974).

34. 483 F.2d at 1107.

meeting was called and it was agreed that National Distillers would provide Brad's with internal financial management assistance; lend it another $600,000; defer payment on $630,000 of accounts receivable; assist Brad's in liquidating unprofitable assets in order to provide working capital; and intervene with the government.[35] Shortly thereafter, Brad's executed notes for the amounts due and secured them with a real estate mortgage and a security interest in certain of its assets. Brad's also assigned other assets to National which could be sold to increase the liquidity in the working capital fund. Leon Rudd, an internal auditor employed by National, was sent to Brad's plant to oversee its finances and establish control procedures.[36] Rudd remained with Brad's for fifteen months and during this time National loaned Brad's another $169,000 and deferred another $667,000 in accounts payable. Despite Rudd's efforts and National's largess, Brad's ceased doing business.[37]

The Court of Appeals for the Fifth Circuit began its analysis with a discussion of the instrumentality rule cases where the controlling "creditor" was generally an owner of the dominated corporation or had formed the corporation to advance its own interests.[38] Reviewing the cases, the court noted that ownership of a dominated company was not the determinative factor when imposing liability.[39] Rather, the court extracted a broader principle of control liability:

> If 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.
>
> An examination of "instrumentality" cases involving the creditor-debtor relationships demonstrates that courts require a strong showing that the creditor assumed actual, participatory, total control of the debtor. Merely taking an active part in the management of the debtor corporation does not automatically constitute control, as used in the instrumentality doctrine, by the creditor corporation.[40]

35. *Id.* at 1108.
36. *Id.*
37. *Id.* at 1109.
38. *See supra* note 2 and cases cited therein.
39. *Krivo*, 483 F.2d at 1109, 1114.
40. *Id.* at 1105.

Had *Krivo* ended its analysis at that point, a relatively direct and understandable principle would have emerged from the case. Unfortunately, the court may have been overly influenced by the instrumentality cases involving debts between parent and subsidiary corporations, for it further stated: "In summary, then, the control required for liability under the 'instrumentality' rule amounts to total domination of the subservient corporation to the extent that the subservient corporation manifests no separate corporate interests of its own and functions solely to achieve the purposes of the dominant corporation."[41] The court further noted the requirement under the instrumentality rule that injury in the form of injustice or inequitable consequences result from a misuse of control.[42]

In applying the law as discerned by it to the case, the Fifth Circuit affirmed the trial court decision that there was insufficient evidence to establish a jury question on the issue of control.[43] The plaintiffs had contended that Rudd dominated Brad's decision making. The court disagreed. Instead, it noted that Rudd was not thrust upon the debtor and, although Rudd's signature on all checks was mandatory, he only voiced his displeasure when expenditures were proposed that were unrelated to Brad's machine shop opera-

---

41. *Id.* at 1106. See *supra* note 2 and cases cited therein for statements of the rule in virtually identical terms. These cases address the question of controlling stockholder and parent corporation liability arising out of their domination of controlled corporations. The court in *Krivo* appeared to rely at least in part on a statement in 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 43 (rev. perm. ed. 1983) for support. However, section 43 focused on the liability of parent corporations for obligations of their subsidiaries. Given the ability of one with a substantial ownership interest to cause a controlled corporation to serve such person's parochial or selfish interests, it is debatable whether this language from the "ownership" cases should be included in resolving questions involving liability arising strictly from a debtor-creditor relationship. This language results in such an onerous burden that it is reasonable to expect that plaintiffs with an otherwise meritorious case will have little if any chance of prevailing. The confusion which can result is exemplified by Lane v. Dickinson State Bank, 605 S.W.2d 650 (Tex. Civ. App. 1980), in which the plaintiff alleged that a bank controlled a debtor corporation to such an extent that the bank became the alter ego of the debtor. The court rejected the plaintiff's contention, holding "we have found no authority for applying the alter ego doctrine to a situation such as this one, where the individuals are not alleged to be shareholders, incorporators, directors or officers of the target corporation." *Id.* at 653.

42. *Krivo*, 483 F.2d at 1106.

43. *Id.* at 1114.

tion.[44] Further, Rudd's powers were essentially negative in character and although Rudd determined which trade creditors would be paid, he shared this responsibility with Brad's personnel. Finally, although Rudd's powers were considerable, they were limited to overseeing Brad's finances and neither he nor anyone else had influence over other key areas of Brad's operations.[45] The court concluded that although National Distillers had the capacity to exert great pressure, this power was inherent in any creditor-debtor relationship; therefore, the existence and exercise of this power did not constitute sufficient control for purposes of the "instrumentality" rule. What was needed in order to establish liability, but was not shown, was that National Distillers exercised control in the actual operations of the debtor corporation.[46]

While the courts have recognized the potential liability of a creditor who assumes control of a debtor under the instrumentality or alter ego theory, it is apparent from these cases that courts are extremely reluctant to impose such liability.[47] It appears from the decisions that courts recognize the practical necessities that arise when creditors are confronted with debtors in financial distress. Moreover, a value judgment appears to have been made by the courts that it is worthwhile to permit creditors to take relatively strong measures, when working with a debtor's business, to protect the creditor's debt rather than adopt a rule which would have the effect of forcing creditors to seek premature liquidation or bankruptcy proceedings. To summarize, under the instrumentality rule courts permit a creditor to place itself in a position to obtain all necessary information, to request a negative veto power over a debtor's financial transactions and to provide assistance or counseling to a debtor.[48] There

---

44. *Id.* at 1111.

45. *Id.*

46. *Id.* at 1114.

47. See, for example, *supra* text accompanying notes 11-25, and 33-46 for a discussion of cases that did not impose liability.

