The Principal Principle: Controlling Creditors Should Be Held Liable for Their Debtors' Obligations

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The rich ruleth over the poor: and the borrower is servant to him that lendeth.[1]

INTRODUCTION

Sometimes when a business entity runs into financial difficulty, its senior creditor requires the troubled entity to submit to creditor control or face default and bankruptcy. In many of these cases, the controlling creditor is secured[2] and has been monitoring the debtor's affairs.[3] The

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[1] *Proverbs* 22:7. Under the modern taxonomy of the RESTATEMENT (SECOND) OF AGENCY (1958), the term "agent" may be substituted for the word "servant" without changing the result substantially, at least for the purposes of this Article. *See infra* notes 69-96 and accompanying text.

[2] Although the creditor control cases examined below arise in a variety of contexts, this Article focuses primarily on secured lending transactions; and although some of the cases examined in this Article arise under real property law or under pre-Uniform Commercial Code law, many arise under article 9 of the Uniform Commercial Code. Article 9 provides a convenient, coherent framework for the discussion of creditor control.

Under the Uniform Commercial Code, a security interest is "an interest in personal property or fixtures which secures payment or performance of an obligation." U.C.C. § 1-201(37) (1977). In the ordinary commercial lending transaction, the security interest "attaches" and becomes enforceable against the debtor when the debtor has signed a security agreement, value has been given, and the debtor has acquired rights in the collateral. *See id.* § 9-203(1). If the secured party is in possession of the collateral pursuant to agreement, no written agreement signed by the debtor is needed. *Id.* § 9-203(1)(a).

A financing statement is then filed with the appropriate officer, although in some instances it is not necessary to do so. *Id.* § 9-302. After all necessary steps have been taken, the security interest is said to have been "perfected," entitling the creditor to certain priorities over junior secured creditors, unsecured creditors, and the debtor's trustee in bankruptcy. *Id.* § 9-301. Upon the debtor's default, the secured party may take possession of or sell the collateral, *see id.* §§ 9-503, 9-504. The power to seize and sell the collateral with minimal judicial interference gives the secured creditor a powerful weapon to compel the debtor's compliance, particularly in light of the creditor's right to declare a default when the creditor in good faith deems itself "insecure" under § 1-208. That rather vague standard confers a great deal of power on the creditor. *See, e.g.*, Comment, *Standards for Insecurity Acceleration Under Section 1-208 of the Uniform Commercial Code*, 13 U. MICH. J.L. REF. 623 (1980).

Under article 9, parties enjoy considerable latitude in defining their relationship under the security agreement. *See, e.g.*, U.C.C. §§ 9-201, 9-501(1) (1977). That freedom is one of the key attributes of article 9. However, when a secured party uses her power under article 9 to take control of the debtor, the creditor may be subject to liability, as demonstrated below.

[3] Loan agreements often contain covenants requiring the debtor to submit periodic financial reports to the creditor. *See, e.g.*, Nassberg, *Loan Documentation: Basic but Crucial*, 36 BUS. LAW. 843, 850-51 (1981). For more detailed discussions of lending

creditor's goal in assuming control is either to rescue the debtor from insolvency (thus rescuing the controlling creditor) or, failing complete rescue, to salvage[4] as much as possible from the wreckage of the debtor entity.[5] If the rescue is successful, the debtor will be able to pay its debts as they mature, and there would be no reason to hold the controlling creditor liable.[6] This Article, however, is concerned with whether controlling creditors should be liable if the control relationship ends in the debtor's bankruptcy.

This control relationship may take many forms. In the course of the relationship, the creditor through direct and indirect means may cause the debtor to obtain additional infusions of investment or credit. Infusions of credit may be secured or unsecured, thereby generating new assets that become part of the senior creditor's collateral.[7] The control-

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agreements, see, *e.g.*, Simpson, *The Drafting of Loan Agreements: a Borrower's Viewpoint*, 28 BUS. LAW. 1161 (1973) [hereafter Simpson, *Drafting*]; Simpson, *Structuring and Documenting Business Financing Transactions Under the Federal Bankruptcy Code of 1978*, 35 BUS. LAW. 1645 (1980) [hereafter Simpson, *Structuring*].

[4] *See, e.g.*, Melamed v. Lake County Nat'l Bank, 727 F.2d 1399, 1404 (6th Cir. 1984).

[5] One commentator candidly noted that one of the "positive" characteristics of a business "workout" is that a workout "can provide an opportunity for individual creditors to improve their legal and economic position vis-à-vis other creditors . . . ." Yellin, *Workouts and the Bankruptcy Reform Act of 1978*, in LENDING TRANSACTIONS AND THE BANKRUPTCY CODE 818-19 (1984); *see also* Seneker & Wetmore, *Structuring a Real Estate Loan Workout Agreement with Peripheral Vision of Possible Bankruptcy*, in REAL ESTATE BANKRUPTCIES AND WORKOUTS 241, 254-72 (Kuklin & Roberts eds. 1983).

