Mobile Steel and Beyond: Trends in Equitable Subordination

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MOBILE STEEL AND BEYOND: TRENDS IN EQUITABLE SUBORDINATION

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I. INTRODUCTION

A corporation's initial financial structure generally consists of debt as well as capital contributions. Although a shareholder is not a creditor of the corporation in which he owns stock,[1] a shareholder may acquire the additional status of creditor by advancing a loan to the corporation. The primary advantages of lending money to a business rather than merely purchasing stock are favorable tax treatment[2] and lower risk in the event of the corporation's liquidation.

Lending money to a corporation results in favorable tax treatment for three reasons. First, since the corporation is entitled to a deduction of the interest paid on indebtedness,[3] the interest payments received by the shareholder creditor are only subject to taxation once—when received by the shareholder-creditor. Stock dividends, on the other hand, may be paid only out of after-tax earnings and are, therefore, subject to "double taxation."[4] Second, the corporation's repayment of the loan principal is considered a nontaxable return of capital.[5] Third, a shareholder who lends money to his corporation may fully de-

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1. 18A AM. JUR. 2D *Corporations* § 488 (1985).

2. *See* Note, *Equitable Subordination of Shareholder Debt to Trade Creditors: A Reexamination*, 61 B.U.L. REV. 433, 433-34 n. 3 (1981). *See also* Anderson, *"Thin" Corporate Capitalization*, 1957 S. CALIF. TAX INST. 35; Holland, *Tax Effects of Stockholder Loans to Corporations*, 9 N.Y.U. FED. TAX INST. 1003 (1951).

3. I.R.C. § 163 (1982 & Supp. II 1984). *See* sources cited *supra* note 2.

4. I.R.C. §§ 11(a), 301 (1982 & Supp. II 1984); 306 (1982). *See* sources cited *supra* note 2.

5. J. CHOMMIE, FEDERAL INCOME TAXATION 28 (2d ed. 1973). *See* sources cited *supra* note 2.

duct a bad debt incurred in his trade or business;[6] even if the bad debt is not incurred in the shareholder's trade or business, it is deductible as a short-term capital loss.[7] Losses on stock are not entitled to such favorable treatment if the stock was held for more than six months.[8]

The advantage of holding creditor status on a corporation's liquidation results from the priority accorded creditors. The Bankruptcy Reform Act of 1978 (the Bankruptcy Code) provides that a corporation undergoing a Chapter 7 liquidation proceeding must satisfy all creditors' claims before its shareholders can receive any distribution of its assets.[9] Since a corporation that has filed for relief under Chapter 7 rarely has assets sufficient to cover all its obligations, the shareholders may be left out entirely. The risk of lending money to a corporation is, therefore, significantly lower than that associated with ownership of the corporation's stock.

There is nothing inherently wrong with a shareholder's advancing money to his business in the form of a loan.[10] In fact, in the case of the closely-held corporation, shareholders are often the most appropriate or even the only source of cash for continuing operations.[11] While the business is solvent, the classification of a shareholder's loan to the corporation matters little. When the corporation is unable to pay its debts as they come due, however, the problem of priority may arise. A dominant or controlling shareholder, as a fiduciary of the corporation,[12] has the burden of proving that his loan transaction with the company was inherently fair and entered into in good faith.[13]

In certain circumstances, equity may require that a shareholder's claim as a creditor in a bankruptcy proceeding be either subordinated to the claims of general trade creditors or disal-

6. I.R.C. § 166 (1982). *See* sources cited *supra* note 2.

7. *See* I.R.C. §§ 165(f)-(g), 166 (1978); 1211 (1982); 1212 (1982 & West Supp. 1986). *See also* sources cited *supra* note 2.

8. I.R.C. § 1222 (Supp. II 1984).

9. 11 U.S.C. § 726 (1982 & Supp. II 1984).

10. *In re* Black Ranches, Inc., 362 F.2d 19, 37 (8th Cir.), *cert. denied*, 385 U.S. 990 (1966); Goldstein v. Wolfson, 132 F.2d 624, 626 (2d Cir. 1943); Obre v. Alban Tractor Co., 228 Md. 291, 294, 179 A.2d 861, 862 (1961); Hanson v. Bradley, 298 Mass. 371, 379, 10 N.E.2d 259, 263 (1937); 18A AM. JUR. 2D *Corporations* § 504 (1985).

11. Small v. Williams, 313 F.2d 39, 42 (4th Cir. 1963).

12. Pepper v. Litton, 308 U.S. 295, 306 (1939).

13. Spach v. Bryant, 309 F.2d 886, 888-89 (5th Cir. 1962).

lowed altogether. A bankruptcy court, as a court of equity,[14] has the power to adjust certain claims against a debtor corporation, and the Bankruptcy Code expressly acknowledges the court's power to disallow[15] or subordinate[16] claims.

Traditionally, bankruptcy courts have used similar principles for the equitable subordination of both controlling shareholders' and parent corporations' claims against the debtor corporation. The following are the most common grounds for subordinating these claims: (1) the existence of fraud or illegality in the particular transaction; (2) severe undercapitalization of the corporation, attributable to the claimant; and (3) the existence of such complete control of the corporation that it is essentially an instrumentality or "alter ego" of the claimant. Historically, it has been very difficult to predict with any certainty whether a court will exercise its power of equitable subordination. Courts have decided each case on its particular facts, and different courts have emphasized different factors in applying broad equitable principles.

In *In re Mobile Steel Co.*,[17] the Fifth Circuit set forth certain threshold conditions that must be met before a court exercises its power to subordinate a claim in bankruptcy. One commentator has concluded that "*Mobile Steel's* three-pronged test and other principles enunciated in the case should define more clearly responsibilities of the courts in this area and also provide corporate insiders with the guidelines they so desperately need in making advances to their corporations."[18]

Part II of this Article provides a general examination of the doctrine of equitable subordination as it has been applied to claims by controlling or dominant shareholders and by parent corporations. Part III describes the principles enunciated by the Fifth Circuit Court of Appeals in the *Mobile Steel* opinion. Finally, parts IV and V analyze the effect these guidelines have had on subsequent decisions by other courts that have considered claims by both insiders and noninsiders.

14. Bank of Marin v. England, 385 U.S. 99, 103 (1966); Heiser v. Woodruff, 327 U.S. 726, 732 (1946); Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934).

15. 11 U.S.C. § 502 (1982 & Supp. II 1984).

16. 11 U.S.C. § 510 (1982 & Supp. II 1984).

17. 563 F.2d 692 (5th Cir. 1977).

18. Note, *Deep Rock in the Deep South: Equitable Subordination of Claims in Fifth Circuit Bankruptcy Proceedings*, 11 CUM. L. REV. 619, 637 (1980).

II. Overview of Equitable Subordination

As noted above, the bankruptcy court's power to order subordination of certain claims grew out of the court's general equitable powers.[19] Disallowance of claims, on the other hand, has long been statutorily authorized.[20] When a claim is disallowed, it is considered invalid and nonexistent for purposes of distributing the debtor's assets. Thus, the entity whose claim is disallowed effectively loses its status as a creditor in the bankruptcy proceeding.

In contrast, subordination of a creditor's claim does not necessarily negate the claim. A subordinated claim remains a valid claim against the debtor's estate, but, under equitable principles, enjoys a lower status than the claims of general creditors. In practice, of course, subordination of a claim is tantamount to disallowance if the debtor's assets are insufficient to satisfy all allowed claims.[21]

The Bankruptcy Code now expressly authorizes the subordination of claims.[22] Of particular significance for claims by

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19. For a discussion of the bankruptcy court's pre-Bankruptcy Code jurisdiction to order equitable subordination, see Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 83-85 (1961).

20. *See* Bankruptcy Act of 1898, ch. 541, §§ 2(2), 57(k), 30 Stat. 544, 545, 561 (1898); 11 U.S.C. § 502 (1982 & Supp. II 1984).

21. For discussions of the distinction between disallowance and subordination of claims in bankruptcy, see Reimer, *Claims Against Bankrupt Corporations Based on Advances by Controlling Stockholders or Parent Corporations*, 73 Com. L.J. 273, 274 (1968); Herzog & Zweibel, *supra* note 19, at 85-88.

22. Section 510 provides:

> (a) A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.
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> (b) For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.
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> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
>> (1) Under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

shareholders or parent corporations is section 510(c), which specifically refers to "principles of equitable subordination." The statute, however, provides no specific guidelines for applying the concept; it was Congress' intent that the courts develop the doctrine of equitable subordination by basing their holdings on prior case law.[23] Thus, the enactment of the Bankruptcy Code has not produced any clear-cut rules for the courts to follow in determining whether a particular claim should be subordinated. Courts that have decided to subordinate a shareholder's or a parent corporation's claim against the estate of a debtor corporation have generally focused on the existence of one or more of the three factors listed above: (1) fraud or illegality, (2) undercapitalization, and (3) the claimant's complete domination and control of the business.[24]

In order for a court to disallow or subordinate a claim on the basis of fraud, it is not necessary that all the elements of common-law fraud be present. The term "fraud" in this context has a much broader scope. For example, in *Pepper v. Litton*,[25] the seminal case on the doctrine of equitable subordination, the Supreme Court found that a stockholder's breach of his fiduciary duty to the debtor corporation was sufficient to trigger the subordination of his claim.

In *Litton* the controlling shareholder caused his corporation to confess a judgment in his favor for salary claims. When the corporation filed for bankruptcy, he then attempted to use his claim to deplete the corporation's assets—to the detriment of Pepper, an outside creditor. The United States Supreme Court upheld the lower court's subordination of Litton's claim on the basis of "cardinal principles of equity jurisprudence."[26] Justice Douglas, writing for the Court, stated that in cases such as *Litton* "a sufficient consideration [to support a finding of fraud] may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and

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(2) order that any lien securing such a subordinated claim be transferred to the estate.

11 U.S.C. § 510 (1982 & Supp. II 1984).

23. 124 Cong. Rec. 11,095, 17,412 (1978).

24. *See supra* text following note 16.

25. 308 U.S. 295 (1939).

26. *Id.* at 306.

creditors."[27]

Another type of fraudulent conduct that can result in subordination of a claim is misrepresentation of a corporation's financial condition.[28] When one creditor knowingly misrepresents the corporation's financial status and other creditors extend credit in reliance on that misinformation, courts will often subordinate the fraudulent creditor's claim to the claims of creditors who suffered injury thereby.

A related basis for subordination is illegality. If a creditor's claim arises from an agreement that is itself illegal, the claim will of course be disallowed entirely. In contrast, courts will order subordination when the illegality bears more than an incidental relationship to the claim asserted.[29]

Yet another situation that may give rise to subordination is undercapitalization of the debtor corporation. This occurs when the corporation's shareholders fail to supply sufficient amounts of paid-in capital for the business' operation. When a shareholder lends money to his undercapitalized corporation and then asserts a claim as a creditor in bankruptcy, the court will generally disregard the form of the transaction and will treat the "loan" as a contribution to capital. This treatment may result in the shareholder's claim being relegated to a status that is just above, equal to, or even below that of other shareholders.[30]

The undercapitalization cases reveal a great deal of judicial confusion. First, a court must determine whether the corporation has an insufficient amount of paid-in capital. To this end, courts generally consider a number of factors, including the corporation's debt-equity ratio,[31] expert testimony regarding the reasonableness of the corporation's capital structure,[32] and the

27. *Id.* at 310-11.

28. *See, e.g.*, E. E. Gray Corp. v. Meehan, 54 F.2d 223 (1st Cir. 1931).

29. *See, e.g.*, Columbia Gas & Elec. Corp. v. United States, 151 F.2d 461 (6th Cir. 1945)(court subordinated claim based on transaction conducted for primary purpose of restraining competition in violation of antitrust laws). *See also* Schwartz v. Mills, 192 F.2d 727, 729 (2d Cir. 1951); West 52nd Theatre Co. v. Tyler, 178 F.2d 128, 129 (2d Cir. 1949); Herzog & Zweibel, *supra* note 19, at 100; Note, *supra* note 18, at 629.

30. S. REP. No. 989, 95th Cong., 2d Sess. 73-74 (1978), *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5787.

31. *See, e.g.*, *In re* Fett Roofing & Sheet Metal Co., 438 F. Supp. 726, 730 (E.D. Va. 1977), *aff'd*, 605 F.2d 1201 (4th Cir. 1979); *In re* Brunner Air Compressor Corp., 287 F. Supp. 256, 261-62 (N.D.N.Y. 1968).