48. *See, e.g.*, Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973), *modified and petition for reh'g denied*, 490 F.2d 916 (5th Cir. 1974); Ford v. C.E. Wilson & Co., 129 F.2d 614 (2nd Cir. 1942); Harris Trust & Sav. Bank v. Keig (*In re* Prima Co.), 98 F.2d 952 (7th Cir. 1938), *cert. denied* 305 U.S. 658 (1939); Chicago Mill & Lumber Co. v. Boatmen's Bank, 234 F. 41 (8th Cir. 1916).

is a stronger likelihood that liability will be imposed under this rule when a creditor demands and assumes such control over the entire spectrum of a debtor's business affairs that existing management is supplanted and is reduced to carrying out the directions of the creditor.[49] It is, however, difficult to define the precise point at which liability will attach in view of the relatively small number of cases that have applied the instrumentality rule to the debtor-creditor relationship.[50]

B. *Liability Arising From Agency*

In *A. Gay Jenson Farms Co. v. Cargill, Inc.*,[51] the Minnesota Supreme Court was receptive to imposing liability upon a control creditor when the plaintiff asserted a theory of responsibility predicated on agency law. In that case eighty-six farmers sought to impose liability on Cargill, Incorporated, a lender to Warren Grain and Seed Company. Warren was the operator of a grain elevator which purchased from and stored grain for local farmers, and which owed $2,000,000 to the plaintiffs.[52] Cargill began lending funds to Warren in 1964 for working capital, its initial loan being $175,000. Ultimately, when Warren ceased operations in 1977 it was indebted to Cargill for $3,600,000. A real estate mortgage and a chattel mortgage on Warren's grain inventories secured the loans. In return for the financing, Cargill was given a right of first refusal to purchase grain from Warren. As part of a 1967 agreement to increase funding, Cargill was given access to Warren's financial records. Warren also agreed not to make capital improvements in excess of $5,000 without Cargill's consent. Additionally, Warren was prohibited from guaranteeing any debts, encumbering its assets, declaring a dividend, or selling or buying stock without Cargill's consent.[53]

---

49. *See, e.g.*, Credit Managers Ass'n of S. Cal. v. Superior Court, 51 Cal. App. 3d 352, 124 Cal. Rptr. 242 (1975).

50. Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343 (1975).

51. 309 N.W.2d 285 (Minn. 1981).

52. *Id.* at 287-88.

53. *Id.* at 288.

Between 1967 and 1973 Cargill made a number of recommendations to Warren concerning the operation of its business. However, Warren never implemented the recommendations. As Warren's indebtedness continued to exceed its line of credit, Cargill kept a daily debit position on Warren and a bank account funded by Cargill was available from which Warren could draw checks. In the spring of 1977, farmers, hearing that Warren's checks were not being paid, contacted Cargill regarding Warren's status. They were initially informed there would be no problem with payment.[54] In April 1977, an audit disclosed that Warren was $4,000,000 in debt and Cargill learned that Warren's financial statements had been deliberately falsified. Cargill refused to provide additional financing and sent an officer to supervise the grain elevator in its final days of operation.[55]

Claiming Cargill was a principal of Warren, the plaintiffs alleged that Cargill was jointly liable for Warren's indebtedness to them. A jury found Cargill liable and the Minnesota Supreme Court affirmed, holding that Cargill, "by its control and influence over Warren, became a principal with liability for the transactions entered into by its agent Warren."[56] The court pointed to several specific factors which demonstrated Cargill's control over Warren: (1) Cargill's constant recommendations; (2) Cargill's right of first refusal to buy grain; (3) Warren's inability to mortgage its property, purchase stock or pay dividends without Cargill's approval; (4) Cargill's right to inspect Warren's premises; (5) Cargill's criticism of Warren's business practices; (6) Cargill's belief that Warren needed "strong paternal guidance"; (7) Warren's drafts and forms containing Cargill's name; (8) Cargill's financing of all Warren's grain purchases and operating expenses; and (9) Cargill's power to discontinue the financing of Warren.[57] As one might expect, Cargill argued that these factors were to be found in the ordinary debtor-creditor relationship; however, the court responded that even if this as-

---

54. *Id.* at 289.
55. *Id.*
56. *Id.* at 290.
57. *Id.* at 291.

sertion were true these factors must be viewed in the light surrounding Cargill's aggressive financing.[58]

The court justified its decision by characterizing the relationship between Cargill and Warren as unique.[59] However, in reality the actions taken by Cargill which resulted in liability were similar to those taken by other creditors who avoided liability under the instrumentality theory.[60] It is clear the court's decision was heavily influenced by the following statement from the *Restatement of Agency*:[61] "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."[62]

In *Buck v. Nash-Finch Co.*[63] the South Dakota Supreme Court applied this same rule of agency to a similar set of facts, but reached a different result. The defendant, Nash-

---

58. *Id.*

59. *Id.* at 293.

60. *See supra* text accompanying note 48.

61. RESTATEMENT (SECOND) OF AGENCY § 14 O (1957).

62. *Id.* Comment a to section 14 O offers further guidance as to the circumstances under which a creditor in a control position will or will not become responsible for a debtor's obligations. It provides:

> A security holder who merely exercises a veto power over the business acts of his debtor by preventing purchases or sales above specified amounts does not thereby become a principal. However, if he takes over management of the debtor's business either in person or through an agent, and directs what contracts may or may not be made, he becomes a principal, liable as a principal for the obligations incurred thereafter in the normal course of business by the debtor who has now become his general agent. The point at which the creditor becomes a principal is that at which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with his debtor may be.

RESTATEMENT (SECOND) OF AGENCY § 14 O comment a (1957). While it may be assumed that this comment did not undertake to set forth the entire universe of circumstances under which a control creditor may become a principal, it is interesting to note that the hypothesized facts in this comment are at variance with many of those in the *Jenson* decision. As in the case of comment a, many of Cargill's powers were negative in character. Also, the debtor did not implement many of Cargill's recommendations and the decision does not set forth facts which demonstrate that Cargill assumed day-to-day control over the debtor's business affairs. For whatever reason, the *Jenson* decision chose not to address the comment to section 14 O. It is difficult to harmonize the comment with section 14 O. The comment suggests a test for imposing liability similar to that used in the instrumentality cases, while section 14 O appears to envision a broader standard for imposing liability which will be more readily satisfied. This apparent dichotomy may account for the result in the *Jenson* case, notwithstanding the differences between the facts in *Jenson* and the example in comment a.

63. 102 N.W.2d 84 (S.D. 1960).

Finch Company, was a wholesaler of grocery merchandise. Through a wholly-owned subsidiary, it provided secured financing for a Piggly Wiggly supermarket and thereafter sold merchandise to it. Nash provided merchandising and accounting services to Piggly Wiggly. At Nash's insistence, Piggly Wiggly agreed that a Nash accountant would visit the market twice a week, make up the payroll, compile weekly operating reports and financial statements and be a required co-signer of all checks.[64] Nash kept in constant contact with the operations and financial condition of the market and made suggestions regarding market operations. Later, at Nash's suggestion, the supermarket's owner hired a store manager. At trial the owner testified it was his understanding that he had to "get along" with the new manager or Nash would foreclose its liens.[65] Nash discouraged Piggly Wiggly from buying goods from other vendors which were available from Nash.[66] Apparently, the supermarket failed and it was ultimately sold to another company in which Nash held a controlling interest.