[6] If the creditor has committed tortious acts during the course of the workout such as misrepresenting the debtor's solvency to other creditors, it is possible that the senior creditor may incur liability to tort victims even if the workout has succeeded.

[7] *See, e.g.*, Central States Stamping Co. v. Terminal Equip. Co., 727 F.2d 1405, 1409 (6th Cir. 1984) (involving direct misrepresentations to junior creditors by the senior creditor); *In re* Osborne, 42 Bankr. 988, 999-1000 (Bankr. W.D. Wis. 1984) (same); *see also In re* Falstaff Brewing Corp. Antitrust Litig., 441 F. Supp. 62, 65 (E.D. Mo. 1977) (involving allegations that a dominant lender forced the debtor to procure new equity investment); Chaitman, *The Equitable Subordination of Bank Claims*, 39 BUS. LAW. 1561, 1571 (1984) (discussing allegations that a controlling creditor forced the debtor to increase its unsecured debt burden in order to pay down its secured debt). In Barrett v. Bank of Am., 178 Cal. App. 3d 960, 963, 224 Cal. Rptr. 76, 78 (1986), a loan officer advised a borrower to bring in new investors by merging with another firm. The court held, *inter alia*, that the advice had exposed the bank to possible liability to the customer under theories of principal and agent, fiduciary duty, and constructive fraud. In *In re* Beverages Int'l, 50 Bankr. 273, 284 (Bankr. D. Mass. 1985), the senior secured creditor and controlling shareholder of the debtor entity delayed obtaining and recording the security interest for his loan to the debtor; he "admitted that the purpose of the delay was to encourage third parties to extend credit

ling creditor may cause the debtor to delay payments to other creditors[8] or veto certain expenditures altogether[9] so that the debtor's cash position — and hence the collateral — is enhanced. The controlling creditor may cause the debtor to dispose of unencumbered but vitally productive assets and to transmute the proceeds into a possibly less productive, but encumbered, form.[10] The controlling creditor may cause the debtor to delay filing a petition in insolvency, thus impairing the chances of a successful reorganization while at the same time insulating prior transactions from subsequent attack as preferences or fraudulent conveyances.[11] The creditor may become involved in the debtor's daily

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. . . ." *See also* Dearhammer, *Improving Credit Information Exchange Between Bankers and Trade Creditors*, 60 J. COMM. BANK LENDING 53, 57 (1977) ("The banker wants to encourage trade creditors into the picture to keep his customer afloat. I see nothing wrong with this approach as long as the banker does not misrepresent the financial condition of his customer . . . .").

[8] *See, e.g.*, Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098, 1111 (5th Cir. 1973), *modified and reh'g denied*, 490 F.2d 916 (5th Cir. 1974); *In re* American Lumber, 5 Bankr. 470, 474 (Bankr. D. Minn. 1980).

[9] *See, e.g.*, *Melamed*, 727 F.2d at 1404; *Krivo*, 483 F.2d at 1111.

[10] *See, e.g.*, *In re* Ludwig Honold Mfg., 46 Bankr. 125, 127-29 (Bankr. E.D. Pa. 1985); *see also* State Nat'l Bank of El Paso v. Farah Mfg., 678 S.W.2d 661, 677-678, 691 (Tex. Civ. App. 1984) (senior creditors influenced selection of debtor's chief executive officer, who then sold off some of the debtor's productive assets to repay the debtor's obligations to senior creditors).

[11] *See, e.g.*, Bale v. Mammoth Cave Prod. Creditor Ass'n, 652 S.W.2d 851, 854 (Ky. 1983) (creditor's alleged efforts to delay debtor's bankruptcy included misrepresentations to junior creditors in an attempt to forestall action against debtor). In *In re* Belco, Inc., 38 Bankr. 525, 528 (Bankr. W.D. Okla. 1984), the senior secured creditor first induced the debtor to dismiss a voluntary proceeding brought within 90 days (the applicable preference period under 11 U.S.C. § 547 (1982)) of the perfection of its security interest and then seized the encumbered assets after the dismissal, thus avoiding preference liability. In *In re* W.T. Grant Co., 699 F.2d 599 (2d Cir. 1982), *cert. denied*, 464 U.S. 822 (1983), certain junior creditors unsuccessfully objected to a proposed settlement of litigation between the senior creditors and the debtor's trustee in bankruptcy. The junior creditors alleged that the senior creditors "used their position of control over Grant's management to prevent Grant from promptly seeking relief under the Bankruptcy Act, feeding it just enough money to keep its head above water while strengthening their security position . . . ." *Id.* at 605.