32. *See, e.g.*, *In re* Mobile Steel Co., 563 F.2d 692, 703 (5th Cir. 1977); Costello v.

corporation's use of the loan to purchase permanent assets of the business.[33]

Many courts have also required some indication of the shareholder's intent to undercapitalize before subordinating his claim.[34] This intent may be inferred, however, from the shareholder's failure to enforce timely repayment of the "loan" so that the money advanced by the shareholder is in effect a part of the corporation's paid-in capital.[35] Case law has given rise to some controversy over whether a court should subordinate a shareholder's claim on the basis of undercapitalization alone or whether some additional misconduct by the shareholder is a necessary prerequisite to equitable subordination.[36]

Finally, courts have subordinated the claims of creditors, whether individuals or parent corporations, who exercised such control that the bankrupt was considered a mere "instrumentality" or alter ego of the creditors. In a close corporation, a single person or parent corporation often owns all or a majority of the stock, manages the business, and effectively controls all the company's affairs. Under these circumstances, when the corporation files for bankruptcy, the dominant shareholder who files a claim against the debtor's estate is in effect attempting to prove a claim against himself.

The older cases held that the presence of the "instrumental-

Fazio, 256 F.2d 903, 906-07 (9th Cir. 1958).

33. *See, e.g.*, Boyum v. Johnson, 127 F.2d 491, 494 (8th Cir. 1942); Arnold v. Phillips, 117 F.2d 497, 501 (5th Cir. 1941).

34. *See, e.g.*, *In re* Brunner Air Compressor Corp., 287 F. Supp. 256, 261 (N.D.N.Y. 1968); *In re* Mader's Store for Men, Inc., 77 Wis. 2d 578, 604-05, 254 N.W.2d 171, 186 (1977). *See also* Boyum v. Johnson, 127 F.2d 491, 494 (8th Cir. 1942); Arnold v. Phillips, 117 F.2d 497, 501 (5th Cir. 1941); *In re* Fett Roofing & Sheet Metal Co., 438 F. Supp. 726, 730 (E.D. Va. 1977), *aff'd*, 605 F.2d 1201 (4th Cir. 1979). *But see In re* Mobile Steel Co., 563 F.2d 692, 702 (5th Cir. 1977).

35. *See* Boyum v. Johnson, 127 F.2d 491, 494 (8th Cir. 1942); Arnold v. Phillips, 117 F.2d 497, 501 (5th Cir. 1941); *In re* Fett Roofing & Sheet Metal Co., 438 F. Supp. 726, 730 (E.D. Va. 1977), *aff'd*, 605 F.2d 1201 (4th Cir. 1979); *In re* Mader's Store for Men, Inc., 77 Wis. 2d 578, 604-05, 254 N.W.2d 171, 186 (1977). At least one commentator, however, has argued that the shareholder's intent should not affect an inquiry into the adequacy of a corporation's capitalization. *See* Loiseaux, *Loans or Capital Contribution to the Close Corporation*, 38 REF. J. 4, 5 (1964).

36. *See 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)(undercapitalization alone is sufficient for subordination). For a persuasive argument that undercapitalization alone should warrant subordination of a controlling shareholder's claim, see Note, *supra* note 2.

ity" relationship itself was sufficient to subordinate a controlling shareholder's or parent corporation's claim.[37] Later, this so-called "pure instrumentality rule" was modified to require some element of fraud or self-dealing by the claimant before equitable subordination would be justified.[38]

Probably the best known instrumentality case is *Taylor v. Standard Gas and Electric Co.*,[39] which gave rise to a popular term for equitable subordination, the "Deep Rock" doctrine. In *Taylor* the parent corporation, Standard, completely dominated its subsidiary, Deep Rock. The parent corporation made large loans to its subsidiary, but also forced Deep Rock to pay large amounts of dividends on preferred stock so that the preferred stockholders would not have any voting power under Deep Rock's corporate charter.[40] The Supreme Court subordinated the parent corporation's claims to those of Deep Rock's general creditors. The essence of the "Deep Rock" doctrine is that a court should subordinate a creditor's claim when both control and mismanagement are present. The Supreme Court later referred to the *Taylor* decision as one "based on the equities of the case—the history of spoliation, mismanagement, and faithless stewardship of the affairs of the subsidiary . . . to the detriment of the public investors."[41]

A further step in the development of the instrumentality concept occurred when the Supreme Court decided *Comstock v. Group of Institutional Investors*.[42] In that case, the Court stated: "It is not the mere existence of an opportunity to do wrong which brings the [Deep Rock] rule into play, it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives

37. *In re* Watertown Paper Co., 169 F. 252 (2d Cir. 1909). *See, e.g.*, Hunter v. Baker Motor Vehicle Co., 225 F. 1006 (N.D.N.Y. 1915).

38. Forbush Co. v. Bartley, 78 F.2d 805 (10th Cir. 1935); Commerce Trust Co. v. Woodbury, 77 F.2d 478 (8th Cir. 1935); Duffy v. Treide, 75 F.2d 17 (4th Cir. 1935); Finn v. George T. Mickle Lumber Co., 41 F.2d 676 (9th Cir. 1930); Majestic Co. v. Orpheum Circuit, Inc., 21 F.2d 720 (8th Cir. 1927); N.Y. Trust Co. v. Carpenter, 250 F. 668 (6th Cir. 1918); Peckett v. Wood, 234 F. 833 (3d Cir. 1916).

39. 306 U.S. 307 (1939).

40. *Id.* at 320 n. 4.

41. Pepper v. Litton, 308 U.S. 295, 308 (1939). Elements of instrumentality were also present in *Litton*, in which the Court relied on such abstract notions as "fair play" and "good conscience" to invoke equitable subordination.

42. 335 U.S. 211 (1948).

the wrongdoer of the fruits of his wrong."[43] This language indicated the Court's complete rejection of the "pure instrumentality rule" for equitable subordination. It is now apparent that, in addition to a claimant's complete domination of a debtor corporation, some element of fraud, mismanagement, breach of fiduciary duty, or self-dealing must be present before a court will equitably subordinate the shareholder's or parent corporation's claim.

III. MOBILE STEEL: SOME THRESHOLD REQUIREMENTS

When the Fifth Circuit decided *In re Mobile Steel Co.*,[44] the law of equitable subordination was in some confusion. Courts were applying vague standards—notably "fair play and good conscience"[45]—to determine the propriety of equitable subordination. Although the decision to subordinate a claim is necessarily based on the facts of each case, it is desirable for the courts to develop more concrete standards by which to judge the facts. This is what the Fifth Circuit attempted to develop in the *Mobile Steel* opinion.

The factual setting of *Mobile Steel* was fairly complex. The parties pressing claims against the corporate debtor's estate included the organizers, officers, and directors of Mobile Steel Company, members of their families, and a corporation that was in essence the alter ego of one of the individual claimants. In addition, two sets of claims were at issue in the case.

The E.B.F. Company was formed on February 18, 1965. A short time later, E.B.F. purchased the assets of the old Mobile Steel Company for approximately $1.2 million. E.B.F. financed this purchase in part by a $250,000 loan from three of its officers who received debentures in return. E.B.F. then changed its name to "Mobile Steel Company, Inc." Because of E.B.F.'s purchase of old Mobile Steel, the new company was short of cash and was forced to borrow over $800,000 to finance its operations.[46]

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43. *Id.* at 229.

44. 563 F.2d 692 (5th Cir. 1977).

45. *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 310-11 (1939); *In re* Ahlswede, 516 F.2d 784, 788 (9th Cir. 1975); Braddy v. Randolph, 352 F.2d 80, 84 (4th Cir. 1965).

46. 563 F.2d at 696-97.

Later in 1965 Mobile Steel acquired a subsidiary, McGowin-Lyons Hardware & Supply Co., Inc., which purchased $185,000 of the debentures from the three officers. In 1968 McGowin-Lyons was dissolved, relieving Mobile Steel of its obligation to pay on the debentures. The remaining $65,000 of debentures, by which Mobile Steel was still bound, provided the basis for one set of claims in Mobile Steel's bankruptcy.[47]

In 1966 McGowin-Lyons, Mobile Steel's subsidiary, received $400,000 from a condemnation sale. When McGowin-Lyons was dissolved, its opportunity under the Internal Revenue Code[48] to avoid recognizing the capital gain by reinvesting the proceeds in similar property passed to the parent corporation, Mobile Steel. The deadline for this reinvestment was December 31, 1969. Shortly before that time, the partnership of Benjamin, Tumlin & Woods agreed to sell Mobile Steel some commercial property in Savannah, Georgia for $236,364.83. The sale was consummated through promissory notes and mortgages, and no cash changed hands in the transaction. Benjamin, Tumlin & Woods consisted of three of the claimants: two individuals and the alter ego corporation.[49]

In 1970 Mobile Steel entered into an agreement with Ingalls Iron Works Company, under which Ingalls would purchase another Mobile Steel subsidiary, Jones & Armstrong Steel Co., Inc., for $600,000. Mobile Steel had agreed to transfer the Savannah property free and clear to Jones & Armstrong in exchange for the cancellation of an account receivable; this transfer was part of the consideration received by Ingalls under the 1970 agreement. Upon dissolution of Benjamin, Tumlin & Woods, Mobile Steel issued new promissory notes to the individual partners, based on the 1969 sale of the Savannah property. These notes provided the foundation for the second set of claims against Mobile Steel's estate.[50]

The bankruptcy judge disallowed the first set of claims, which were based on the debentures held by the three E.B.F. officers, because the claims arose out of contributions to capital. The judge also subordinated two of the claims based on the

47. *Id.* at 697.
48. I.R.C. § 1033 (1967).
49. 563 F.2d at 697-98.
50. *Id.* at 698.

promissory notes held by Benjamin, Tumlin & Woods because of the claimants' breach of fiduciary duty and lack of good faith in dealing with Mobile Steel.[51] The district court affirmed the decision,[52] but the Fifth Circuit Court of Appeals reversed because both sets of claims failed to satisfy the court's proposed test for equitable subordination.

The Fifth Circuit affirmed the equitable power of the bankruptcy court to subordinate claims,[53] but set limits on this power. Initially the court stated that "equitable considerations can justify only the subordination of claims, not their disallowance."[54] The court explained that when the claimant's inequitable conduct is directed against the debtor, the debtor will have adequate protection in a legal remedy or defense. Likewise, other creditors will be fully protected by the equitable remedy of subordination if the claimant's inequitable conduct is directed against them. Thus, "[d]isallowance of claims on equitable grounds would add nothing to the protection against unfairness already afforded the bankrupt and its creditors."[55]

The court then set forth its innovative three-pronged test for determining the appropriateness of equitable subordination. First, "[t]he claimant must have engaged in some type of inequitable conduct."[56] Presumably, "inequitable conduct" would encompass fraud and illegality, undercapitalization, and complete control and domination of a corporation. Second, "[t]he misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant."[57] Finally, "[e]quitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act."[58]

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51. *Id.* at 695-96.

52. *Id.* at 696.

53. *Id.* at 698-99.

54. *Id.* at 699.

55. *Id.* n. 10.

56. *Id.* at 700 (citing Comstock v. Group of Institutional Investors, 335 U.S. 211, 229 (1948)); Frasher v. Robinson, 458 F.2d 492, 493 (9th Cir.), *cert. denied,* 409 U.S. 109 (1972); Spach v. Bryant, 309 F.2d 886, 889 (5th Cir. 1962).

57. 563 F.2d at 700 (citing Comstock v. Group of Institutional Investors, 335 U.S. 211, 229 (1948)); *In re* Branding Iron Steak House, 536 F.2d 299, 302 (9th Cir. 1976); *In re* Brunner Air Compressor Corp., 287 F. Supp. 256, 265 (N.D.N.Y. 1968).

58. 563 F.2d at 700 (citing Luther v. United States, 225 F.2d 495, 499 (10th Cir. 1955), *cert. denied,* 350 U.S. 947 (1956)); *In re* Columbia Ribbon Co., 117 F.2d 999, 1002 (3d Cir. 1941).

The *Mobile Steel* court also enunciated three principles for lower courts to follow in applying the three-pronged test. The court stated first that a claim may be subordinated whether or not the inequitable conduct of the claimant was related to obtaining or maintaining the claim.[59] Second, the court stated that "a claim or claims should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct."[60] Finally, and most important, the court addressed allocation of the burden of proof. The court stated that a trustee in bankruptcy who objects to a claimant's verified proof of claim must present the court with "some substantial factual basis to support [his] allegation of impropriety."[61] Thus, a merely formal objection to a fiduciary's claim is insufficient to shift to the fiduciary the burden to prove the transaction's good faith and fairness. Without this requirement, the court feared that a fiduciary would be forced to show the good faith and fairness of *each* transaction at the trustee's whim, with the possible effect of discouraging "those most interested in a corporation from attempting to salvage it through an infusion of capital."[62]

Numerous decisions have cited with approval and adopted *Mobile Steel's* three-pronged test for equitably subordinating claims. Parts IV and V of this Article will examine these cases, analyzing first those cases arising out of the Fifth Circuit.

IV. Mobile Steel in the Fifth Circuit: Steps Toward Predictability and Consistency?

Cases from the Fifth Circuit that have applied *Mobile Steel's* three-pronged test may, for purposes of this analysis, be classified according to whether the court ordered subordination of the claims at issue. Some rather detailed discussion of the facts in each case is necessary to compare the cases for the predictability and consistency of their outcomes.