Alleging Nash was the undisclosed principal of the supermarket, trade creditors who were not paid filed suit against Nash for the money due them.[67] The trial court ruled that Nash assumed such control of the market that it was liable as a principal for all merchandise purchased from the plaintiffs.[68] On appeal, the South Dakota Supreme Court "experienced no difficulty in discovering a basis in the evidence warranting a finding of an assumption of control by Nash-Finch Company, and a yielding of and acting under such control by [the market] in certain phases of his business."[69] However, the court reversed the trial court because it found no evidence in the record indicating that Nash controlled the market's buying operations.[70]

It is difficult, if not impossible, to harmonize the results in the *Jenson* and *Buck* cases. Unlike other control cases,

---

64. *Id.* at 85.
65. *Id.* at 86.
66. *Id.* at 87.
67. *Id.* at 84.
68. *Id.*
69. *Id.* at 89-90.
70. *Id.* at 91.

the court focused on one element of the parties' relationship, albeit an important one, the buying operations. However, it failed to examine the entire relationship between the parties.[71] Such a narrow perspective prevents truly injured creditors from recovering in meritorious cases. Moreover, the court apparently ignored the fact that Nash controlled the payment to suppliers, a more significant form of control than the type of merchandise to be purchased. Considering that a Nash-controlled company ultimately purchased the supermarket, it is questionable whether the court's narrow focus on control of purchasing activities resulted in a just application of the rule.

Would the plaintiffs in the instrumentality cases have fared better under the Restatement rule? Initially, Section 14 O of the *Restatement of Agency*[72] appears to be a potent weapon of which creditor's counsel should be aware. The central question is whether the term "control" in the *Restatement* will be construed to require the same elements of control exercised in the same degree as the instrumentality cases. If not, two different rules of liability will exist. It is questionable whether two different rules aimed at accomplishing the same result make sense and provide certainty in the prediction of results. On the other hand, with its history rooted in the parent corporation and shareholder control cases, the instrumentality rule may be too restrictive to afford injured parties relief. Perhaps, in order to provide necessary protection for other creditors where a position of control has been wrongfully abused, it is worthwhile to maintain a distinction between the seemingly broader language of the *Restatement*, as applied in the *Jenson*[73] decision, and the instrumentality rule.

For counsel seeking guidance as to the extent of action their clients may take to protect themselves without becoming liable for an improper exercise of control, the instrumentality and agency cases suggest certain specific types of

71. *See id.*

72. *See supra* note 62 and accompanying text. Other decisions which did not discuss section 14 0, but which have addressed the question of creditor liability under agency principles, are Commercial Credit v. L.A. Benson Co., 170 Md. 270, 184 A. 236 (1936) and Kelly v. Tracy & Avery Co., 73 N.E. 455 (Ohio 1905).

73. 309 N.W.2d 285 (Minn. 1981).

permissible and impermissible actions. Creditors may: monitor a debtor's business and financial affairs and insist on detailed information;[74] obtain a veto power over proposed financial activities;[75] provide counseling or advice with respect to discrete business matters;[76] and recommend consultants.[77] Creditors may not: obtain a veto over all proposed business activity;[78] coerce the debtor into granting a third party the right to operate the business to the exclusion of officers and employess;[79] provide assurances of payment to other creditors unless they are prepared to make such payments;[80] or become involved in the debtor's business affairs in such a manner that creates confusion among others as to which party is actually responsible for the debtor's business affairs. A bright line for creditors might be this: If a creditor is at the point where it believes it is necessary to participate in most facets of business affairs on a recurring basis and to direct such affairs to the exclusion of the debtor's officers or employees, the creditor should call the debt and begin proceedings to liquidate or sell the business.

---

74. *See, e.g.*, Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973), *modified and petition for reh'g denied*, 490 F.2d 916 (5th Cir. 1974). *See also supra* text accompanying notes 43-46.

75. *See, e.g.*, Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973), *modified and petition for reh'g denied*, 490 F.2d 916 (5th Cir. 1974). *But see* A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981). *See also supra* text accompanying note 57.

76. *See, e.g.*, Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973), *modified and petition for reh'g denied*, 490 F.2d 916 (5th Cir. 1974); Harris Trust & Sav. Bank v. Keig (*In re* Prima Co.), 98 F.2d 952 (7th Cir. 1938), *cert. denied*, 305 U.S. 658 (1939); Chicago Mill & Lumber Co. v. Boatmen's Bank, 234 F. 41 (8th Cir. 1916). As to potential liability for rendering advice in a negligence context, see *infra* section II E.

77. See, for examples, authorities cited *supra* note 76.

78. *See, e.g.*, Credit Managers Assoc. of S.Cal. v. Superior Court, 51 Cal. App. 3d 552, 124 Cal. Rptr. 242 (1975). *See also supra* text accompanying notes 26-32.

79. See, for example, Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973), *modified and petition for reh'g denied*, 490 F.2d 916 (5th Cir. 1974), in which the defendant escaped liability when the court held that the third party did not control the company to the exclusion of others. *See also supra* text accompanying notes 43-46.

80. *See, e.g.*, A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981). *See supra* text accompanying note 54.

C. *Liability Under Federal Tax Laws*

When the creditor uses its control over a troubled debtor to protect itself, other traps lie waiting to be sprung in the Internal Revenue Code. Section 6672[81] of the Code provides that any person[82] required to collect, truthfully account for, and pay over the so-called trust fund taxes imposed by section 7501 (for example, income tax, social security and railroad retirement taxes withheld from wages) and who willfully fails to collect, account for or pay such taxes is liable for the full amount of the taxes not so collected, accounted for or paid.

The dilemma confronting creditors in this area is best demonstrated by two decisions which arose in the Fifth Cir-

---

81. 26 I.R.C. § 6672 (1954). Hereinafter citations to the Internal Revenue Code are only by section number. Section 6672 provides:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable.

For other relevant sections dealing with withholding taxes see I.R.C. §§ 7501, 3101, 3202, 3402-3403.