In Seneker & Wetmore, *supra* note 5, at 267, the authors note that

> since the lender presumably has within its power the ability to keep the borrower afloat, the lender can often control the likelihood of bankruptcy occurring within the next ninety days — the crucial time period for a preference. The workout should be structured if possible so that the preference period will run before the debtor or a third party has a strong incentive to file a bankruptcy case.

operations.[12]

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[12] *Melamed*, 727 F.2d 1399, illustrates a "workout" in which the creditor took control of the debtor's operations. The debtor's trustee in bankruptcy asserted claims of fraudulent transfer and tortious interference against the bankrupt's major secured creditor. After a jury verdict for the trustee, the appellate court reversed and remanded the case as a result of standing defects, but held that the evidence of tortious interference was sufficient to withstand a motion for a directed verdict. *Id.* at 1404. In response to the creditor's claim that "it did nothing more than any lienor would do to protect its interest and that its actions were designed to help all creditors of [the debtor], that this was a typical 'workout' situation," *id.* at 1403, the circuit court also noted that the creditor: required the debtor's president to take a 50% salary reduction; installed its own accountant in place of the debtor's; exercised approval for all payments made by the debtor; impeded the debtor's access to information about the availability of funds; and prepared a 13-point memorandum outlining a course of conduct to " 'help salvage whatever is possible' " for the creditor. *Id.* at 1403-04. Interestingly, the court did not deny that the conduct was "typical"; it just characterized it as "impermissible." *Id.* at 1404.

Similarly, in an equitable subordination case, *American Lumber Co.*, 5 Bankr. at 473, the debtor defaulted and the major creditor (a bank) attempted to salvage its collateral by various means. These included refusal to honor the debtor's payroll checks; reduction of the debtor's corporate officers' salaries to one-sixth of their former level; and selective refusal to pay certain of the debtor's other creditors (allowing payment solely to those few accounts payable that would lead to the enhancement of the creditor's collateral). The debt was subordinated as a result of that conduct. *Id.* at 474, 478.

The equitable subordination cases are arguably distinguishable from the affirmative liability cases forming the basis of this Article, since subordination does not entail a damage award. It would thus seem to make sense to read the subordination cases warily, on the supposition that the courts may be more willing to find control when the consequences of that finding will be less severe. The flaw in that argument, however, is that equitable subordination often closely approximates relief in damages if, for example, the debtor is deeply insolvent, the lienholder to be subordinated is fully secured, and the aggregate value of the claims of the former junior creditors equals or exceeds the value of the collateral released from the lien. Therefore, the equitable subordination cases may actually be useful as models for control liability. *See also* Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505 (1977) (discussion of the relationship between equitable subordination and fraudulent conveyance law). *See generally* Chaitman, *The Equitable Subordination of Bank Claims*, 39 BUS. LAW. 1561 (1984); DeNatale & Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417 (1985).

Although *American Lumber* provides a vivid picture of a tangled workout, thus amply justifying the result, certain aspects of the court's opinion are nevertheless troubling. Among the many indicia of control listed by the court were the creditor's foreclosure of its security interests in receivables and contract rights, which "deprived [the debtor] of the only source of ready cash with which to conduct its business," and the execution of security agreements covering the debtor's unencumbered assets. 5 Bankr. at 478. Although the court does not explain how or why the acts of foreclosing on existing security and obtaining additional security after default can constitute control, one can speculate that the court implicitly characterized the seemingly innocuous foreclosure

This Article proposes a rule that a creditor exercising control of its debtor should be liable for some of the debtor's obligations. A precise, if cumbersome, statement of proposed rule is as follows: When a creditor has exercised substantial control over its debtor's operations, and when that control has affected the payments made or costs incurred by the debtor and has also enabled the creditor to realize a potential benefit (whether or not actually received), then upon the debtor's insolvency[13] the controlling creditor should be held liable for obligations of the debtor; such a creditor's liability extends to all obligations incurred, either (1) during the period of actual control or (2) before the exercise of control, but which resulted in the actual receipt of benefits by the creditor.[14] The reasons for the rule, and its limits, require extensive background and analysis.

This Article begins by exploring justifications for[15] and limitations of the rule.[16] Next, it describes the means by which creditors exercise control and the extent of control needed to trigger liability.[17] The rest of the Article demonstrates that the rule is within the common law of

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and taking of additional security to be manifestations of an underlying plan to take control.