59. 563 F.2d at 700 (citing Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939)).
60. 563 F.2d at 701.
61. *Id.*
62. *Id.*

A. *Claims Not Subordinated*

In *In re Dade County Dairies, Inc.*,[63] a Florida district court refused to subordinate a creditor's claim. In that case Samfel, Inc. owned the property occupied by Dade County Dairies, Inc. Dade County Dairies had for some time prior to its insolvency been giving Samfel monthly payments nearly twice as large as the monthly rental rate. Samfel alleged that these monthly payments were not actually rental payments, but were in satisfaction of a loan Samfel had made to Dade County Dairies. Samfel failed, however, to prove the existence of the loan and sought to recover administrative rent for the six-month period during which the leased premises had been in the possession of the receiver and the bankruptcy trustee. The bankruptcy judge denied Samfel's motion for payment of administrative rent, and Samfel appealed to the district court. Although members of the Feldman family completely owned the stock of both Samfel and Dade County Dairies, the court made no finding that either corporation was the alter ego of the other or of any Feldman family member.[64]

The bankruptcy trustee first argued that the monthly payments made by Dade County Dairies prior to its insolvency should be offset against Samfel's claim for administrative rent because Samfel failed to establish the fact of a loan. The district court, applying section 68(a) of the Bankruptcy Act of 1898, refused to set off the improper "loan" payments against the administrative rental claim because the obligations were lacking in mutuality.[65]

The trustee argued in the alternative that Samfel's claim was properly denied under principles of equitable subordination. The district court, however, cited the third prong of the *Mobile Steel* test—that equitable subordination of a claim must not be inconsistent with the provisions of the Bankruptcy Code—and allowed Samfel's claim in full. The court took a limited view of the bankruptcy court's equitable powers and concluded that since section 64(a)(1) of the Bankruptcy Code explicitly establishes the first priority of administrative rent, the bankruptcy

63. 474 F. Supp. 438 (Bankr. S.D. Fla. 1979).
64. *Id.* at 439-40.
65. *Id.* at 440.

court is "without equitable power to place it in any other position."[66]

In *In re Multiponics, Inc.*,[67] the Court of Appeals for the Fifth Circuit decided to subordinate one claim, which is discussed below,[68] but not to subordinate another. The debtor corporation, Multiponics, Inc., was incorporated in 1968 and filed a bankruptcy petition in 1971 under Chapter 10 of the Bankruptcy Act of 1898. During 1969 Multiponics borrowed a total of $3,350,000 from Chase Manhattan Bank and Deposit Guaranty National Bank. Carl Biehl, a founding shareholder and director of Multiponics, and several other directors extended personal guaranties for payment of the loan. Biehl was also the sole shareholder of Machinery Rental, Inc. When Multiponics defaulted on its loans in 1971, the banks looked to Biehl for payment of the $1,711,771.81 then due. About two months after Multiponics filed its bankruptcy petition, however, Machinery Rental purchased the promissory notes from the banks and then filed a proof of claim against Multiponics for the outstanding balance due.[69]

The bankruptcy trustee argued that the court should subordinate Machinery Rental's claim because the corporation was the alter ego of Biehl. The special master, however, concluded that Machinery Rental had shown a valid business reason for purchasing the notes and denied subordination on that basis. The district court held that the master's conclusion was clearly erroneous and ordered that Machinery Rental's claim be subordinated.[70] The Fifth Circuit reviewed the record and held that Machinery Rental had indeed purchased the bank notes for a valid business purpose: "Machinery Rental sought to purchase the machinery of Multiponics primarily in order to obtain a depreciation allowance to reduce Machinery Rental's tax liability and secondly to rent out the machinery at a profit."[71] The trustee had rejected Machinery Rental's written offer to purchase the machinery and failed to return $50,000 that Machinery

66. *Id.*
67. 622 F.2d 709 (5th Cir. 1980).
68. *See infra* notes 101-08 and accompanying text.
69. 622 F.2d at 722.
70. *Id.*
71. *Id.* at 723.

Rental paid to keep its offer open.[72]

The court also upheld the master's finding that no alter ego relationship existed between Biehl and Machinery Rental and noted that "the alter ego doctrine and piercing of the corporate veil are truly exceptional doctrines, reserved for those cases where the officers, directors or stock holders utilized a corporate entity as a sham to perpetuate [sic] a fraud, to shun personal liability, or to encompass other truly unique situations."[73] Because the trustee failed to carry its burden of proof on the issue of the alleged alter ego relationship,[74] the court declined to subordinate Machinery Rental's claim. In fact, Machinery Rental succeeded to the banks' preferred status on the notes.[75]

In *In re Georgian Villa, Inc.*,[76] a Georgia bankruptcy court decided not to subordinate a claim based on an exchange agreement. The claimants in that case were Glenmore and Sarah Carter, the founders and directors of Georgian Villa, Inc. and Atlanta West General Hospital, Inc., which both filed petitions in 1977 under Chapter 11 of the Bankruptcy Act of 1898. In 1974 the Carters had entered into a real estate "exchange agreement" with Georgian Villa. The two parties executed the exchanges as contemplated, but Georgian Villa failed to convey one 54.5-acre tract to the Carters.[77] A later agreement obligated Atlanta West either to convey the tract of land to the Carters or to pay them $53,225.00, but neither event ever occurred.[78]

The receiver for the two corporations filed a complaint that named the Carters as defendants and sought to sell Georgian Villa's assets free and clear of all encumbrances and liens. The Carters, however, claimed that the 54.5-acre parcel was subject to an implied trust in their favor because they had fulfilled all their obligations under the exchange agreement.[79]

The bankruptcy court held that no implied trust existed. The court found that the intent of the parties at the time of conveyance could not be determined because the tract in ques-

72. *Id.* at 724.
73. *Id.* at 724-25.
74. *Id.* at 723.
75. *Id.* at 725.
76. 10 Bankr. 79 (Bankr. N.D. Ga. 1981).
77. *Id.* at 81.
78. *Id.* at 82.
79. *Id.*

tion was never conveyed. The court concluded, however, that Georgian Villa's failure to convey the land was either a breach of fiduciary duty or mismanagement.

The receiver also argued that Atlanta West never profited under the Carters' direction and that the Carters failed to assert their claim until the debtors encountered financial difficulties. The court cited *Mobile Steel*'s three-pronged test and guiding principles. Purporting to rely on one of those principles—that the objectant to a valid proof of claim must support its allegation with some substantial factual basis[80]—the court concluded that "the objection to the allowance of the Carters' claim on the ground that it should be equitably subordinated is merely formal."[81] The court, therefore, allowed the Carters' claim in full, but ordered specific performance—conveyance of legal title to the Carters—rather than payment of money in satisfaction of the claim.

In a 1981 decision, *In re T.E. Mercer Trucking Co.*,[82] a Texas bankruptcy court declined to rule on the subordination of claims by Fruehauf Corp. against the assets of T.E. Mercer Trucking Co. and G.E.M. Storage & Terminal Co., Inc., which had both filed for relief under the Bankruptcy Code. Fruehauf filed an adversary proceeding for relief from the stay, claiming "mortgages and security interests in practically all assets of the debtor corporations."[83]

A number of issues were before the court on motions for summary judgment, including whether Fruehauf's claim should be subordinated.[84] The court denied the summary judgment mo-

80. *See supra* notes 61-62 and accompanying text. The court read the third principle from *Mobile Steel* as follows: "[D]ealings of a fiduciary are subjected to rigorous scrutiny and the burden is on the fiduciary to prove good faith and the inherent fairness of the transactions from the view of the corporation and those interested therein." 10 Bankr. at 86. Perhaps this interpretation suggests some inherent ambiguity in the *Mobile Steel* opinion itself.

81. *Id.* at 86. The court failed to enumerate the receiver's specific allegations.

82. 16 Bankr. 176 (Bankr. N.D. Tex. 1981).

83. *Id.* at 180.

84. The court also considered several other motions for summary judgment. One of these was whether the corporate debtors and the trustee had standing to urge application to Fruehauf of § 20(a) of the Interstate Commerce Act, which provides that a common carrier may not lawfully issue any securities without the authorization of the Interstate Commerce Commission. 49 U.S.C. § 20 (1976). The debtors and the trustees argued that Fruehauf's loan agreements were actually "securities." The court held that the characterization of the loan agreements was immaterial, 16 Bankr. at 180-81, and that the

tion for subordination and requested further evidentiary hearings.[85] Fruehauf's loan contracts were extraordinary in that they

> gave Fruehauf joint control of all bank accounts of the Corporate Debtors requiring co-signatures for substantial checks, gave Fruehauf the right to place its designee on the Board of Directors of the Debtors; required all corporate bylaws, stock books and certificates to be delivered to Fruehauf's counsel; gave Fruehauf the right to have one of its employees participate in the day-to-day operations of the Debtor's premises with complete veto powers on any items or matters whatsoever; gave Fruehauf the right to require the liquidation of all assets of the Debtors and the various other ventures; gave Fruehauf the right to set salaries of officers and directors; required the Corporate Debtors to pledge all their stock, and provided in the event of a dispute between the Mercer management and the Fruehauf monitoring agent that an appeal would lie to the Fruehauf management for final determination.[86]

The court suggested that such loan agreements might indicate an alter ego situation sufficient to establish inequitable conduct under the *Mobile Steel* test. The trustee was allowed, therefore, "to amend its pleading so as to make a more definitive statement of Fruehauf's inequitable conduct and the nature and extent of any alleged damages."[87] The court also indicated that it would consider whether Fruehauf's conduct resulted in harm to unsecured creditors.[88]

In 1983 the Fifth Circuit again relied upon *Mobile Steel* in *In re Missionary Baptist Foundation of America, Inc.*,[89] which considered the reorganization of a religious nonprofit corporation and its subsidiaries under Chapter 11 of the Bankruptcy

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debtors and the trustee lacked standing to assert a violation of § 20(a), *id.* at 183.

The court also denied a second motion for summary judgment. The debts of G.E.M. and Mercer to Fruehauf were evidenced by a consolidated loan agreement. The court concluded that it was unable to grant summary judgment "on the issue of whether each corporate debtor was intended to be liable on the entire consolidated indebtedness or only on its historical share." 16 Bankr. at 185. The resolution of that issue would raise questions about the adequacy of consideration and the possibility that Fruehauf had engaged in usury. *See id.* at 184-86.

85. *Id.* at 190.

86. *Id.* at 189-90.

87. *Id.*

88. *Id.*

89. 712 F.2d 206 (5th Cir. 1983).

Code.[90] The transactions giving rise to the claims involved several parties.

In 1975 Land Wall, the president, controller, and director of Missionary Baptist Foundation of America, Inc. (MBFA), formed a partnership with Robert G. Huffman, the claimant. In that same year Wall and Huffman established a corporation called West Texas Homes. The partnership then purchased a nursing home with a $228,000 loan from a commercial lender. In 1977 Wall himself purchased another nursing home. Both nursing homes were sold to MBFA later that year, and MBFA assumed all indebtedness on the properties. Huffman and Wall each received a promissory note in the amount of $74,007 as evidence of MBFA's indebtedness. Prior to the sale of the homes to MBFA, West Texas Homes operated both homes under contractual agreements. At the time of the sale West Texas Homes assigned its contractual rights in the homes to MBFA and received two promissory notes, each in the amount of $88,860. When West Texas Homes later dissolved, Huffman and Wall each received one of the notes. At the time of its Chapter 11 petition MBFA owed Huffman a total of $119,005 on the two notes.[91]

Both the bankruptcy judge and the district court found that Huffman was an insider of the debtor under section 101(25)(B) of the Bankruptcy Code,[92] and they ordered his claims subordinated to those of general unsecured creditors under section 510(c)(1).[93] The Fifth Circuit affirmed the finding that Huffman was an insider of MBFA, but reversed the subordination of Huffman's claims. The court remanded the issue to the bankruptcy court for further enunciation of its findings under the *Mobile Steel* test, particularly on the issue of inequitable conduct. Once again, the predominant consideration was whether the trustee's objection to Huffman's claims was supported by a substantial factual basis or whether it was merely formal.[94]

90. For discussion of the ramifications of a claim for equitable subordination in a Chapter 11 case, see Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code*, 56 AM. BANKR. L.J. 293 (1982); Given & Philipps, *Equality in the Eye of the Beholder—Classification of Claims and Interests in Chapter 11 Reorganizations*, 43 OHIO ST. L.J. 735 (1982).

91. 712 F.2d at 209.

92. 11 U.S.C. § 101(28)(B) (Supp. II 1984).

93. 11 U.S.C. § 510(c)(1) (Supp. II 1984).

94. 712 F.2d at 212-13. *See infra* notes 109-14 and accompanying text.