82. As defined in I.R.C. § 6671, the term person "*includes* an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs." (emphasis added.) The courts have not hesitated to define the term "person" expansively and, taking note of the word "includes," have refused to limit the term person to those with a formal position or connection with the taxpayer.

> [T]he definition of "persons" does not require that they be formally vested with the office or employed in the position normally charged with this function; the definition simply "includes" such persons. Indeed, the language itself does not require that they be officers or employees of the corporation at all, so long as they are in fact responsible for controlling corporate disbursements. . . . [I]t is evident from the face of the section that it was designed to cut through the shield of organizational form and impose liability upon those actually responsible for an employer's failure to withhold and pay over the tax.

Pacific Nat'l Ins. Co. v. United States, 422 F.2d 26, 30-31 (9th Cir.), *cert. denied*, 398 U.S. 937 (1970). *See also* Commonwealth Nat'l Bank of Dallas v. United States, 665 F.2d 743 (5th Cir. 1982); United States v. Graham, 309 F.2d 210 (9th Cir. 1962); Walker v. United States, 68-1 U.S. Tax Cas. (CCH) ¶ 9370 (W.D. Okla. 1968); Dallas v. United States, 68-1 U.S. Tax Cas. (CCH) ¶ 9290 (N.D. Tex. 1968).

cuit.[83] In *United States v. Hill*[84] a contractor borrowed funds from a bank, securing the loan with an assignment of progress payments. In January 1962, the contractor informed the bank that it had a $400,000 deficit but was somewhat short of cash, having $53.82 in its checking account. Needless to say, the bank acted with dispatch. As of January 18, 1962, the bank was granted the right to approve all checks over $500. The result was that the bank refused to honor certain checks.[85] In February the bank allowed certain progress payments, in which it had a security interest, to be used to pay essential bills. At all times the bank knew its borrower had withheld income and social security taxes but had not paid such taxes to the government.[86] On February 18, 1962, the contractor's bonding company made a loan to the contractor and obtained the right to approve all checks drawn by the contractor. The bonding company refused to permit the contractor to pay withholding taxes for the fourth quarter of 1961. Following the contractor's demise, the government sued the bank and others for unpaid withholding taxes, alleging the bank was a responsible person within the meaning of section 6672.[87] Following a jury verdict for the government, the trial court entered judgment n.o.v. for the bank. The United States appealed. The Court of Appeals for the Fifth Circuit affirmed, rejecting the government's contention that the bank was liable: "That the Bank allowed the company to retain and use some of the funds belonging to it cannot be transposed into an assumption of tax liability by the Bank."[88] Although the undisputed record showed the bank possessed a right to approve checks and that the bank instructed the company that progress payments could not be used to pay taxes, the court found that the bank's exercise of a veto power over corporate checks in order to keep the com-

83. The decisions are: Commonwealth Nat'l Bank of Dallas v. United States, 665 F.2d 743 (5th Cir. 1982) and United States v. Hill, 368 F.2d 617 (5th Cir. 1966).

84. 368 F.2d 617 (5th Cir. 1966).

85. *Id.* at 620.

86. *Id.*

87. *Id.* at 619-20.

88. *Id.* at 623.

pany alive was insufficient to bring it within the statute's penal provisions.[89]

The *Hill* decision should be contrasted with the 1982 *Commonwealth National Bank of Dallas v. United States* decision.[90] There the bank lent money to a corporation and in return obtained a lock-box arrangement for receivables. The bank permitted overdrafts on the debtor's checking account and honored all payroll checks, but did not honor checks drawn to pay withholding taxes.[91] Although the president of the debtor corporation directed the bank not to honor checks drawn to pay withholding taxes, the bank participated in the decisions concerning which other creditors would be paid. All funds coming into the bank were either used to pay honored checks or to pay back the bank's loan. The court held the bank liable for the amount of unpaid withholding taxes, since the bank assumed control over how the employer's funds were to be spent and which of the creditors were to be paid.[92]

In both *Hill* and *Commonwealth Bank* the creditors exercised control over their debtors' funds and made decisions and issued directions as to which obligations would be paid. Thus, it would seem the legal consequences should be identical. The creditor is left wondering how to navigate in these waters with conflicting directions.

A review of other decisions in this area provides some guidance as to the type of control which creditors should avoid. In *First American Bank & Trust Co. v. United States*[93] a federal district court imposed liability on a bank for unpaid withholding taxes where a bank officer approved all corporate checks, the bank knew withholding taxes were

---

89. *Id.*

90. 665 F.2d 743 (5th Cir. 1982).

91. *Id.* at 746.

92. The court stated:

> We emphasize that the fact that a bank makes loans (either directly or in the form of overdrafts) to a corporate employer that is failing to pay over withheld federal employment taxes to the United States will not, without more, subject the bank to § 6672 liability. What will subject the bank to liability for those taxes is the assumption of control over how the employer's funds are to be spent and over the process of deciding which creditors of the employer are to be paid and which are not, and when.

Id. at 757.

93. 79-1 U.S. Tax Cas. (CCH) ¶ 9205 (W.D. Okla. 1979).

due, the bank permitted payments to selected creditors and itself, and the bank advised the debtor not to pay such taxes. In *United States v. North Side Deposit Bank*[94] a bank again was liable for payment of trust fund taxes where the bank was the recipient of all its debtor's receivables, the bank began selectively honoring and dishonoring checks and the bank knew the debtor could no longer pay its taxes. A more modest exercise of control over a debtor still rendered a creditor liable for withheld taxes in *Goebert v. United States,*[95] in which an officer of a creditor had himself installed as an officer of the debtor corporation with complete authority to sign checks. He caused the debtor to use its funds to pay loans to the creditor. Although he testified that he did not know withholding taxes were due, the court was not convinced.[96] The court in *Werner v. United States*[97] best summarizes the judicial attitude:

> The Court does not feel that § 6672 was intended to reach one who as a bona fide creditor, and not as the power behind a puppet corporation, importunes a failing corporation to pay off its debts. Obviously creditors can and do wield considerable power over an ailing business through the threat of draconian collection measures, but so long as creditors limit such pressure tactics to inducing payment of what is owed them, and do not seek to take effective control of the debtor in order to improve the debtor's ability to pay, then the mere fact of an obligation owed to the creditor and the creditor's forceful demand for payment, together with the creditor's capacity through threat of collection to make the debtor dance to his tune, ought not to render the creditor a person responsible for the debtor's payment of taxes within the meaning of § 6672. Only he who actually calls the tune should be held accountable to the piper.[98]