It is also interesting that in *American Lumber* foreclosure was portrayed as an act justifying equitable subordination. By contrast, the parties objecting to the settlement in *W.T. Grant*, 699 F.2d at 599, unsuccessfully asserted that the senior creditors' failure to foreclose justified equitable subordination. *But see* Chicago Mill & Lumber Co. v. Boatmen's Bank, 234 F. 41 (8th Cir. 1916), in which an unsecured creditor of a lumber mill sought recovery against the debtor's major secured creditor, a bank, for the debtor's debts as a result of the secured creditor's alleged control. The circuit court affirmed a directed verdict against the unsecured creditor. The court noted that even though the bank had installed its assistant cashier as the president of the debtor and the debtor's sole shareholder "took no active personal participation in the affairs of the company" following the installation of the bank's employee, *id.* at 43-44, the secured creditor was not in control of the debtor because "the bank was a large creditor, and as such largely interested in the prosperity of the company, and most naturally should desire to keep an oversight over its doings." *Id.* at 46.

[13] A debtor may be said to be insolvent when liabilities exceed assets or when it is unable to pay its debts as they mature. For present purposes, it will be assumed that both definitions must be satisfied before liability will attach. If the debtor is able to pay its obligations as they mature, junior creditors will not have occasion to seek relief elsewhere. If assets exceed liabilities, then the claims of unpaid junior creditors can be satisfied from the debtor's estate without any contribution from outside sources (such as a controlling creditor). *Cf.* 11 U.S.C. § 101(26) (1982).

[14] *See infra* text accompanying notes 48-49.

[15] *See infra* text accompanying notes 21-34.

[16] *See infra* text accompanying notes 35-52.

[17] *See infra* text accompanying notes 53-68.

agency and may be adopted without legislative action.[18] The Article also critically examines other doctrines supporting and contradicting the use of the rule[19] and concludes by discussing possible consequences of the rule's adoption.[20]

I. WHY SHOULD CONTROL YIELD LIABILITY?

A. Why Do Creditors Exercise Control?

The examples of control conduct listed above illustrate that the central purpose of control is to obtain a benefit for the controlling creditor. This benefit may be the successful rehabilitation of the debtor, the enhancement of the collateral, or the avoidance of deterioration of the collateral. The benefit is not always realized, of course, but the potential for benefit is the controlling creditor's motivation.[21] Although it is true that the creditor exercising control rarely does so for the purpose of making a profit (in the colloquial business sense of reaping a return in excess of net outlay), the usual purpose of control is to mitigate a loss

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[18] *See infra* text accompanying notes 69-154.

[19] *See infra* text accompanying notes 155-227.

[20] *See infra* text accompanying notes 228-38.

Readers familiar with agency law will recognize that the proposed rule addresses the same subject matter as RESTATEMENT (SECOND) OF AGENCY § 14(O) (1958). That section is discussed and criticized below in the context of the agency materials. *See infra* text accompanying notes 69-96.

[21] Throughout this Article, the controlling creditor's motives and goals are discussed as if the creditor were a wholly rational entity and its decisions were made after careful deliberation among highly skilled professionals. In fact, those assumptions may be somewhat unrealistic. One bankruptcy attorney provided a less glamorous explanation for the zeal and poor judgment occasionally demonstrated by lenders in workout situations: " 'When a loan is in real trouble, generally it goes to a loan workout person at the bank . . . . But before it gets to him, it's in the hands of the lending officer. And he is out to protect his rear end, and through overzealousness he may stray over that thin gray line.' " Greene, *The Judge Hates a Bossy Lender*, FORBES, Oct. 10, 1983, at 102; *see also* Barrett v. Bank of Am., 178 Cal. App. 3d 960, 968, 224 Cal. Rptr. 76, 81 (1986) (implying that a loan officer became involved in a troubled borrower's affairs because the loan officer was concerned about the effect of the loan on his own career).

In recognition of the creditor's understandable desire to mitigate a losing transaction, Congress enacted 11 U.S.C. § 547(c)(5) (1982), which provides that an undersecured secured creditor with an interest in the debtor's receivables or inventory whose position improves during the 90 days preceding bankruptcy must disgorge the preference in an amount equal to the reduction in the outstanding deficiency. The statute requires this regardless of whether the reduction is attributable to payments made by the debtor, to the enhancement of the collateral, or to both. In lieu of the 90 days, a one year preference period applies to the debtors' "insiders," including a "person in control of the debtor." 11 U.S.C. §§ 547(b)(4)(B); 101(28)(B)(iii), (C)(V) (1982).

that otherwise would have been incurred.[22] That goal closely resembles the desire to make a profit on an initial expenditure.[23]

The benefit sought by the controlling creditor is often derived directly or indirectly from the junior creditors, either by outright transmutation (for example, supplies sold on credit processed into encumbered inventory)[24] or by depriving the junior creditors of assets to which they otherwise would have been entitled (the encumbrance of formerly unencumbered assets;[25] the sheltering of voidable transfers due

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[22] *But see* Henderson v. Rounds & Porter Lumber Co., 99 F. Supp. 376 (W.D. Ark. 1951), in which the shareholder/creditor's control began when the debtor entity first formed. This provided the controlling party with an assured source of low cost raw materials. *Id.* at 378; *cf.* Gannett Co. v. Larry, 221 F.2d 269 (2d Cir. 1955) (captive supplier case). *Gannett* is distinguishable from the paradigmatic lending transaction that begins as an arm's-length relationship.