In 1980 the United States Bankruptcy Court for the Northern District of Georgia decided *In re Carolee's Combine, Inc.*[95] Carolee's Combine, Inc. was a corporation organized by Carolee W. Davies for the purpose of acquiring, restoring, and auctioning antique architectural merchandise. Davies, the sole officer and shareholder of Carolee's Combine, contributed little capital to the corporation; she obtained the money necessary for purchasing, transporting, and refinishing the antique inventory through an innovative fund-raising technique.

To each person who advanced cash to the corporation, Carolee's issued a "Promissory Note" and a "Finder's Fee" letter. Under the terms of the note Carolee's would return the principal advanced plus ten percent annual interest to the "lender" on the first day of the scheduled two-day auction. The "Finder's Fee" letter entitled the holder to a flat ten percent of the principal amount of the advance as a bonus payable at the same time.[96] When the auction lost $195,570.93, Carolee's paid $313,764.32 to the individuals who had advanced cash, while the general creditors received nothing.[97] At issue in the case was the payment made to Jay Core, one of Carolee's "lenders."

The trustee argued that Carolee's payment to Core was based on an equity investment rather than a loan, that Core should return the money to the debtor estate, and that Core's claim should be subordinated to the claims of general unsecured creditors. The court held that the trustee had met his burden of proof under each of the three prongs of the *Mobile Steel* test. According to the court, Core's conduct, as well as that of the other investors, was inequitable both because it shifted the risk of loss to the general creditors and because it created a secret first lien on the debtor's assets.[98] In addition, under state corporate law the interests of the persons who advanced money to Carolee's were "shares," and "one cannot withdraw capital from a corporation without first arranging for the payment of its valid debts."[99]

The trustee was, therefore, able to recover the money paid

95. 3 Bankr. 324 (Bankr. N.D. Ga. 1980).
96. *Id.* at 326.
97. *Id.*
98. *Id.* at 327-28.
99. *Id.* at 328.

South Carolina Law Review, Vol. 37, Iss. 4 [1986], Art. 5

to Core because it was a transfer voidable under state law and because Core's claim was properly subordinated to the claims of unsecured creditors. The court noted that "the fact that the defendant was paid does not prevent this Court from subordinating his claim against the bankrupt, and, as a necessary corollary to that subordination, requiring him to return that which he has received."[100]

B. Claims Subordinated

As noted above, one claim in *In re Multiponics, Inc.*[101] prompted the Fifth Circuit Court of Appeals to exercise its power of equitable subordination. Carl Biehl, a director of Multiponics, Inc., claimed that the debtor corporation owed him a total of $1,212,500. Biehl had previously paid two creditors as personal guarantor of Multiponics' debts to them; in return the two creditors assigned their claims against Multiponics to Biehl.[102]

The court distinguished *Multiponics* from *Mobile Steel* and found that the trustee in *Multiponics* had met his burden of overcoming Biehl's facially valid proof of claim by providing substantial material facts pointing to the inequitable nature of Biehl's conduct.[103] The burden, thus, shifted to Biehl to show the fairness and good faith of his transactions with Multiponics.

In applying the first part of the *Mobile Steel* test, the court held that Biehl failed to prove that his conduct was not inequitable. As a director of Multiponics, Biehl authorized and participated in several transactions that involved self-dealing and violated Multiponics' debenture agreement.[104] Further, the court held that Multiponics was severely undercapitalized under both tests set forth in *Mobile Steel*: the testimony of financial experts indicated that the capital structure of Multiponics was insufficient at all relevant times, and Multiponics would not have been able to obtain loans from informed outside sources based on its balance sheet. The majority of its financing was obtained only

100. *Id.* at 327.
101. 622 F.2d 709 (5th Cir. 1980). *See supra* notes 67-75 and accompanying text.
102. *Id.* at 713. These two claims were for $1,000,000 and $212,500.
103. *Id.* at 714-15.
104. *Id.* at 715-16.

through the personal guarantees of its directors.[105]

Biehl, citing the second prong of the *Mobile Steel* test, argued that his conduct did not result in actual injury to Multiponics and that the court should therefore refuse to subordinate his claim. The *Multiponics* court indicated that Biehl had misinterpreted the test and that the crucial issue was injury to the corporation's creditors rather than to the bankrupt corporation itself.[106] By causing a violation of the debenture agreement and acquiescing in an inaccurate valuation of Multiponics' assets, Biehl had damaged both the debenture holders and the lenders. As the court noted,[107] Biehl failed to address the other side of the test—unfair advantage to the claimant.

The *Multiponics* court also determined that, under the third prong of the *Mobile Steel* test, subordination of Biehl's claim would be consistent with the provisions of the Bankruptcy Code. After stressing the equitable nature of bankruptcy proceedings and considering all the facts and circumstances surrounding Biehl's conduct, the court concluded that "where ingenuity spawns unprecedented vagaries of unfairness, we should not decline to recognize their marks, nor hesitate to turn the twilight for Biehl into a new dawn for other creditors."[108]

As noted above, the Fifth Circuit reversed the bankruptcy court's subordination order and the district court in *In re Missionary Baptist Foundation of America, Inc.*[109] Unfortunately for the claimant, remand did not cause the bankruptcy court to look upon him with greater favor; his claim was again subordinated.[110] The court found that Huffman had not himself committed any overt acts of misconduct, but was merely the beneficiary of Wall's actions.[111] This finding, however, was not enough to protect Huffman: "[I]t is clear that Wall dealt with MBFA as his mere instrumentality or *alter ego* . . . [and] that he breached the fiduciary relationship . . . in his self dealing with the debtor and its affiliates."[112] The court also imputed Wall's

105. *Id.* at 718-20.
106. *Id.* at 720-21.
107. *Id.* at 721 n. 11.
108. *Id.* at 722.
109. *See supra* notes 89-94 and accompanying text.
110. 48 Bankr. 885 (Bankr. N.D. Tex. 1985).
111. *Id.* at 888.
112. *Id.* at 889.

inequitable conduct in two transactions to Huffman.[113] The notes MBFA had given to Wall and Huffman were paid without fail, while numerous other creditors received nothing. Thus, the court concluded, the "concept of fair and equitable distribution was violated . . . [and] equitable subordination of the claim is not inconsistent with the provisions of the Bankruptcy Code."[114]

V. Mobile Steel: Beyond the Fifth Circuit

Mobile Steel has been warmly received in other circuits. It has been cited with approval or explicitly adopted by courts in every circuit except the Fourth, which, as of this writing, has no reported decisions on the issue of equitable subordination. More significantly, no court has rejected the essential thrust of the *Mobile Steel* analysis. This section will examine the equitable subordination cases from other circuits, which will again be classified, where appropriate, according to whether or not the court decided to subordinate the claim in question.

A. D.C. Circuit

In 1982 a bankruptcy court subordinated a claim in *Reiner v. Washington Plate Glass Co.*[115] Reiner was the president and sole shareholder of Washington Plate Glass Co. (WPG) from its creation until 1971, when he transferred one-half of his stock to WPG's sales manager. Six years later, in a transaction characterized by the court as "not fraudulent nor in anticipation of bankruptcy,"[116] Reiner sold his remaining interest in WPG to the corporation and received in exchange a note secured by WPG's assets. The company made regular payments on the note until 1980, when WPG defaulted and ceased business operations. WPG filed its voluntary petition for relief under the Bankruptcy Code in 1981.

The court held that WPG's promise to pay Reiner was necessarily conditioned on the company's ability to pay without jeopardizing capital or the interests of other creditors and that

113. The court held that Huffman could be regarded as an insider only in connection with two of the transactions involving Wall. *Id.*

114. *Id.* at 890.

115. 27 Bankr. 550 (D.D.C. 1982).

116. *Id.* at 551.

allowance of Reiner's claim as secured would be "manifestly unfair to the company's general unsecured creditors."[117] The court, therefore, required that Reiner show a benefit to the company from the sale of stock in order to satisfy the *Pepper v. Litton* "inherent fairness" test.[118] Reiner failed to meet his burden.

The court, citing *Multiponics*,[119] *Mobile Steel*, and *In re Westgate-California Corp.*,[120] concluded that enforcement of Reiner's security interest would prejudice other creditors and that "[e]quitable subordination under the circumstances of this case is also consistent with the [1978 Code's] fundamental purpose of preserving the bankrupt's assets for the benefit of creditors."[121]

B. First Circuit

1. Claims Not Subordinated

In 1983 a Massachusetts bankruptcy court reluctantly denied a trustee's request for equitable subordination of an Internal Revenue Service claim in *In re Bellucci*.[122] Bellucci, a former practicing attorney, had misappropriated approximately $500,000 of clients' funds. After those clients placed the debtor in an involuntary Chapter 7 proceeding, the IRS filed its substantial claim for unpaid taxes and interest. When it became apparent that liquidation of the debtor's assets would produce a sum insufficient to satisfy even the tax claim in full, the Chapter 7 trustee applied to the court for subordination of the IRS claim to the claims of the defrauded clients. The bankruptcy court,

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117. *Id.* at 552.

118. 308 U.S. 295 (1939). *See supra* notes 25-27 and accompanying text.

119. *See supra* notes 67-75 and accompanying text.

120. 642 F.2d 1174 (9th Cir. 1981). *See infra* notes 231-37 and accompanying text. The district court arguably misinterpreted *Westgate* since that case made no mention of any requirement that subordination be consistent with the Bankruptcy Code.

121. 27 Bankr. at 552. This language may form a basis for attacking the result in *In re* Dade County Dairies, Inc., 474 F. Supp. 438 (S.D. Fla. 1979). *See supra* notes 63-66 and accompanying text. Arguably, mechanical enforcement of an administrative priority, when it is shown that the claimant has engaged in inequitable conduct to the detriment of creditors or the debtor, violates the fundamental purposes of the Code and, thus, is inconsistent with it. Furthermore, it is hardly conceivable that Congress intended the administrative priority to be a vehicle for the exploitation of creditors and the debtor.

122. 24 Bankr. 493 (Bankr. D. Mass. 1982), *aff'd*, 29 Bankr. 814 (Bankr. App. 1st Cir. 1983).

applying the *Mobile Steel* test, concluded that subordination was not justified. The court determined that since the IRS had not engaged in any inequitable conduct, its claim must enjoy the statutory priority specifically provided by the Bankruptcy Code.[123] The bankruptcy appellate panel, affirming the lower court's holding, described *Mobile Steel* as "controlling law,"[124] but cited no First Circuit decision expressly adopting the test.

2. *Claims Subordinated*

In *In re Formaggio Manufacturing, Inc.*,[125] a Rhode Island bankruptcy court held that an insider's claim should be subordinated. Ralph Grasso, the claimant in that case, had organized the debtor corporation in April 1978. In July of the same year an entry was made in the corporate books to reflect Grasso's indebtedness to the corporation for approximately $74,000. In September 1979,[126] Grasso issued two checks to himself: one for $34,083 for "past-due wages" and one for $15,000 for "past-due rent" on property owned by Grasso and occupied by the corporate operation. Grasso then endorsed the checks back to the corporation. The debtor's books reflected neither obligation, and Grasso conceded that the sole purpose of this "transparent accounting sleight of hand"[127] was to reduce his obligation to the corporation. The court found the transactions voidable as preferential and fraudulent transfers. The court also concluded that all three prongs of the *Mobile Steel* test had been satisfied and subordinated any further claims Grasso might have against the corporation to the claims of unsecured creditors.[128]

In 1985 a Massachusetts bankruptcy court relied on *Mobile Steel* to subordinate a claim in *In re Beverages International Ltd.*[129] The debtor corporation (BIL) was a liquor distributor that was wholly owned by members of the Cicerchia family until

123. *See* 24 Bankr. at 496-97.

124. 29 Bankr. at 815.

125. 23 Bankr. 688 (Bankr. D.R.I. 1982).

126. The checks were issued less than one month prior to filing. The corporate books were adjusted on July 1, 1979. *Id.* at 689.

127. 23 Bankr. at 690. This description is, of course, the court's rather than Grasso's.

128. The court merely recited the *Mobile Steel* test and held, without further discussion, that all necessary factors were present. *Id.* at 692.

129. 50 Bankr. 273 (Bankr. D. Mass. 1985).