As tempting as it may seem, a lender who begins exercising control over a debtor's finances and decisions as to which

---

94. 83-2 U.S. Tax Cas. (CCH) ¶ 9503 (W.D. Pa. 1983).
95. 412 F. Supp. 356 (E.D. Pa. 1976).
96. *Id.* at 361.
97. 374 F. Supp. 558 (D. Conn. 1974), *aff'd*, 512 F.2d 1381 (2d Cir. 1975).
98. 374 F. Supp. at 563.

obligations will be selectively paid assumes a substantial risk of an unwanted appointment with the tax collector.[99]

Another trap for the unwary is contained in section 3505(a) and (b) which provides that: (a) if a lender pays wages directly to employees or their agent, the lender is liable for all taxes required to be withheld by their employer plus interest; and (b) if a lender provides funds to an employer for the specific purpose of paying wages with actual notice or knowledge that the employer does not intend to or will not be able to pay withheld taxes, the lender is liable for any of such unpaid taxes plus interest in an amount not to exceed twenty-five percent of the funds lent for such purpose.[100]

---

99. For other decisions on this issue, see Adams v. United States, 504 F.2d 73, 76 (7th Cir. 1974) ("§ 6672 is broad enough to reach an entity which assumes the function of determining whether or not the employer will pay over taxes withheld from its employees."); Key v. United States, 82-1 U.S. Tax Cas. (CCH) ¶ 9249 (S.D. Ind. 1982); Silberberg v. United States, 355 F. Supp. 1163 (S.D.N.Y. 1973); Girard Trust Corn Exch. Bank v. United States, 259 F. Supp. 214 (E.D. Pa. 1966); Melillo v. United States, 244 F. Supp. 323 (E.D.N.Y. 1965). *See also* Slodov v. United States, 436 U.S. 238, 259-60 (1978) (United States Supreme Court held that a person who assumes control over a taxpayer is not liable under section 6672 when at the time he assumes control there are no funds with which to satisfy preexisting trust fund tax obligations, even though the taxpayer later generates income).

100. The full text of I.R.C. § 3505 provides:

(a) **Direct payment by third parties.**—For purposes of sections 3102, 3203, 3402, and 3403, if a lender, surety, or other person, who is not an employer under such sections with respect to an employee or group of employees, pays wages directly to such an employee or group of employees, employed by one or more employers, or to an agent on behalf of such employee or employees, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) required to be deducted and withheld from such wages by such employer.

(b) **Personal liability where funds are supplied.**—If a lender, surety, or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of section 6323(i)(1)) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by this subtitle to be deducted and withheld by such employer from such wages, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer with respect to such wages. However, the liability of such lender, surety, or other person shall be limited to an amount equal to 25 percent of the amount so supplied to or for the account of such employer for such purpose.

(c) **Effect of payment.**—Any amounts paid to the United States pursuant to this section shall be credited against the liability of the employer.

While creditors should be aware of section 3505(a), the application of its provisions is straightforward and does not require further discussion.[101] However, the section 3505(b) language "with actual notice . . . that such employer . . . will not be able to make timely payment . . ." is susceptible to varying interpretations. The net cast by this provision was demonstrated in *Fidelity Bank, N.A. v. United States*,[102] where a lender agreed to help keep a struggling borrower afloat by permitting overdrafts on its account. As part of this process the bank honored overdraft checks that were drawn to pay the debtor's payroll. The Court of Appeals for the Tenth Circuit viewed each overdraft check honored as a separate loan and held the bank liable under section 3505(b), finding: "Thus, every time the bank supplied funds for payment of wages it had to know it would be requested to supply the funds for paying the withholding taxes. This, we believe, fits well within the situations envisioned for application of section 3505(b)."[103] The court noted that the evidence did not show that the bank decided which creditors were to be paid or that the bank initiated payment decisions. While the evidence was insufficient to hold the bank liable under § 6672, the court held it was sufficient to establish liability under § 3505(b) because a lesser showing of lender control than that required under § 6672 is sufficient to impose liability.[104]

It is arguable that the sweep of § 3505(b), particularly as applied in the *Fidelity Bank* decision, runs too far afield in view of the need to encourage lenders and others to assist struggling business enterprises. Nevertheless, a wise creditor will always insist that, as a condition of advancing funds,

101. *See, e.g.*, United States v. Towne Realty, Inc., 575 F. Supp. 77 (E.D. Wis. 1983).

102. 616 F.2d 1181 (10th Cir. 1980).

103. *Id.* at 1185.

104. *Id.* at 1185-86. See United States v. Swindell-Dressler Co., 79-2 U.S Tax Cas. (CCH) (W.D. Pa. 1979), where a creditor was held liable under section 3505(b) when it made periodic payments to a debtor's bank account, co-signed all checks including payroll checks but refused to sign checks presented to pay withholding taxes on the grounds that the debtor should attempt to generate internal cash to pay such obligations. See also Treas. Reg. § 31.3505-1(b)(3) (1976) for the Internal Revenue Service interpretation of when an ordinary working capital loan will or will not result in liability under section 3505(b).

records be submitted which indicate that withholding taxes have been paid. It will also take necessary measures to confirm that such taxes will be paid in the future.

D. Attempts to Impose Liability Under the Securities Laws

Section 15 of the Securities Act of 1933[105] and Section 20(a) of the Securities Exchange Act of 1934[106] impose liability upon persons who control others found guilty of violating such Acts unless, in the case of Section 15, the controlling person "had no knowledge of or reasonable grounds to believe in the existence of" a violation, and, in the case of Section 20(a), the controlling person "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation."

In *Fuls v. Shastina Properties, Inc.*[107] disgruntled purchasers of property sought to impose liability under section 20(a) on Diversified Mortgage Investors (DMI), the lender who financed the developer's operations. Affidavits supporting the lender's motion for summary judgment showed that the lender received financial statements and sales reports, and periodically inspected the property, but did not have any right to exercise control or participate in the lot sales activities.[108] The court granted summary judgment because "nothing submitted by plaintiffs indicates that fraudulent ac-

---

105. 15 U.S.C. § 77o (1982) provides:

Liability of Controlling Persons. (a) Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency or otherwise, controls any person liable under sections 77k or 77*l*, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

106. 15 U.S.C. § 78t (1982) provides: **Liability of Controlling Persons. (a) Joint and several liability; good faith defense.** Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

107. 448 F. Supp. 983 (N.D. Cal. 1978).