Builders Fin. Co. v. United States, 352 F. Supp. 491 (E.D. Mich. 1970), *aff'd sub nom.* Mueller v. Nixon, 470 F.2d 1348 (6th Cir. 1972), appears to be a rare example of substantial lender control stemming from the outset of the lending relationship. There, a troubled debtor agreed that officers of the lender would take charge of the debtor's operations and gave the lender the right to vote much of the debtor's stock. 352 F. Supp. at 492-93. The lender and one of its officers were held liable for the debtor's withholding tax obligations under the Internal Revenue Code by virtue of both the agreement and the actual exercise of control. *Id.* at 495; *cf. In re* Kentucky Wagon Mfg., 71 F.2d 802 (6th Cir.), *cert. denied*, 293 U.S. 612 (1934).

[23] In Douglas, *Vicarious Liability and Administration of Risk (Part II)*, 38 YALE L.J. 720, 737-38 (1928), the author (later Justice Douglas) argued that because controlling creditors do not receive profits from the debtor, controlling creditors should not be liable for their debtors' obligations, unlike entrepreneurs. Douglas set forth two justifications. First, the absence of profit means that the controlling creditor receives no compensation for bearing risks. Second, when the debtor is insolvent, the controlling creditor would not be able to distribute the risk of liability.

There are flaws in each argument. First, the creditor assumes control in order to reap a benefit — salvaging the creditor's position. That is surely some compensation for the risk of liability. Second, even assuming the "compensation for risk" issue were valid, Douglas erred in focusing on the debtor's enterprise as the sole mechanism available for risk distribution. The imposition of control liability shifts the burden of cost distribution from the debtor to the controlling creditor, a separate entity with its own operations. In other words, the risk of control liability will become another of the costs of being a creditor and will be folded into the price of credit. *See infra* text accompanying notes 229-30. The debtor's insolvency is therefore almost irrelevant to the question of the creditor's ability to distribute the risk.

[24] *See, e.g., In re* Samuels & Co., 526 F.2d 1238, 1254-57 (5th Cir.), *cert. denied*, 429 U.S. 834 (1976). The dissenting opinion seems to argue, in effect, that the secured lender knowingly cut off the debtor's funding to enhance the collateral (the debtor's inventory) without having to pay the debtor's unsecured suppliers.

[25] *See, e.g., American Lumber*, 5 Bankr. at 478.

to the running of statutes of limitation).[26] In the usual control case, the debtor is deeply insolvent at the time that the creditor assumes control and the enhancement of the controlling creditor's position cannot be traced to an erosion of the debtor's (nonexistent) net worth. The junior creditors are therefore the major sources of the controlling creditor's benefit.[27]

The exercise of control may involve costs to the junior creditors that might not have been incurred in the absence of control. For instance, without control, the debtor might not have obtained as much unsecured credit; the debtor might have come under the protection of the Bankruptcy Code (voluntarily or involuntarily) at an earlier date; the debtor might not have encumbered or transferred as many of its assets; or the debtor might have satisfied more of its accounts payable.

Thus, control may benefit the senior creditor and impose costs on the junior creditors. Under current law, the controlling creditor usually would not be required to bear those costs in the absence of proof both of misconduct and of direct causation of the junior creditors' losses.[28]

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[26] *See, e.g., Belco*, 38 Bankr. at 528.

[27] There is nothing particularly novel about the notion that taking property from an insolvent debtor is, in effect, taking it from the debtor's other creditors. That idea is the predicate of the preference provisions of the Bankruptcy Code, 11 U.S.C. § 547 (1982). *See, e.g.*, 4 COLLIER ON BANKRUPTCY (15th ed. 1985), ¶ 547.41 nn. 7-10 ("any improvement in the value of the secured creditor's collateral is presumably at the expense of unsecured creditors who have permitted the debtor to continue operation, acquire new inventory and generate new receivables").

A similar concern (that transfers from an unprofitable entity must prejudice the other creditors) may explain the rule that dividends to corporate shareholders cannot be paid out unless the corporation has a surplus. *See, e.g.*, 11 W. FLETCHER, CYCLOPAEDIA OF CORPORATIONS § 5329 (1971).