April 1982. At that time Richard Gordon, then vice-president and later president of M. H. Gordon & Sons (MHG), purchased one-third of the outstanding stock in BIL. Part of the consideration was an unsecured, interest-free $250,000 loan that Gordon made to the debtor. Gordon reimbursed himself with money from MHG and executed a promissory note to MHG containing the same terms as the note from BIL to him. The agreement also obligated BIL to purchase inventory from MHG. Two weeks after the closing BIL paid MHG $180,000 for inventory that was largely unsellable. MHG later failed to transfer to BIL some of its distribution lines as it had promised to do.[130]

In December 1982 Gordon and his father persuaded the Cicerchias that BIL should purchase Narragansett Sales from the Gordons. The purchase price was $24,000 plus a capital contribution of $28,000 from each of BIL's three shareholders, Gordon and two of the Cicerchias. As part of the purchase, BIL assumed a lease on property owned by an entity controlled by the Gordons and bought computer equipment from Gordon's father for $25,000. In addition to documents relating to the December transactions, BIL also executed a security agreement covering the April loan.[131]

When BIL filed for bankruptcy, MHG asserted a claim for $250,000 against the debtor corporation, based on Gordon's purchase of BIL stock. The court found that the first prong of the *Mobile Steel* test was satisfied because of the following inequitable conduct: MHG's sale of defective inventory to BIL, its failure to transfer distribution lines, the delay between the loan from Gordon and the execution of the security agreement covering the loan, the presentation of the security agreement in the sale of Narragansett and other Gordon assets to the debtor at a time when the debtor was ill-equipped to make the purchase, and the use of BIL's employees at Gordon's facilities while they were being paid by BIL.[132] The court determined that these acts resulted in the depletion of BIL's assets and the enrichment of MHG at BIL's expense. The court also found that MHG's conduct satisfied the second and third prongs of the *Mobile Steel* test: BIL's other creditors had suffered injury, and subordina-

130. *Id.* at 278.
131. *Id.*
132. *Id.* at 283.

tion would not be inconsistent with bankruptcy principles because MHG "would not have had a secured claim in the absence of its affiliation with and domination of the debtor."[133]

In *In re Labelle Industries, Inc.*,[134] a Rhode Island bankruptcy court cited *Mobile Steel* several times in setting aside a creditor's claim as a contribution to capital, but omitted any consideration of the test's third prong—that the subordination be consistent with the Bankruptcy Code. John Hogan was the president and sole shareholder of Comet Dye Works, the creditor. In 1978 Hogan began to liquidate Comet, and his son Michael, who had been an employee of Comet, created the debtor corporation, Labelle, to manufacture waterbeds. Michael owned fifty-five percent of Labelle and was its president; his father and mother owned the other forty-five percent. In 1979 Comet ceased operating as a textile dyeing concern and became involved exclusively in purchasing waterbed manufacturing equipment and leasing it to Labelle. Although the leases contained specific terms for payment and repossession in the event of default, no payments were ever made, and Comet never attempted to repossess the equipment until after the bankruptcy petition was filed.[135]

Upon objections to Comet's motion for relief from the automatic stay, the court found that "[t]he 'leases' were utilized in an attempt to provide assets to their son's business, without the risks normally attendant to insider contributions."[136] Thus, "[T]he transactions 'resulted in injury to the creditors . . . or conferred an unfair advantage on the claimant.' "[137]

C. *Second Circuit*

1. *Claims Not Subordinated*

In *In re Castillo*[138] the bankruptcy trustee attempted to set aside the debtors' conveyance of their residence to the mortgagee. The conveyance was made in lieu of foreclosure. The mort-

133. *Id.* at 284.
134. 44 Bankr. 760 (Bankr. D.R.I. 1984).
135. *Id.* at 761.
136. *Id.* at 762.
137. *Id.* at 763 (quoting *Mobile Steel*, 363 F.2d at 700).
138. 7 Bankr. 135 (Bankr. S.D.N.Y. 1980).

gagee took possession of the property on January 26, 1980, and perfected his interest on April 11, 1980. The debtors then filed a voluntary Chapter 7 petition on July 25, 1980.[139] The New York bankruptcy court dismissed the trustee's complaint for failure to state a cause of action because the conveyance to the noninsider mortgagee occurred more than ninety days prior to the filing of the petition and was, thus, not preferential. The complaint additionally failed to set forth elements necessary to support a claim for fraudulent conveyance. Finally, the trustee failed to allege inequitable conduct by the mortgagee sufficient to satisfy the first prong of the *Mobile Steel* test.[140]

A request for subordination was also denied in *In re Teltronics Services, Inc.*[141] In that case a New York bankruptcy court adopted the *Mobile Steel* test as well as the three guiding principles enumerated in that case.[142] The court divided the parties whose claims might be subordinated into two classes: insiders and noninsiders. The court determined that "[t]he primary distinctions between subordinating the claims of insiders versus those of non-insiders lie in the severity of misconduct required to be shown, and the degree to which the court will scrutinize the claimant's actions toward the debtor or its creditors."[143] The court found that when the claimant is a noninsider, egregious conduct must be proven with particularity.[144]

While a creditor is ordinarily not a fiduciary of the debtor, he may become one if he attempts to interfere in the debtor's

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139. *Id.* at 136.

140. *Id.* at 138. *See also In re* Lion Capital Group, 49 Bankr. 163, 179 (Bankr. S.D.N.Y. 1985)(rejecting subordination because there was no fraud or other inequitable conduct and no unfair advantage).

141. 29 Bankr. 139 (Bankr. E.D.N.Y. 1983).

142. The court stated:

> First, the inequitable conduct of the claimant need not have been related to the acquisition or assertion of his claim . . . . The inequity 'may equally arise out of any unfair act' . . . which affects the bankruptcy results to other creditors . . . . Second, since equitable relief is by its very nature remedial rather than penal, a claim should be equitably subordinated only to the extent necessary to offset the harm suffered by the debtor and its creditors as a result of the inequitable conduct . . . . Finally, the burden of proving all the elements of subordination is on the objectant.

Id. at 168.

143. *Id.* at 169 (citing 4 Bankr. 53 (Bankr. S.D.N.Y.), *aff'd*, 20 Bankr. 186 (S.D.N.Y.), *aff'd*, 699 F.2d 599 (2d Cir. 1983)).

144. 29 Bankr. at 169.

business to an extent not justified by a reasonable desire to protect his interests.[145] The *Teltronics* court, summarizing prior case law on the showing necessary to subordinate a noninsider creditor's claim, stated that "a non-insider 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."[146] *Teltronics*, thus, created three classes of parties whose claims may be subordinated: insiders, creditors with such control over the debtor that they are held to the same standards as insiders, and creditors lacking such control. To persuade the court to subordinate the claims of a creditor without control, the trustee must "prove that the claimant is guilty of gross misconduct tantamount to 'fraud, overreaching or spoliation to the detriment of others.' "[147] If the objectant can establish such behavior, he need not show control by the noninsider.[148]

Applying this analysis to the facts before it, the court first found that the creditor, LMU, had no direct control over the debtor because it owned no stock in the debtor, shared no common officers or directors with the debtor, and had no contractual right to participate in the management of the debtor. Second, the court determined that the following facts were insufficient to establish "undue entanglement with the bankrupt's operations":[149] (1) that the debtor was required to purchase certain quantities of equipment from the creditor and to limit additional outside secured financing to a preset level under the terms of the loan agreements; (2) that the creditor eventually placed

145. *See* Bartlett & Lapatin, *The Status of a Creditor as a 'Controlling Person,'* 28 MERCER L. REV. 639 (1977); Douglas-Hamilton, *Creditor Liabilities Resulting From Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343 (1975). For pre-*Mobile Steel* applications of this principle, see *In re* Prima, 98 F.2d 952 (7th Cir. 1938); *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). *See also In re* W. T. Grant Co., 699 F.2d 599, 610 (2d Cir. 1983)("[A]part from [voidable preferences and fraudulent conveyances] there is generally no objection to a creditor's using his bargaining position, including his ability to refuse to make further loans needed by the debtor, to improve the status of his existing claims."); *In re* American Lumber Co., 5 Bankr. 470 (D. Minn. 1980).

146. 29 Bankr. at 171.

147. *Id.* at 169 (quoting *In re* W. T. Grant Co., 4 Bankr. 53, 75 (Bankr. S.D.N.Y. 1983)).

148. *See id.* at 172.

149. *Id.*

the debtor on C.O.D. payment terms; (3) that the creditor refused to provide additional guaranteed financing; and (4) that the creditor carefully monitored the debtor's financial position and made recommendations regarding future actions by the debtor.[150] Finally, the court held that the creditor did not engage in sufficiently egregious conduct to warrant subordination of its claim. Specifically, the court found that a document the trustee described as "a blueprint for LMU's takeover scheme" was largely an exploration of "alternative courses of action in the event of a default."[151] The court also applied this benign description to the creditor's proposal to compete against the debtor in the debtor's marketing area because the creditor deliberately avoided soliciting the debtor's former employees or customers. The court found no evidence that the creditor had fraudulently induced the debtor to take certain actions by promising to make a loan and expressed doubt that this had in fact occurred:

> [S]ince the alleged sanctions employed by LMU . . . are more directly attributable to Teltronics' large trade account balance, . . . it appears that LMU's equity negotiations were not the cause of damage sustained by Teltronics' other creditors. Accordingly, pursuant to the *Mobile Steel* test, the alleged inequitable conduct is an insufficient predicate for invoking the harsh remedy of equitable subordination.[152]

In *In re Roamer Linen Supply, Inc.*,[153] a New York bankruptcy court rebuffed the efforts of two debtors-in-possession to subordinate the secured claims by the IRS and a bank to administrative bankruptcy expenses. The claimed expenses were composed largely of past and projected legal fees owed to the debtors' attorney. The debtors argued that the IRS and the bank should have sought a foreclosure or objected to the particular sale of the assets involved, but the court summarily rejected this contention:

> Having successfully sought the authority to continue to use Bank Leumi's cash collateral in order to be in a position to

150. *Id.*
151. *Id.* at 173.
152. *Id.* at 174.
153. 30 Bankr. 932 (Bankr. S.D.N.Y. 1983).

structure a negotiated sale of assets, the debtors can not now be heard to argue that Bank Leumi and the IRS should be subordinated to all of the administration expenses in this case, including the debtors' attorneys' fees because these secured claimholders did not sufficiently resist the debtors' sale strategy. Neither Bank Leumi nor the IRS ever engaged in any inequitable conduct in this case so as to trigger the equitable subordination doctrine set forth in Code section 510(c)(1).[154]

2. *Claims Subordinated*

In *In re Lockwood*,[155] a New York bankruptcy court relied heavily on *In re Westgate-California Corp.*[156] to subordinate the claim of a judgment creditor who had filed a motion for relief from the automatic stay. The plaintiff claimant had obtained a default judgment against the debtors in state court after the defendant debtors answer was stricken for failure to comply with a discovery order. The bankruptcy court, however, found that the default resulted from the "gross incompetence" of the debtors' attorney, who had received the requested papers from the debtor defendants, but had failed to deliver them to the plaintiff. The bankruptcy court held that the doctrines of res judicata and collateral estoppel are inapplicable "where equitable principles require reexamination . . . of a claim that has been reduced to judgment."[157] The court further explained that "a judgment offered as a claim against the estate could be collaterally attacked 'for the purpose of showing that it was obtained by collusion . . . *or is founded upon no real debt.*' "[158]

Upon examination, the court determined that the plaintiff's claim was meritless because the debt owed the plaintiff was a debt of a corporation wholly owned by one of the debtors and the debtors had not personally guaranteed the debt. Thus, the court reasoned, the plaintiff's claim, if any, was solely against the corporation and not against the individuals in bankruptcy.[159]

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154. *Id.* at 937.
155. 14 Bankr. 374 (Bankr. E.D.N.Y. 1981).
156. 642 F.2d 1174 (9th Cir. 1981). *See infra* notes 231-37 and accompanying text.
157. 14 Bankr. at 378.
158. *Id.* (quoting Margolis v. Nazareth Fair Grounds & Farmers Market, 249 F.2d 221, 223-24 (2d Cir. 1957))(emphasis added by court).
159. 14 Bankr. at 380.

Furthermore, the trustee, not the debtor, was seeking to subordinate the plaintiff's claim, and the trustee, not being a party to the disputed judgment, had not had an opportunity to litigate the merits of the claim.[160] The court found that the plaintiff had engaged in conduct injurious to the debtors' other creditors by obtaining a judgment when it had no claim against the debtor: "Through its misconduct, the Plaintiff has obtained a judgment lien giving it a secured position against the real property of the debtors, an asset that would otherwise be available to satisfy the claims of other [true] creditors."[161] Therefore, the court subordinated the plaintiff's claim.

Lockwood is noteworthy in two respects. First, it cited *Mobile Steel*'s three-pronged test, but never applied the third prong.[162] Second, and more significantly, unless the creditor's conduct in *Lockwood* can be described as egregious, the continuing validity of this case is questionable in view of the Second Circuit's decision in *Teltronics*,[163] which was issued two years later by the same bankruptcy court that decided *Lockwood*.

In re McFarlin's, Inc.[164] involved a claim based on a lease executed between the debtor and a partnership composed of three of the debtor's four officers. In 1981 the officers of McFarlin's, a clothing retailer, decided to open a new store, and the chosen location required about $75,000 of improvements. When the bank refused financing, three of the four officers formed a partnership, F.G. & G., and obtained the loan through the partnership by making personal guaranties. F.G. & G. used the loan's proceeds to purchase the necessary improvements, and then leased the improvements to McFarlin's under a five-year lease at $3,000 per month.[165] The net result of this arrangement was that McFarlin's was obligated to pay $180,000 for improvements that it could have purchased for $120,000 if the officers had personally guaranteed a loan to the corporation. In addition,

160. *Id.* at 381.