108. *Id.* at 989.

tivities were taking place. DMI therefore cannot be held liable as a controlling person."[109]

The Court of Appeals for the Fifth Circuit in *Ayers v. Wolfinbarger*[110] also dismissed an attempt to impose such liability upon creditors absent a showing of any facts other than an extension of credit. In this case, stock was sold. As security for the balance of the purchase price, additional stock was pledged to the sellers. Subsequently, the purchasers caused the corporation to issue additional stock to the plaintiffs in an allegedly fraudulent transaction.[111] The plaintiffs brought suit and alleged, *inter alia*, that the seller-pledgees were liable for the purchaser's fraudulent acts under section 15 as controlling persons. The court, however, was unwilling to extend liability where the stock was pledged simply as security for the deferred payments.[112]

The plaintiffs in *Miller v. Woodmoor Corp.*[113] were more successful in withstanding the motion to dismiss filed by Westinghouse Credit Corporation, the lender that financed a real estate development. The plaintiffs, purchasers of unimproved real estate, charged that Westinghouse exercised control over both the sales and development aspects of the developer's scheme which involved fraudulent misrepresentations and omissions of fact. The court refused to dismiss the complaint which alleged violations by Westinghouse of section 15 and section 20(a) because "the allegation that Westinghouse wielded extensive authority over the affairs of the enterprise is sufficient to state a cause of action."[114]

In *In re Falstaff Brewing Antitrust Litigation*[115] the purchaser of a substantial portion of Falstaff's stock sued the

---

109. *Id.* at 990.

110. 491 F.2d 8 (5th Cir.), *reh'g denied*, 493 F.2d 1405 (5th Cir. 1974).

111. 491 F.2d at 10.

112. *Id.* at 15. The court stated:

> The plaintiffs urge that, because of the default provisions contained in the escrow agreement, continued control was vested in the sellers. Bearing in mind that the plaintiffs had the burden of establishing control, we summarily dismiss this argument as without merit. We are unwilling to extend the definition of controlling person to a situation where as here, stock is simply pledged as security for deferred payments . . . .

Id. (citations omitted).

113. [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,109 (D. Colo. 1976).

114. *Id.* at 91,999.

115. 441 F. Supp. 62 (E.D. Mo. 1977).

company's lenders. As part of his complaint, he alleged that the lenders were liable under section 15 and section 20(a) for a number of securities law violations.[116] The plaintiff alleged that the lenders became involved in the day-to-day operations of Falstaff due to their concerns regarding its financial condition. He further alleged that the lenders required Falstaff to replace officers and directors, implement certain policies, revise its debt structure, obtain an equity investor, give additional security to the lenders, and obtain their approval before buying or selling assets.[117] It was alleged the lenders gained this control by threatening to declare a default and accelerate their loans.[118]

Ruling on the lenders' motions to dismiss the complaint, the court agreed with plaintiff that, by its terms, section 20(a) could apply to a lender who assumed a controlling influence and held that the control exercised by the lenders and the requisite scienter were sufficiently alleged under section 20(a) to withstand a motion to dismiss.[119]

While the number of cases that have considered the specific issue of creditor liability as a controlling person under the Securities Acts are relatively few in number,[120] one again

---

116. *Id.* at 65.

117. *Id.*

118. *Id.*

119. *Id.* at 68. The court reasoned:

> The allegation that the lender defendants controlled the daily affairs of Falstaff, although possibly difficult to prove, is surely sufficient under § 20(a). The court reaches this conclusion in spite of its doubts that the lenders' efforts to secure their loans through various commercially acceptable methods would make them controlling persons. A scienter requirement, possibly co-extensive with that set out in *Ernst & Ernst*, *supra*, is certainly required. However, it too is sufficiently alleged.

Id.

120. Plaintiffs have also sought to hold creditors liable under other theories, such as aiding and abetting, which transcend the control issue with which this article is concerned. *See, e.g.*, Monsen v. Consolidated Dressed Beef Co., 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930 (1978); First Virginia Bankshares v. Benson, 559 F.2d 1307 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978); United States Steel & Carnegie Pension Fund, Inc. v. Orenstein, 557 F.2d 343 (2d Cir. 1977); Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975); Cosmopolitan Credit & Inv. Corp. v. Blyth Eastman Dillon & Co., 507 F. Supp. 954 (S.D. Fla. 1981); Clark v. Cameron-Brown Co., 72 F.R.D. 48 (M.D.N.C. 1980); Marrero v. Banco Di Roma, 487 F. Supp. 568 (E.D. La. 1980); Tucker v. Janota, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,701 (N.D. Ill. 1978); Stirling v. Chemical Bank, 382 F. Supp. 1146 (S.D.N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir. 1975); Ferland v. Orange Groves of

sees the potential for liability when creditors become involved in the day-to-day affairs of a borrower in order to protect their loans. Although the *Falstaff* court appeared to appreciate the dilemma confronting the lenders, it refused to dismiss the complaint, thus ensuring substantial costs to defend the litigation at least through discovery and perhaps through trial. The cases provide one easy answer — simply lending money is insufficient to result in liability as a controlling person.[121] The tough question — how far can a creditor go in taking action to protect its debt — remains unanswered. Analogizing to the instrumentality and agency cases, exercising modest veto power over limited financial debtor actions, obtaining necessary financial information, and making limited suggestions about business practices would not render a creditor a control person. If such were not the case, long recognized and well established lending practices could result in vast liability under the Securities Acts. It is unlikely that Congress intended such a result.

E. Liability Predicated on Tort Theories

Frequently, in order to protect its interests, a creditor comes to the aid of a struggling debtor and provides a variety of services to assist the operation of the debtor's business, such as managing payables and receivables, providing technical expertise in manufacturing processes or offering guidance on the retention and dismissal of personnel. The list can be as extensive as there are distressed debtors. Sometimes, as shown in the instrumentality and agency cases, such assistance takes the form of providing consultants and managers.[122] What happens if, notwithstanding altruistic intentions, the efforts are for naught or exacerbate the matter and the business fails? Can such creditor efforts result in liability to the business owner or others under tort theories?