[28] *See infra* text accompanying notes 97-227. For thorough descriptions of many creditor control cases reflecting traditional views of creditor control liability, see, *e.g.*, Douglass-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW 343 (1975); Douglass-Hamilton, *When Are Creditors in Control of Debtor Companies?*, 26 PRACTICAL LAW. 61 (1980); Kunkel, *The Fox Takes Over the Chicken House: Creditor Interference with Farm Management*, 60 N.D.L. REV. 445 (1984); Lundgren, *Liability of a Creditor in a Control Relationship with Its Debtor*, 67 MARQ. L. REV. 523 (1985). *See also* AMERICAN BAR ASSOCIATION, EMERGING THEORIES OF LENDER LIABILITY (H. Chaitman ed. 1985).

B. Are the Obligations of the Debtor to Junior Creditors Attributable to the Benefits Sought by the Controlling Creditor?

The connection between the debtor's unpaid obligations and the controlling creditor's benefit is most visible if the benefit actually received during the control period matches or exceeds the debtor's unpaid obligations. Although this would be unusual, it provides a useful starting point.[29] Assuming that the debtor was insolvent at all relevant times,[30] the only possible source of the controlling creditor's benefit is the junior creditors. The benefit must come either (1) from assets that the junior creditors supply directly to the debtor in the form of goods, services, new unsecured credit, or forebearance, or (2) from formerly unencumbered assets of the debtor that were made unavailable to the junior creditors. These assets could be made unavailable by encumbering them during the control period or by payment to the senior creditor. In the latter case the junior creditors suffer from the debtor's inability to pay, just as they suffer from the debts directly incurred. There is a difference in timing, but in both cases the senior creditor benefits at the expense of junior creditors.

Most control cases are not so simple, however. The total amount of secured debt may be large in relation to the lower priority debt, but rarely will the marginal benefit to the controlling creditor during the control period outweigh the whole junior debt.

There are several reasons for that probable disparity. First, in any litigated control liability case, the debtor will have failed; otherwise the debtor would have paid all creditors. Thus, the controlling creditor may have sought a substantial benefit and been thwarted by the debtor's inability to generate the benefit. The differences among a successful workout (paying all debts), an unsuccessful workout in which the benefits to the controlling creditor exceed the costs to junior creditors, and an unsuccessful workout in which costs exceed benefits, often are a function of the duration of the debtor's financial life.

Second, in some instances the controlling creditor will have exercised egregiously bad judgment in making the decision to exercise control. In those cases the benefit never could have exceeded the costs.

Third, in other cases, the nature of the debtor's enterprise makes it unlikely that the creditor's aggregate benefit exceeds the debtor's costs.

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[29] *See infra* text accompanying notes 30-33.

[30] The term "insolvent" has two meanings, both of which are probably prerequisites to creditor control liability. *See supra* note 13. In context of the present discussion, the focus is on the debtor's lack of net worth.

That is true for low margin industries requiring a high volume, high turnover of inventory to generate a relatively small net profit. A creditor exercising control in that context cannot drain off a sizable portion of the debtor's assets without "killing the golden goose." As a result, the debtor's outstanding payables at any given moment greatly exceed the controlling creditor's expected benefit.

Fourth, in most control liability cases many of the debtor's assets are devalued suddenly as a result of the debtor's bankruptcy. The shift from going-concern values to liquidation values can be catastrophic.[31] That collapse not only shrinks the pool of assets available to satisfy the claims of junior creditors but also evaporates the tenuous benefit to the controlling creditor. The failure of the workout thus would create a great disparity between costs and benefits, even if none had previously existed.

Just as in the paradigmatic case in which the cost incurred can be traced to benefits actually received, in each of the foregoing examples the costs incurred by the controlled debtor created the opportunity for benefit to the controlling creditor, even when those benefits never were received. An analogy illustrates the relationship between the debtor's costs and the creditor's benefit. A dairy farmer owns a cow. The farmer buys feed for the cow, and he expects to get milk from her. Sometimes the value of the cow's milk is less than the cost of the feed needed. Nevertheless, the farmer is still liable to the feed suppliers. Similarly, when a creditor takes control of a debtor, the purpose for doing so is to reap a benefit. The debtor's costs are analogous to the feed. The creditor must pay for the feed, even when the cost of the feed exceeds the value of the milk.

To illustrate that the debtor's costs are attributable to the benefits sought by the controlling creditor, assume that Senior Creditor has taken control of Debtor Corporation, an insolvent widget manufacturer.