161. *Id.*

162. Several other Second Circuit decisions have also cited *Mobile Steel* and ignored the third prong of the test. *See In re* Colin, 44 Bankr. 806 (Bankr. S.D.N.Y. 1984); *In re* Micro-Acoustics Corp., 34 Bankr. 279 (Bankr. S.D.N.Y. 1983); *In re* Featherworks Corp., 25 Bankr. 634 (Bankr. E.D.N.Y. 1982).

163. *See supra* notes 141-52 and accompanying text.

164. 49 Bankr. 550 (Bankr. W.D.N.Y. 1985).

165. *Id.* at 552-53.

at the end of the five-year lease period McFarlin's would have had no equity in the improvements and no option to purchase them. The three partners, however, would have made a $60,000 profit at McFarlin's expense. The partners also testified that at the expiration of the five-year period they intended to renew the lease, thus reaping still more profits at the debtor's expense.[166]

The New York bankruptcy court, applying the *Mobile Steel* test, found the lease arrangement "inequitable," "outrageous," and "unconscionable"[167] and subordinated all F.G. & G.'s claims. The court also found damage to the debtor because, even if F.G. & G. would have transferred title to the improvements at the end of the lease's term, the effective annual interest rate of this "loan" would have been 42.36%. In addition, the court concluded that the arrangement had harmed the debtor's other creditors because even though McFarlin's accumulated over $950,000 in prepetition debt, it faithfully paid rent under the lease up to the day it filed its Chapter 11 petition.[168]

The court also subordinated F.G. & G.'s claim for rent due to the real property lessor, who had assigned his administrative rent claim to F.G. & G. Contrary to *Dade County Dairies*,[169] the court had no difficulty in deciding that the claim's status as an administrative expense did not bar its subordination:

> Where insiders have injured the debtor, preferred themselves over the other creditors, and created an unfair bargain, the principles of fairness would be violated if the insiders' claim was allowed to share equally with the other creditors . . . [T]here does not appear to be any inconsistency with the Code in subordinating F.G. & G.'s claims.[170]

In *In re Tampa Chain Co.*,[171] a New York bankruptcy court analogized equitable subordination to piercing the corporate veil. The trustee in that case sought a marshaling order requiring a secured creditor to proceed first against the guarantors and their supporting co-op before proceeding against the debtor estate. He was opposed by both the secured creditor and the

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166. *Id.* at 554-55.
167. *Id.* at 555.
168. *Id.* at 552.
169. *See supra* notes 63-66 and accompanying text, note 121.
170. 49 Bankr. at 555-56.
171. 53 Bankr. 772 (Bankr. S.D.N.Y. 1985).

shareholder-guarantors of the debt. The court first noted that marshaling traditionally required ownership of assets by a common debtor and that "[o]rdinarily this requirement is not met where the two funds sought to be marshaled are held separately by a corporation and its shareholder."[172] The court found, however, that marshaling is appropriate in cases of inequitable conduct by insiders:

> Finding a common debtor has the effect of first liquidating the collateral posted by the corporate principals and requiring them to share equally with or be subordinated to other creditors upon subrogation. . . . Here, the elements of inequitable conduct and fraud justifying disregard of the corporate veil or requiring equitable subordination are clearly present. While corporate formalities and records are evidenced, they show continuous use of Tampa Chain as a personal piggy bank from which the Reichards withdrew much of Tampa's initial capitalization, replenished it through depositing Wolf Reichard's own funds, and from which he transferred some $770,000.00 in inventory to another family owned company on hardly commercial terms. This is hardly a case of business acumen. It is a case of abuse of corporate funds.[173]

Thus, the court would apparently subordinate any subrogated claim of the debtor's principals arising from the marshaling procedure, if consistent with the *Mobile Steel* guidelines.

D. *Third Circuit*

1. *Claims Not Subordinated*

Courts in the Third Circuit have applied *Mobile Steel* on three occasions. In *In re Omega Lithographers, Inc.*,[174] a Pennsylvania bankruptcy court refused to subordinate a claim based on a loan to the bankrupt by its director and sole shareholder. The court first stated that a claim would not be subordinated solely because its holder, as a director or officer, made a loan to the corporation. Such a per se subordination "would discourage those most interested in the corporation from attempting to sal-

172. *Id.* at 778.
173. *Id.* at 779.
174. 17 Bankr. 753 (Bankr. M.D. Pa. 1982).

vage it through the infusion of capital."[175] The burden was, thus, on the movant creditor to justify subordination, and the creditor showed neither injury to the debtor or the creditor nor an unfair advantage to the claimant.

A more significant case was *In re Ludwig Honold Manufacturing Co.*,[176] in which a district court adopted both the *Mobile Steel* test and the *Teltronics* application of that test to noninsider creditors.[177] The adoption of *Teltronics*, however, may be characterized as dicta since the court ultimately concluded that "under either the fiduciary or non-fiduciary standard the [claimant has not] engaged in [any] inequitable conduct sufficient to warrant subordination."[178] The court found the following factors insufficient to warrant subordination: that the creditor claimant monitored the debtor's financial condition on an almost daily basis, that the creditor made various suggestions to the debtor about its business operations, that the creditor threatened to declare the loan in default when the debtor failed to effect remedial business measures, and that the debtor's sole shareholder often used the debtor's assets to satisfy the debt because he had personally guaranteed the loan. The court noted that "[n]otwithstanding the close watch by [the creditor bank] and its suggestions to the debtor about its business operations, [the bank] did not overbear the will of the debtor or become its alter ego."[179]

2. *Claims Subordinated*

A bankruptcy court did subordinate a creditor's claim for insider misfeasance in *In re Americana Apparel, Inc.*[180] In that case the debtor corporation executed a preincorporation agreement stipulating that it would enter into a consultation agreement with Charles Gordon & Sons, Inc., the claimant in the

175. *Id.* at 754 (citing *Mobile Steel*, 563 F.2d at 701). The court's infelicitous use of the expression "infusion of capital," which is also found in *Mobile Steel*, should be avoided. The movant creditor might have been suprised to find out that an "infusion of capital" is not necessarily a "capital contribution."

176. 46 Bankr. 125 (Bankr. E.D. Pa. 1985).

177. *See supra* notes 141-52 and accompanying text.

178. 46 Bankr. at 129.

179. *Id.* at 127.

180. 55 Bankr. 160 (Bankr. E.D. Pa. 1985).

bankruptcy proceeding. The same three individuals were officers of both corporations, a situation the court characterized as "tantamount to hiring oneself as a consultant."[181] Further, the preincorporation agreement provided that the postincorporation consultation contract would entitle Charles Gordon & Sons to a fee of 3.5% of the debtor's gross receipts. No written contract was ever executed, none of the participants could remember the terms of any oral contract, and no evidence indicated that any consultation services were ever provided to the debtor *qua* corporation. In addition, the liability for "services" was never reflected on any financial statement of the debtor, the claimant never recorded the receivable amounts in its books, and the debt was never included in the debtor's schedules, disclosure statement, or proposed plan. In fact, the debt came to light only when the claimant filed its proof of claim approximately two years after the debtor filed its Chapter 11 petition. Under these circumstances, the court had no difficulty determining that the claim should be subordinated.[182]

E. Sixth Circuit

1. Claims Not Subordinated

Despite the clear statement in *Mobile Steel* and numerous other cases that neither a claimant's position of dominance nor its insider status alone constitutes a sufficient ground for equitable subordination, trustees and creditors seem unable to resist the temptation to seek the remedy on these bases. This was the case in *In re All Products Co.*,[183] which apparently was the first decision in the Sixth Circuit to adopt explicitly the *Mobile Steel* test. The bankruptcy court, however, denied the creditors' motion to subordinate for failure to demonstrate that the claimant, the debtor's parent corporation, had engaged in any inequitable conduct.[184]

181. *Id.* at 163.

182. This court also cited all three prongs of the *Mobile Steel* test, but failed to discuss the third prong. *See supra* note 162 and accompanying text.

183. 32 Bankr. 811 (Bankr. E.D. Mich. 1983).

184. *Id.* at 816.

2. *Claims Subordinated*

A more complex set of facts led to subordination of a secured claim in *In re Pat Freeman, Inc.*[185] Two men, DeWitt and Freeman, were the debtor's original shareholders. In 1980 plaintiff Loudin contracted with DeWitt and Freeman as individuals to sell them his restaurant and the real estate on which it stood. Although the purchase agreement required the buyers to execute a financing statement and deliver it to the escrow agent, the buyers failed to comply with this term. As a result, Loudin never obtained a perfected security interest in the restaurant property. The bill of sale transferred the restaurant's personal property to three buyers: DeWitt, Freeman, and the debtor. In April 1981 DeWitt sold his interest to Freeman in exchange for, among other things, a note secured by a financing statement covering the debtor's personal property. This property consisted largely of the trade fixtures obtained from Loudin. DeWitt also assigned his interest in the land contract to Freeman, in violation of a provision in the contract. The dispute came before the court when the trustee proposed a sale of the trade fixtures, in which both DeWitt and Loudin claimed security interests.[186]

The court first held that Loudin's claim was unsecured[187] and then turned to the question of subordination. After referring to the *Mobile Steel* test, the court rejected DeWitt's argument that equitable subordination applies only against claimants with fiduciary duties: "The mere absence of a fiduciary, standing alone, does not preclude application of the doctrine of equitable subordination."[188] The court then subordinated the claim:

> It was clearly inequitable for DeWitt, given his contractual duty to execute and deliver a financing statement on behalf of Loudin, to gain secured status by filing his own statement. The Court notes that if DeWitt had met his contractual obligations in full, his secured claim would be secondary to Loudin's claim. By contriving to obtain first priority on the collateral, DeWitt was unfairly advantaged and this Court cannot countenance

185. 42 Bankr. 224 (Bankr. S.D. Ohio 1984).
186. *Id.* at 227.
187. *Id.* at 229.
188. *Id.* at 231.

such misconduct as a court of equity.[189]

Having found that the first two parts of the test were met, the court then apparently placed on DeWitt the burden of proving inconsistency with the Bankruptcy Code.[190] It does not appear from the opinion that DeWitt cited *Teltronics*[191] or its progeny to argue that a nonfiduciary must be guilty of particularly egregious conduct before a court is justified in subordinating his claim. In fact, nothing in the opinion even hints at a different standard for nonfiduciaries.

F. Seventh Circuit

1. Claims Not Subordinated

In *In re Wilnor Drilling, Inc.*,[192] an Illinois district court reversed a bankruptcy court's order subordinating the expenses and fees of the Official Investors' Committee to those of the Official Creditors' Committee.[193] The bankruptcy court had apparently ordered the fees and expenses of the Investors' Committee equitably subordinated to those of the Creditors' Committee because the Investors' Committee was discretionary, while the Creditors' Committee was statutorily mandated.[194]

The district court found this distinction irrelevant and held that subordination would not be allowed unless the facts satisfied all three prongs of the *Mobile Steel* test:

> The Investors' Committee claim to reasonable fees and expenses is not fraudulently represented through bad faith or inequitable conduct. Similarly, the Investors' Committee did not engage in any conduct which caused harm or injury to the

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189. *Id.*

190. "DeWitt has not shown the Court how application of this doctrine of equitable subordination in this case would be inconsistent with any other provision of the Code." *Id.*

191. *See supra* notes 141-52 and accompanying text.

192. 29 Bankr. 727 (S.D. Ill. 1982).

193. The Creditors' Committee was formed pursuant to the mandate of 11 U.S.C. § 1102(a)(1) (1982). The court created the Investors' Committee upon motion of the S.E.C. pursuant to 11 U.S.C. 1102(a)(2) (1982), which provides: "On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders."

194. 29 Bankr. at 731.

debtors or other creditors, rendering to them an unfair advantage. Finally, the Bankruptcy Code does not contain any express or implicit authority to subordinate the fees and expenses of a mandatory committee to the fees and expenses of a discretionary committee. In fact, the Bankruptcy Code does not differentiate between the two types of committees in any respect. Thus, the Bankruptcy Court had no authority to subordinate the Investors' Committee's fees and expenses.[195]

The *Wilnor* opinion is notable for its attempt to apply the third prong of the *Mobile Steel* test—consistency with the provisions of the Bankruptcy Code. As noted elsewhere, many courts purporting to apply the *Mobile Steel* test have ignored this requirement altogether. It is possible, however, that the district court would have subordinated the claim for fees and expenses if the Investors' Committee had engaged in inequitable conduct that caused harm to the debtor or other creditors.