Fla., Inc., 377 F. Supp. 690 (M.D. Fla. 1974); Ingenito v. Bermec Corp., 376 F. Supp. 1154 (S.D.N.Y. 1974); Harriman v. E.I. DuPont de Nemours & Co., 372 F. Supp. 101 (D. Del. 1974).

121. *See, e.g.*, Ayers v. Wolfinbarger, 491 F.2d 8 (5th Cir.), *reh'g denied*, 493 F.2d 1405 (5th Cir. 1974); Fuls v. Shastina Properties, Inc., 448 F.Supp 983 (N.D. Cal. 1978).

122. *See supra* text accompanying notes 48 & 76-77.

In certain circumstances the courts will impose liability using the traditional tort theory of assumption of duty. *In re Franklin National Bank Securities Litigation*[123] concerned the collapse of the twentieth largest bank in the United States. Following a suit by the Federal Deposit Insurance Corporation (FDIC) against various insurers on bankers blanket bonds, the insurers began third party actions against the FDIC. The complaints alleged that the government corporation exceeded its traditional regulatory role and " 'voluntarily undertook to issue orders and directives and make recommendations and suggestions' "[124] with respect to the operation of the bank's business and that it was reasonable for the bank and its directors, officers and shareholders to rely on the government to protect them.[125] In essence, they alleged the government became a volunteer assisting and participating in the bank's business and thereby assumed a duty to act with the requisite care. In denying the government's motion to dismiss the complaints for failure to state a claim, the court stated that if the government assumed control, as alleged by the plaintiffs, it could not negligently operate the business without escaping liability.[126] The court's ruling takes on added significance because the court permitted the third party plaintiffs to overcome the obstacles contained in the Federal Tort Claims Act.[127]

Perhaps surprising to some, the court's decision is consistent with concepts of negligence law. The *Restatement (Second) of Torts* provides that one who undertakes to assist another is liable for the resulting harm where that person's conduct either increases the risk of harm or the harm arises

---

123. 445 F. Supp. 723 (E.D.N.Y. 1978).

124. *Id.* at 728 (quoting from a memorandum of two third-party plaintiffs).

125. 445 F. Supp. at 728.

126. [W]e think that if the Government goes beyond the normal regulatory activities and substitutes its decisions for those of the officers and directors, and if the bank and bank directors reasonably rely on these actions of the Government, the Government may assume a duty to those parties to prevent fraud. . . . [O]nce having taken control of a bank, as it is alleged to have done here, it could not operate it in a negligent manner without being subject to liability.

Id. at 733-35. *Compare* Harmsen v. Smith, 586 F.2d 156 (9th Cir. 1978), *with* First State Bank of Hudson County v. United States, 599 F.2d 558 (3rd Cir. 1979), *cert. denied*, 444 U.S. 101 (1980).

127. 28 U.S.C. §§ 2671-2680 (1982).

from reliance on the conduct of the person who assumed the responsibilities.[128] In view of such authorities, when a creditor provides specific assistance to a debtor or assumes control over a debtor's operations, whether directly or by suggesting a third person, and a debtor relies on the creditor, the creditor may risk being held liable for failing to perform such assumed duties with reasonable care. However, a number of questions arise. What is the scope of the duty? Recognizing the social efficacy of bona fide creditor efforts to assist a struggling business, will the courts adopt an exception to the rule or attempt to maintain an incentive for creditors to provide such assistance by adopting a gross negligence or recklessness test? Should courts do so? How will performance of the duty be measured? Presumably, under the doctrine of contributory negligence, the debtor will be required to object to or not carry out actions which he believes are improper. Will courts stretch the concept of foreseeability to third parties such as other creditors? These and a multitude of other questions are raised by application

---

128. RESTATEMENT (SECOND) OF TORTS § 323 (1965). The section provides in full:

> One who undertakes, gratuitously or for consideration, to render services to another which he should recognize as necessary for the protection of the other's person or things, is subject to liability to the other for physical harm resulting from his failure to exercise reasonable care to perform his undertaking, if
>
> (a) his failure to exercise such care increases the risk of such harm, or
>
> (b) the harm is suffered because of the other's reliance upon the undertaking.

Id. While the term "physical harm" is used in the text of section 323, comment d to the section would indicate that the section applies to other types of injury such as economic loss. Moreover, the annotations to section 323 demonstrate the courts have applied the assumption of duty rule to cases involving economic injury. *See, e.g.*, Schwartz v. Greenfied, Stein and Weisinger, 90 Misc. 2d 882, 396 N.Y.S.2d 582 (1977); McDonald v. Title Ins. Co. of Ore., 49 Or. App. 1055, 621 P.2d 654 (1980). A similar synopsis of the law is contained in 65 C.J.S. *Negligence* § 4(4) (1966):

> One who undertakes to do an act or perform a service for another has the duty to exercise care, and is liable for injury resulting from his failure to do so, even though his undertaking was a purely voluntary undertaking or even though it was completely gratuitous, and he was not under any obligation to do such act or perform such service, or there was no consideration for the promise or undertaking sufficient to support an action ex contractu based thereon.

(Citations omitted.) It is interesting to note that the complaint in Credit Managers Ass'n v. Superior Court, 51 Cal. App. 3d 352, 124 Cal. Rptr. 242 (1975), contained a count alleging that the lenders acted negligently in managing the debtor.

of the assumption of duty rule in the *Franklin National* case. Such questions have traditionally posed a problem in this area of the law. As Professor Prosser noted, "[j]ust when the duty is undertaken, when it ends and what conduct is required, are nowhere clearly defined, and perhaps cannot be."[129]

The use of tort law theories to expand the liabilities of lenders who choose to exercise substantial control over their debtors was demonstrated by the recent jury verdict in *State National Bank of El Paso v. Farah Manufacturing Co.*[130] In *Farah* the plaintiff-debtor alleged that its lenders used a change in the management control clause in their loan agreement with Farah to engage in fraud and duress and to improperly interfere with Farah's business. A variety of improper and selfish interests were ascribed to the lenders. Following a jury trial, a verdict in excess of eighteen million dollars was awarded to Farah.