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[31] *See, e.g., In re* Lackow Bros., 752 F.2d 1529, 1531 (11th Cir. 1985) (the secured creditor's collateral, consisting of inventory and accounts receivable, had a going-concern value of approximately $3.9 million immediately before the debtor's bankruptcy; only $1.2 million of that was realized upon liquidation). The reason for the decline may be that purchasers of inventory are reluctant to buy discontinued items from an entity that will not be available to honor warranty claims or to share the burden of product liability claims. Similarly, account debtors may refuse to pay claims on receivables because they no longer have an incentive to maintain cordial relations with the vendor. Also, specialized or customized equipment may be very valuable as part of the debtor's ongoing operation, due to idiosyncrasies of the enterprise. Sold separately, the same equipment may be worth little more than scrap metal. *See generally* Fortgang & Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1063-65 nn. 6-16 (1985).

Senior Creditor's reason for exercising control is to rescue its undercollateralized loan. Senior Creditor hopes the exercise of control will cause Debtor to become profitable and to pay off its debts, but knows that this outcome is unlikely. Thus, to hedge its bets, Senior Creditor causes Debtor to increase its production and sales, thus enhancing the inventory and accounts receivable (which are the Senior Creditor's collateral). This requires Debtor to increase its credit purchases of raw materials from its unsecured vendors, thus increasing its accounts payable. The vendors presumably are unaware of either Debtor's financial trouble or Senior Creditor's control; otherwise, the vendors might refuse to sell on unsecured credit terms.

Beyond the purchases of raw materials, which can be directly traced to the processed goods and resulting receivables, Debtor must incur other expenses that contribute indirectly to the enhancement of Senior Creditor's collateral package. Debtor's operations must continue during the production increase; it must still incur its normal costs of labor, overhead, taxes, and the like. All of these expenses, too, are vital to Senior Creditor's collateral-enhancement plan; if Debtor were to stop incurring those costs, its operation would cease. Thus, all junior indebtedness contributes to the benefits sought by the controlling creditor. The costs incurred by the debtor during the period of control are the fuel that drives the debtor, thus enabling the controlling creditor to seek the anticipated benefits.

C. Why Should the Creditor Seeking the Benefits of Control Bear Attendant Costs?

The potential benefits flowing from control, as well as the potential costs, explain why control should give rise to liability. Unless the controlling creditor is forced to pay the costs engendered by the exercise of control, the creditor has no reason to refrain from seeking control and its resulting benefits. Forcing the creditor to weigh the costs before seeking the benefits will discourage creditor control, unless the chance of benefit exceeds the risk and magnitude of the costs by a healthy margin.[32]

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[32] Although it is often deemed axiomatic that an activity ought not be undertaken unless aggregate benefits exceed aggregate costs, the reasons justifying the axiom are not always made clear. One of the most persuasive discussions of the reasons for requiring an enterprise to bear its costs appears in Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, 501-03 (1961). Dean Calabresi suggests that to allow an enterprise to avoid paying for its inevitable costs is, in effect, to force others to subsidize that enterprise, leading to an inefficient allocation of society's

Under current law, control alone is almost never sufficient to justify imposing liability; proof of some form of tortious conduct also is required.[33] The controlling creditor may seek and obtain benefits without having to consider the inevitable costs of that benefit, simply by carefully maintaining the appearance of nontortious control. Current law therefore provides insufficient disincentives for control. Further, the proposed new control liability rule will avoid the need to prove specific instances of control. As a result, litigants and the courts escape the problem of determining whether each decision made by the controlling creditor was in the best interests of the debtor. Rather, the simple showing of control establishes that the creditor's decisions were made to recover the anticipated benefit.

There may be times when the senior creditor decides correctly to exercise control because the chances of a successful rehabilitation of the debtor are great or the risks are small. In these cases, it is to everyone's advantage that the creditor exercise control. Under the proposed rule it is realistic to expect a creditor to make that decision in cases in which the secured debt is large in relation to the unsecured debt. Of course, it would be naive to suggest that creditors contemplating control can quantify the cost/benefit ratio with great precision or that any creditor will exercise control in a closely balanced case. The proposed rule requires the margin of benefit to be substantial before a creditor decides to undertake the risks. When the creditor does exercise control, the rule deters short-sighted policies and abusive behavior.

Although the proposed rule of control liability primarily rests on the nexus between the creditor's benefit and the debtor's obligations, and although all creditors stand to benefit from dealings with their debtors, the proposed rule does not render all creditors liable. The benefit that anchors the rule is not the ordinary benefit flowing from business transactions. It is instead the extra potential benefit flowing from control. Control enables the creditor to obtain a larger benefit than the creditor could obtain absent control.

The assertion that control entails benefit can be verified by comparing an ordinary creditor to a controlling creditor. The ordinary creditor, secured or unsecured, benefits by extending credit and receiving payments of interest and principal (which may be subsumed in the price of goods sold on credit). The credit market determines the rate of interest. The debtor borrows money to use it for some purpose that will

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resources.