In re Osborne,[196] a Wisconsin opinion, provides a useful synthesis of *Teltronics*[197] and *Mobile Steel*. The *Osborne* court, considering an application for subordination of an insider's claim, stated: "[O]nce an objectant . . . supports allegations of impropriety with a substantial factual showing, the burden shifts to the insider creditor to prove the good faith and inherent fairness of its actions."[198] In contrast, the court asserted that if the creditor is not an insider, the burden remains on the objectant throughout the proceedings.[199] The court noted that while subordination generally requires that noninsiders be guilty of some egregiously wrongful conduct,[200] "the distinction between 'inequitable conduct' and 'gross misconduct' (possibly involving 'moral turpitude') would seem to be a difficult one to draw in practice. There are few cases in which the gross misconduct standard has actually been applied."[201] Finally, the court

195. *Id.* at 730-31. *See* 11 U.S.C. § 703 (1982).
196. 42 Bankr. 988 (W.D. Wis. 1984).
197. *See supra* notes 141-52 and accompanying text.
198. 42 Bankr. at 996 (citing *Mobile Steel*, 563 F.2d at 701-02).
199. *Id.* (citing *Teltronics*, 29 Bankr. at 169).
200. "The degree of misconduct . . . has been variously described as very substantial misconduct involving 'moral turpitude' or some breach of duty or some misrepresentation whereby other creditors were deceived *to their damage* or as gross misconduct amounting to fraud, overreaching, or spoliation." *Id.* (citations omitted).
201. *Id.*

observed that if a creditor both possessed *and* exerted sufficient control over the debtor, to the detriment of other creditors, he would be treated as an insider. This control, however, must be "virtually complete."[202]

In *Osborne* the bankruptcy judge had found that PCA, the claimant, had a relationship with the Osbornes that " 'approach[ed] the status of a joint venture' and that the three creditor applicants 'looked to PCA for payment of Osborne's accounts.' "[203] In addition, after August 1981, when the loan was renewed and increased, PCA controlled the loan[204] and, on at least one occasion, told the Osbornes how the funds were to be spent. The district court concluded: "Undoubtedly . . ., [the claimant] had considerable power over the Osbornes. But the record contains no more than isolated examples of the exercise of that power."[205] Thus, the court required that a creditor show gross misconduct by the claimant before ordering a claim subordinated. The court found PCA guilty of no such misfeasance toward two of the creditor applicants and declined to subordinate PCA's claim to theirs. PCA's requests for the bank to "go along" with the Osbornes and the claimant's prepetition promise to another creditor to "see to it" that the Osbornes' accounts were paid regularly were held insufficient to establish a guarantee on which the other creditors relied to their detriment.[206]

2. *Claims Subordinated*

In *In re Osborne*,[207] the court did order that the claim be subordinated to that of a third creditor, General Feeds, Inc. PCA induced General to continue delivering feed to the debtor through "equivocation and outright misrepresentations concerning forthcoming payment."[208] Citing a Tennessee bankruptcy de-

202. *Id.* at 997. *See also Teltronics*, 29 Bankr. at 170-71 (*supra* notes 141-52 and accompanying text); *Mercer Trucking*, 16 Bankr. at 189-90 (*supra* notes 82-88 and accompanying text); *In re* American Lumber, 5 Bankr. 470, 478 (D. Minn. 1980)(*infra* notes 215-19 and accompanying text).

203. 42 Bankr. at 997 (quoting the bankruptcy judge).

204. *Id.* at 990. "A controlled loan is a loan limited to specific items." *Id.*

205. *Id.* at 997.

206. *Id.* at 998-99.

207. 42 Bankr. 988 (W.D. Wis. 1984).

208. *Id.* at 999.

cision,[209] the court held that "misrepresentation whereby other creditors were deceived to their damage" satisfied the "gross misconduct" standard.[210]

In *In re Loop Hospital Partnership*,[211] another Illinois bankruptcy court also ordered a creditor's claim subordinated. The dispute concerned the priority of the claim by the law firm of Joyce and Kubasiak (J&K) to whom the debtor had assigned a beneficial interest in a land trust. Two banks also claimed an interest under an identical assignment executed the day after J&K's. J&K had represented the debtor during the negotiations for the assignment to the banks. The court avoided deciding the issue of priority under the U.C.C. and held that the Bankruptcy Code justified subordination of J&K's assignment regardless of its status under state law.[212] The court found that J&K had engaged in "inequitable conduct at best" by participating in the debtor's negotiations with the banks and by accepting the assignment despite knowledge that the debtor would represent to the banks that no assignments had been made.[213] The court also found obvious harm to the banks and no inconsistency with the Bankruptcy Code. The decision neither discussed whether J&K was an insider of the debtor nor delineated the standard of behavior to which J&K was held.

G. *Eighth Circuit*

1. *Claims Not Subordinated*

Several cases arising in the Eighth Circuit have expressed a view shared by other courts and noted above: an objectant cannot obtain subordination of a claim simply by relying on a credi-

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209. *In re* Just for the Fun of It of Tenn., Inc., 7 Bankr. 166, 180 (Bankr. E.D. Tenn. 1980)(general contractor's claim subordinated because he filed a "false, misleading and invalid notice of completion" on which other creditors relied in extending funds to the debtor).

210. 42 Bankr. at 1000. The court also followed *Mobile Steel* in limiting subordination "to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct." *Id.* (citing *Mobile Steel*, 563 F.2d at 701).

211. 50 Bankr. 565 (Bankr. N.D. Ill. 1985).

212. *Id.* at 570. The court strongly suggested, however, that Illinois precedent would mandate priority for J&K's assignment. *Id.*

213. *Id.* at 569.

tor's relationship to the debtor. Although insider status and control of the debtor may influence the nature and extent of inequitable conduct that must be shown, they cannot replace inequitable conduct as the basis for ordering subordination of a claim.[214]

2. *Claims Subordinated*

In re American Lumber Co.[215] is one of the few cases in which an outside creditor was found to have exercised sufficient control over the debtor to be treated as an insider. The debtor began operations in January 1975 by purchasing all the assets of the old American Lumber Company with a $2.5 million loan from the First National Bank of St. Paul (the Bank). The Bank lent one million dollars to the Employees Stock Ownership Trust (ESOT) of new American Lumber Co. (ALC), and ESOT contributed the money to ALC in exchange for 92% of ALC's outstanding shares. ESOT, in turn, pledged the shares to the Bank as security for its loan. The Bank also made two additional loans: one to ALC's officers, which they used to purchase the remaining 8% of the corporation's shares, and one directly to ALC. These two loans were secured by a pledge of all the ALC stock, accounts, and contract rights and by a second mortgage on real estate. Of the $2.5 million ALC had paid to old ALC, $2.4 million was used to satisfy old ALC's debts to the Bank. ALC began losing money after only a few months of operation and by September 19, 1975, had to borrow an additional $100,000 from the Bank for operations.[216]

Less than a month later ESOT and ALC were in default. The Bank began dishonoring ALC's checks and requested a security interest in equipment and inventory, but was refused. At that time ALC owed approximately $400,000 in unsecured debt. On October 23, 1975, the Bank told ALC that no further advances would be made, that ALC was considered in default, and that all funds in the Bank's custody were being used to offset

214. *See In re* Bird Eng'g, Inc., 47 Bankr. 193 (Bankr. D. Nebr. 1985); *In re* Antoine's Indus., Inc., 49 Bankr. 82 (Bankr. W.D. Mo. 1984); *In re* De Feo Fruit Co., 24 Bankr. 220 (Bankr. W.D. Mo. 1982).

215. 5 Bankr. 470 (D. Minn. 1980). This case was decided under the 1898 Bankruptcy Act.

216. *Id.* at 472-73.

ALC's obligations. The following day ALC granted the security interest in inventory and equipment.[217]

The Bank assumed effective control of ALC immediately afterward. It received and opened all ALC's incoming mail, deposited all amounts received by ALC in an account controlled solely by the Bank, fired ALC's employees, hired a security service to guard ALC's premises, honored checks presented by ALC payees only to the extent that such payment would enhance the value of an ALC asset in which the Bank had a perfected security interest, rehired a "skeleton crew" to aid in liquidating ALC, and advanced funds necessary to complete those projects in which failure to pay would lessen the value of ALC's accounts receivable. In addition, the Bank twice reassured third parties that ALC was not insolvent and that liquidation would be orderly, intimating that something would be salvaged for the unsecured creditors. Less than a month after taking control of the debtor, the Bank gave notice of foreclosure of its security interest and then sold the inventory and equipment, keeping all proceeds.[218]

The foreclosure of the security interest in inventory and equipment and the Bank's retention of the proceeds destroyed the unsecured creditors' only possibility of payment. The court found that this course of conduct was both inequitable and injurious and concluded that subordination was justified:

> Subordination of the Bank's claim is not inconsistent with the provisions of the Bankruptcy Act. Indeed, failure to subordinate in this case would be contrary to its goal. While defendant argues that subordination will cause members of the financial community to feel that they cannot give financial assistance to failing companies, but must instead foreclose on their security interests and collect debts swiftly, not leaving any chance for survival, the Court is singularly unimpressed.
>
> What the Bank did was not an attempt to save ALC from failure, or even to legitimately cover its own losses. It sought to perpetuate a fraud upon the general unsecured creditors of ALC. This kind of conduct cannot be allowed to prevail.[219]

Another bank's claim was subordinated in *In re Sepco*,[220]

217. *Id.* at 473-74.
218. *Id.* at 474.
219. *Id.* at 478-79.
220. 36 Bankr. 279 (Bankr. D.S.D.), *aff'd*, 758 F.2d 51 (8th Cir. 1984).

this time because the bank had prepared a document called an "Offer of Sale." "Buried in the middle of the so-called 'Offer of Sale' "[221] was a lien subordination clause that made the bank's security interest superior to an existing mechanic's lien. The South Dakota bankruptcy court held that the bank had procured the subordination agreement by fraud, that the bank was equitably estopped from enforcing the agreement against the mechanic's lienholder, that there was a total failure of consideration, and that the bank would be unjustly enriched if the agreement were enforced. For these reasons, the court subordinated the bank's claim to that of the mechanic's lienholder.

The *Sepco* court did not discuss the significance of the bank's status as a noncontrolling noninsider. Admittedly, this fact was of little practical significance because the bank's conduct satisfied the standards set forth in *Teltronics*[222] (fraud and overreaching) and in *Osborne* (misrepresentation).[223] Unfortunately, the decision did little to clear the theoretical haze surrounding this subject. The *Sepco* court also followed *Mobile Steel*'s allocation of proof and extended its application to noncontrolling noninsiders, implicitly rejecting the *Osborne* holding.[224] Finally, the *Sepco* opinion adopted the view that "inequitable conduct . . . need not be related to the acquisition or assertion of the controverted claim as long as it is directed toward the bankrupt or its creditors."[225]

In *In re Answerfone, Inc.*,[226] a bankruptcy court once again considered a case of alleged insider misconduct. Answerfone was an Arkansas corporation that was apparently in sound financial condition through 1982. In early 1983 Joe Limerick arranged to purchase Answerfone from its owners through a shell corporation owned and operated by Limerick's personal secretary, W. N. Thompson. Thompson and Limerick personally guaranteed the secured note covering the purchase price. Immediately after the sale the shell corporation, Answerfone, and Thompson, individually, executed a note for almost $800,000 plus interest, paya-

221. *Id.* at 282.

222. *See supra* notes 141-52 and accompanying text.

223. *See supra* notes 196-210 and accompanying text.

224. *Sepco* did not refer to *Osborne* and, on this point, seems irreconcilable with that case. *See supra* notes 199-205 and accompanying text.

225. 36 Bankr. at 287.

226. 48 Bankr. 24 (Bankr. E.D. Ark. 1985).

ble to Joe Limerick. The note was allegedly in consideration for "consulting services" and obligated the makers to pay in excess of $5,000,000 over a seventy-year period. The note was secured by a lien on all outstanding stock in both corporations and by all of Answerfone's assets. Afterward Limerick and Thompson began to siphon off Answerfone's assets and removed over $200,000 within six months, while Answerfone's creditors went unpaid.[227]

The court held that Limerick's claim was patently fraudulent and that he was an insider because he owned or controlled all the debtor's stock. Applying the tripartite *Mobile Steel* test, the court subordinated Limerick's claim to all other claims except those for interest.[228]

The court also subordinated the seller's claims, noting that payments of $150,000 toward the purchase price had come wholly from Answerfone's assets. Although Limerick and Thompson had personally guaranteed the note,[229] the practical result was that the corporation was paying for its own stock, while legitimate creditors went unpaid. The seller's claim was subordinated to the claims of all creditors except Joe Limerick.[230]

H. Ninth Circuit

1. Claims Not Subordinated

In re Westgate-California Corp.[231] is one of the most frequently cited post-*Mobile Steel* cases. Although courts have repeatedly stated or implied that *Westgate* adopted the *Mobile Steel* test,[232] the *Westgate* court relied primarily on *In re Ahlswede*.[233] The court cited *Mobile Steel* solely for the proposition that subordination ought not to be imposed as a penalty[234] and

227. *Id.* at 25-26.

228. *Id.* at 26-29.

229. *Id.* at 31.

230. The court came as close as it probably could to telling the trustee of its favorable inclination toward motions to set aside both claims entirely. *See id.* at 29, 30.

231. 642 F.2d 1174 (9th Cir. 1981).