Given the possibility of extensive liability for negligently assisting in a debtor's business, creditors would be well advised to carefully consider taking any such proposed action, or proffering others such as consultants.[131]

F. The "Insider" Status of Creditors Under the Bankruptcy Code

While it does not impose substantive liability, section 547(b)(4)(B) of the Bankruptcy Code[132] extends the period during which preferential transfers of property to a creditor may be recovered from ninety days to one year prior to the initiation of bankruptcy proceedings, if the creditor is an "insider" and had reasonable grounds to believe the debtor

---

129. W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 56, at 344 (4th ed. 1971).

130. Case No. 08-82-00160-CV (on appeal Tex. Civ. App.). The case has been appealed and oral arguments were heard in December, 1983. In view of the issues and amount involved, counsel for lenders will wish to monitor the progress of this case.

131. The extent to which an indemnification and hold harmless agreement, with appropriate recitals, may be effective in limiting a creditor's liability is beyond the scope of this article. Anyone about to become substantially involved in assisting a debtor should give consideration to obtaining such an agreement.

132. 11 U.S.C. § 547(b)(4)(B) (1982). For an in depth consideration of the definition and treatment of insiders see Note, *The Term Insider Within Section 547 (b)(4)(B) of the Bankruptcy Code*, 57 NOTRE DAME LAW. 726 (1982).

was insolvent at the time of transfer.[133] In the case of corporations, "insider"[134] is defined as *including*, among others, di-

---

133. 11 U.S.C. § 547(b) provides:

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor —
(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made —
(A) on or within 90 days before the date of the 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; and
(5) that enables such creditor to receive more than such creditor would receive if —
(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

134. 11 U.S.C. § 101(25) provides:

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

rectors, officers, persons "in control" of the corporation and "affiliates."[135]

Thus, the question arises under what circumstances will a creditor be deemed "in control" of its debtor, thereby enabling a debtor in reorganization or a trustee to recover otherwise preferential payments made beyond the ninety day period and up to one year prior to commencement of bankruptcy proceedings. To date the courts have refused to rule that a creditor is in control of a debtor simply by virtue of a credit relationship. Thus, in *In re Jefferson Mortgage Co.*[136] the court rejected a trustee's contention that a creditor was an insider of a debtor by virtue of a lending relationship, where the control exercised was merely incidental to the creditor-debtor relationship.[137] This decision is consis-

---

135. 11 U.S.C. § 101(2) defines affiliate as:

(A) entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities —

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(B) corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities —

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(C) person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the debtor; or

(D) entity that operates the business or all or substantially all of the property of the debtor under a lease or operating agreement;

136. 25 Bankr. 963 (Bankr. D.N.J. 1982).

137. The Trustee has not cited any cases, nor can this court find any, in which a creditor was held to be an "insider" for purposes of section 547 of the Bankruptcy Code merely by reason of being a creditor. Perhaps § 101(25)(B)(iii) might apply if the creditor was a "person in control of the debtor," but that fact has not been established in this case. . . . The Bank 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 relationships at any time and looked for another creditor.

tent with the intent of the drafters of the Bankruptcy Code.[138]

The court in *In re Yonkers Hamilton Sanitarium, Inc.*[139] took a more restrictive view of persons deemed in control of a corporation: "The persons who might be expected to control a corporate debtor are its officers, directors and substantial stockholders. Thus, aside from officers and directors, a person is an insider if that person meets the test of an 'affiliate . . . .' "[140]

The more difficult question is the extent to which a creditor may act and insist upon cooperation without the risk of being held to be "in control" of its debtor. A strong case can be made for permitting creditors to take actions such as providing financial guidance, exercising specific veto powers over the expenditure of funds, insisting upon full disclosure of information and providing limited assistance, without assuming the risk of being deemed in control. These allowances would encourage creditors to provide needed assistance to troubled debtors. Only when a creditor's role is transformed from one of taking a commercially prudent action to safeguard a loan to one of assuming substantial and detailed authority over all facets of a debtor's business would a finding of control be appropriate and consistent with the goal of encouraging creditors to assist their debtors in periods of financial distress.

Id. at 970 (emphasis added). *Accord In re* Taylor, 29 Bankr. 5 (Bankr. W.D. Ky. 1983). *See also* McWilliams v. Gordon (*In re* Camp Rockhill, Inc.), 12 Bankr. 829 (Bankr. E.D. Pa. 1981); *In re* Castillo, 7 Bankr. 135 (Bankr. S.D.N.Y. 1980).

138. " '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 arms length with the debtor.' " Loftis v. Minar (*In re* Montanino), 15 Bankr. 307, 310 (Bankr. D.N.J. 1981) (quoting analysis of H.R. 8200, H. Rep. No. 595, 95th Cong., 1st Sess. 312 (1977); analysis of S. 2266, S. 989, 95th Cong. 2d Sess. 25 (1978), *reprinted in* U.S. CODE CONG. & AD. NEWS at 5787, 5810).

139. 22 Bankr. 427 (Bankr. S.D.N.Y. 1982).

140. *Id.* at 430. The court further stated: "[A] corporate debtor may be influenced by the demands of its major customers or creditors but such influence alone does not constitute the requisite voting control contemplated under Code § 101(25)(B) for purposes of defining a person in control of a corporate debtor who might be regarded as an 'insider.' " *Id.*

III. Conclusion

There are a variety of theories under which a creditor may become liable to other creditors or its debtor for assuming what is found to be inordinate control or an improper exercise of control over a debtor's business affairs. Perhaps more than most creditors realize, there are a number of pitfalls awaiting those who act imprudently, even though their status may confer a superior position.[141]

Regardless of the theory, common elements thread through all the cases. Courts recognize that at times it is imperative for creditors to take strong measures to protect their interests.[142] The courts will sanction specific actions and controls aimed at protecting the obligations due them and will permit limited creditor involvement in the affairs of their debtors.[143] However, if a creditor uses its superior position to supercede management's control over a wide range of the debtor's affairs and undertakes to direct the method in which its debtor's business operations will be conducted, it assumes the risk that its conduct will be judicially scrutinized.[144] This distinction is as it should be, for in the final analysis a creditor who has agreed to advance funds or make credit available then undertakes to engage in the business of finance, not in the business of manufacturing goods or providing services.

141. *See supra* text accompanying notes 78-80.

142. *See, e.g.*, Credit Managers Assoc. of S. Calif. v. Superior Court, 51 Cal. App. 3d 352, 124 Cal. Rptr. 242 (1975); A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981).

143. *See supra* text accompanying notes 48 & 74-77.

144. *See supra* text accompanying notes 78-80.