232. *See, e.g., Washington Plate Glass* (*supra* notes 115-21 and accompanying text); *Answerfone* (*supra* notes 226-30 and accompanying text); *Lockwood* (*supra* notes 155-63 and accompanying text).

233. 516 F.2d 784 (9th Cir. 1975).

234. 642 F.2d at 1178.

on that basis refused to subordinate claims made by the wife of the man who had controlled the debtor. Although the wife had committed numerous wrongs, these had been remedied through litigation and, as a result, the court concluded that "subordination of all of appellant's claims at this point would be primarily punitive and not consistent with equitable principles."[235] The dissent, observing that the majority had admitted that the claimant's fraud had damaged the debtor, argued that "[t]his was not a single act of inequitable conduct but wrongdoing so pervasive and so damaging to the bankrupt that no court governed by equitable principles should permit appellant to share in the assets of [the debtor] on a parity with other creditors and stockholders."[236]

The *Westgate* decision is somewhat troubling. The opinion does not clearly state whether all the harm inflicted by the claimant was remedied by the litigation's outcome. Surely a court should place the burden of proving this issue on the person found guilty of "conversion, fraud, breach of fiduciary duty and falsification of records,"[237] and any doubts should be resolved against the guilty claimant. In this case the claimant forced the debtor to go to a magistrate, the district court, and the court of appeals before she made good the damage she had inflicted. The process took six years and must have imposed a considerable burden on the debtor. Yet the court apparently did not consider these wrongs in its equation.

One other Ninth Circuit case cited the *Mobile Steel* test. In *In re Delta Smelting & Refining Alaska, Inc.*,[238] an Alaska bankruptcy court referred to the decision in a footnote,[239] but seems not to have applied its test.

I. Tenth Circuit

Although one Tenth Circuit opinion cited *Mobile Steel*,[240] as of this writing no cases from that circuit appear to have ap-

235. *Id.* at 1179.
236. *Id.* (Solomon, J., dissenting).
237. *Id.* at 1176.
238. 53 Bankr. 877 (Bankr. D. Alaska 1985).
239. *Id.* at 886 n. 9.
240. Long Island Lighting Co. v. Bokum Resources Corp., 40 Bankr. 274, 296 (Bankr. D.N.M. 1983).

plied the three-part test.

J. Eleventh Circuit

1. Claims Not Subordinated

In *In re Pancho's International, Inc.*,[241] a Florida bankruptcy court refused to subordinate an insider's claim on the basis of undercapitalization. The court held that, even assuming that the debtor *was* undercapitalized, the movant would have to show inequitable conduct by the insider. The court also asserted that "[w]ith the adoption of . . . Section 510(c), it is clear that [the third prong] of the [*Mobile Steel*] test will rarely, if ever, come into play."[242]

A Georgia bankruptcy court rejected a similar undercapitalization argument in *In re N & D Properties, Inc.*[243] The court also distinguished that case from *In re Carolee's Combine, Inc.*[244] and refused to find that a bona fide assignment of a security interest to the claimant, a 45% owner of the debtor, created a secret lien.[245] Finally, the court found no instances of inequitable conduct or self-dealing and expressed a determination to protect minority shareholders who are unfamiliar with a corporation's financial condition:

> Mrs. Estes' position and conduct in light of the controlling law is not the only factor which convinces this court that equitable subordination of her claim would be inappropriate. Such a holding would only serve to punish those who are not informed lenders to corporations run by friends and family.[246]

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241. 26 Bankr. 5 (Bankr. M.D. Fla. 1982).

242. *Id.* at 9.

243. 54 Bankr. 590 (N.D. Ga. 1985). The court also relied on the fact that the claimant was a minority shareholder who had neither direct nor indirect control of the corporation, *id.* at 603, and who, therefore, had no duty to determine the financial state of the debtor before agreeing to pledge or guarantee loans. The court's decision may have been influenced by its opinion of the trustee's method and manner of proceeding against the claimant. *See* 54 Bankr. at 600 n. 4, 605 n. 9.

244. 3 Bankr. 324 (Bankr. N.D. Ga. 1980). *See supra* notes 95-100 and accompanying text.

245. 54 Bankr. at 599.

246. *Id.* at 604.

2. *Claims Subordinated*

In 1982 the United States Bankruptcy Court for the Northern District of Georgia decided *In re Greenbrook Carpet Co.*[247] In that case the same officers controlled both a parent and a subsidiary corporation. The parent corporation, J.E.G., received certain payments from its subsidiary, Greenbrook, within the preference period preceding the filing of an involuntary bankruptcy petition against Greenbrook. J.E.G. transferred close to $74,000 of these funds to Calhoun First National Bank (CFNB) to pay off part of a loan. Greenbrook's trustee in bankruptcy was able to recover the payments from CFNB because CFNB had knowledge of Greenbrook's insolvency and was aware of J.E.G.'s dependency on funds received from Greenbrook. Thus, CFNB was not a good faith transferee of the preferential payments received by J.E.G.

A month after an order for relief was filed against Greenbrook, J.E.G. received and retained a tax refund check for business losses sustained in the prior year. Without the trustee's knowledge J.E.G. applied $1,700 of the refund due Greenbrook to its own claim against Greenbrook's trustee for administrative rent. The balance of the refund due Greenbrook was subsequently placed in a joint certificate of deposit in the names of Greenbrook's trustee and J.E.G.'s attorney.[248]

Greenbrook's trustee argued that J.E.G.'s claim for administrative rent should be subordinated to other creditors' claims because of J.E.G.'s inequitable conduct—the transfer of preferential payments to CFNB and the disposition of the tax refund. The court subordinated J.E.G.'s claim, but did not rely on the common corporate control of the debtor and J.E.G. Instead, the court followed the *Mobile Steel* test and focused on the injury to other creditors resulting from the corporate officers' inequitable conduct. Those officers not only appropriated Greenbrook's tax refund check, but also attempted to use funds received from Greenbrook to avoid personal liability on the CFNB debt. Finally, the court concluded that subordination of J.E.G.'s claim for administrative rent would be consistent with the provisions of the Bankruptcy Code, but did not even consider the claim's

247. 22 Bankr. 86 (Bankr. N.D. Ga. 1982).
248. *Id.* at 87-89.

statutory priority.[249]

In *In re Sayman's, Inc.*,[250] the same bankruptcy court ordered subordination of a claim based on a creditor's inequitable conduct that was wholly unrelated to the creation or the assertion of the creditor's prepetition claim. Sometime after the filing of the petition but before appointment of the trustee, the claimant, Southwestern Bell, had discontinued the debtor's phone service without the court's permission. The trustee tendered an additional deposit, as demanded by Southwestern Bell, but service was not immediately restored. This delay hampered the sale of the debtor's inventory. The court found that all three parts of the *Mobile Steel* test were satisfied and subordinated *all* Southwestern Bell's claims.[251]

VI. CONCLUSION

It is difficult to ascertain whether the courts have been more or less prone to order subordination of a shareholder's claim since the *Mobile Steel* decision. Mere numbers of decisions to subordinate or not to subordinate particular claims cannot provide an answer because each decision must rest on its particular facts. It does appear that the *Mobile Steel* opinion imposed certain constraints on the court's use of its broad equitable powers. Most significant, the Court of Appeals for the Fifth Circuit refused to subordinate the claim in question after setting forth its threshold requirements for ordering equitable subordination.

The decisions discussed above indicate a certain reluctance by the courts to order subordination of a claim. On the other hand, when the courts have decided to subordinate a claim, they have clearly provided that justice be fully carried out.[252]

Whether the *Mobile Steel* test and its attendant principles have added anything to the predictability and consistency of outcomes in these cases is also a difficult question. The fact situations underlying the claims are so diverse that comparison of results is practically impossible.[253] The argument for equitable

249. *Id.* at 91-92.

250. 15 Bankr. 229 (Bankr. N.D. Ga. 1981).

251. *Id.* at 231.

252. *See, e.g., Carolee's Combine, Inc.* (*supra* notes 95-100 and accompanying text); *Greenbrook Carpet Co.* (*supra* notes 247-49 and accompanying text).

253. The apparent discrepancy between the holdings in *Greenbrook Carpet* (*supra*

subordination of a claim appears to arise most often when some form of fraud, mismanagement, or breach of fiduciary duty is present. There is little to indicate that either undercapitalizaiton or the alter ego argument could alone support an order for equitable subordination, even though the *Mobile Steel* guidelines would appear to permit that decision. Thus, the courts seem to have interpreted the first prong of the *Mobile Steel* test narrowly.

One of the most important developments since *Mobile Steel* has been the treatment of noninsider claimants. The *Teltronics*[254] court, for example, adopted a restrictive view of noninsider subordination, and seems to have concluded that insider claims should be subordinated only upon a showing of either near total dominance coupled with inequitable conduct or particularly egregious conduct. As the *Osborne* court noted, however, the *Teltronics* "gross misconduct" standard is poorly defined and difficult to apply.[255] *Pat Freeman,*[256] on the other hand, suggested, *inter alia*, that creditor misrepresentation relied upon by other creditors to their detriment could justify equitable subordination without regard to the amount of control the creditor exercised over the debtor.

An issue that has only recently arisen, and the significance of which cannot yet be determined, comes out of *Missionary Baptist.*[257] On remand the bankruptcy court subordinated a claim based not on the claimant's own inequitable conduct but on inequitable conduct imputed to the claimant. This view may significantly expand the availability of equitable subordination, depending on how other courts receive it and what limits they place upon it.

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notes 247-49 and accompanying text), and *Dade County Dairies* (*supra* notes 63-66 and accompanying text), which both involved claims for administrative rent, can be at least partially explained by the fact that some of the alleged inequitable conduct in *Greenbrook Carpet* occurred after the corporation was already involved in bankruptcy proceedings, while the alleged inequitable conduct in *Dade County Dairies* occurred prior to bankruptcy. The result in *Greenbrook Carpet* seems more equitable to outside creditors.

254. *See supra* notes 141-52 and accompanying text.

255. *See supra* notes 196-210 and accompanying text.

256. *See supra* notes 185-89 and accompanying text. *See also In re* Just For the Fun of It of Tenn., Inc., 7 Bankr. 166, 180 (Bankr. E.D. Tenn. 1980)(general contractor's claim subordinated because he filed a false, misleading, and invalid notice of complaint "on which other creditors relied in extending credit to the debtor").

257. *See supra* notes 89-94 and accompanying text, 109-14 and accompanying text.

In applying the second prong of the *Mobile Steel* test, courts have relied almost exclusively on the injury to the bankrupt's creditors. Opinions rarely even mention the second aspect of this prong—unfair advantage to the claimant—perhaps because it is usually superfluous.

The third prong of the *Mobile Steel* test—consistency with the provisions of the Bankruptcy Code—has proved the least useful. Courts that have applied this prong have usually construed it as referring only to general equitable principles. This requirement, therefore, has added little to the pre-*Mobile Steel* view of when equitable subordination is justified. Further, it appears that courts have increasingly glossed over this factor or ignored it altogether. Only one court appears to have refused to subordinate a claim solely on the basis of inconsistency with the Code.[258] Clearly, parties that claim under Code-prescribed priorities cannot expect a court to deny equitable subordination solely on the basis that the remedy is inconsistent with the provisions of the Code. By its very nature, equitable subordination has no other purpose than to alter the Congressionally mandated scheme of priorities because of equitable factors that are difficult to incorporate into legislation.

The aspect of *Mobile Steel* that has apparently had the greatest impact upon subsequent cases is the allocation of the burden of proof. Requiring the trustee to present some substantial factual basis for his argument that a claim should be subordinated is consistent with the policy allowing the owners of a close corporation to provide financial support for their business. In fact, several of the decisions discussed above turned on the burden of proof issue.[259] Under this approach, a shareholder who lends money to his corporation in good faith should be fairly secure that his claim for repayment will be honored in the event of his corporation's bankruptcy.

The *Mobile Steel* test, however, is capable of flexible application. Although subsequent cases appear to impose a heavier burden on an objectant to a noninsider's claim, it is significant that the doctrine of equitable subordination has even been extended to claims of noninsiders. Claimants must, therefore, exer-

258. *See Dade County Dairies* (*supra* notes 63-66 and accompanying text).

259. *See, e.g., Georgian Villa* (*supra* notes 76-81 and accompanying text); *Missionary Baptist* (*supra* notes 89-94 and accompanying text, 109-14 and accompanying text).

cise caution in the amount of "control" they exert over debtors in furtherance of their interests and must always consider the effect of their actions on other creditors.

The *Mobile Steel* opinion did not prescribe strict rules for ordering equitable subordination of a claim, but merely enunciated principles that a court should consider in making its decision. Although the guidelines impose more concrete standards than the pre-*Mobile Steel* "fair play and good conscience" tests, they also allow the court to adapt its decision to the facts of a particular case. This flexibility is highly desirable in the litigation of an equitable issue, particularly since corporate transactions can take so many different forms.