[33] *See infra* text accompanying notes 97-238; *see also* cases described in sources cited *supra* note 28.

yield a benefit to the debtor greater than the cost of the funds. The noncontrolling creditor is restricted to an arm's-length rate of return because the garden variety creditor cannot compel the debtor to pay a higher rate; the debtor would go elsewhere. Similarly, the creditor cannot compel the debtor to incur extraordinary costs, that is, to obtain assets from other parties and to pass the resulting benefits to the creditor.

By contrast, a controlling creditor exercising control either before or, more likely, after the extension of credit seeks a greater benefit than was obtainable without control. As a result of the benefit to the controlling creditor, the debtor retains less of the benefit from the loan than an arm's length transaction would have yielded; less is available to pay other creditors. At the same time, the controlling creditor has the capacity to cause the debtor to incur extra costs, costs that the debtor alone might not have incurred. The purpose of incurring those costs may be to enhance the benefit to the controlling creditor.

Thus, requiring the controlling creditor to bear the costs incurred by the debtor provides a check on the creditor's desire to reap an above-market, below-cost benefit. The focus of the inquiry, therefore, is not on whether the creditor has benefited, as all creditors benefit, but on whether the creditor has secured the means — control — to obtain an extra benefit and to incur costs without paying for them.[84]

II. How Far Should Control Liability Extend?

A. Should Liability Be Limited to Return of Extra Benefits Received?

Given that the search for an extra benefit motivates the exercise of control, it would seem to follow that to require the controlling creditor to return the extra benefit would restore the debtor to its original condition, thereby ending the controlling creditor's liability. However, there are at least two reasons why the costs incurred, and not just the extra benefit received, should be the measure of liability. First, to require no more than the disgorgement of the extra benefit creates a no-risk situation. The worst possible penalty is merely to return what was taken. Second, in many instances the costs incurred to generate the ben-

[84] The reciprocal of this discussion may explain why a nonbenefiting controller, such as a corporate manager, is generally not held liable for the controlled entity's debts: the absence of any benefit attributable to those debts may negate the presumption that the entity's costs were incurred for the controller's benefit. A thorough exploration of this interesting issue is beyond the scope of this Article.

efit will greatly exceed the actual benefit sought or received, as explained above. To allow the use of the disparity between costs and benefits as a shield against liability would be illogical. A disparity between cost and benefit, as well as the paucity of the benefit, justify liability, not immunity.[35]

B. Should Liability Be Limited Solely to Extra Costs Directly Attributable to the Exercise of Control?

Even in the absence of control, any given debtor may incur substantial costs. The debtor may also become insolvent without help from the controlling creditor. Why, then, should the controlling creditor be liable for all the debtor's obligations? Why not restrict liability solely to the extra costs resulting directly from the exercise of control?[36]

To understand the reason for holding the controlling creditor liable for all costs, it is first necessary to recast the question slightly. To ask whether the controlling creditor ought to be liable for only the extra costs resulting from control is the same as asking for a showing that the exercise of control directly *caused* the incurring of the specific cost claimed by the plaintiff.[37] The solution to the problem of causation is that the exercise of control over an insolvent debtor necessarily causes a direct or indirect transfer of assets from the junior creditors through the debtor to the controlling creditor. As explained earlier, the junior creditors by definition must be the source of the benefits sought by the controlling creditor of an insolvent debtor. That is true whether the controlling creditor's attempt to obtain the benefit involves direct transfers from the junior creditors (an increase in inventory; a delay in payments on account) or indirect transfers (the encumbrance of formerly unencumbered assets; the redirection of operating revenue; the sheltering of voidable transfers).

Thus, all the debtor's costs, and not just the "extra" costs, incurred during the control period were incurred to enable the controlling credi-

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[35] *Cf.* Douglas, *supra* note 23, at 737. In the course of a discussion of the insolvent entrepreneur's ability to absorb risk, Douglas stated: "[H]e and others like him had the opportunity to create a reserve good against the risk of loss in question. The fact that they were unskilled, inefficient, or unintelligent, and did not provide for it is no extenuating factor." *Id.*

[36] Much of the case law of creditor control liability explicitly or implicitly adopts that stance. *See, e.g.*, cases described in sources cited *supra* note 28; *see also infra* text accompanying notes 237-38.

[37] The typical plaintiff in such cases would be an unpaid junior creditor, although the debtor's trustee in bankruptcy may also be entitled to some relief; *see infra* text accompanying notes 237-38.

tor to reap the expected benefit, even if that benefit never materialized. It is not necessary to require either a specific command from the controlling creditor to the debtor regarding the incurring of a specific cost or a tracing of the assets provided by a junior creditor into the controlling creditor's hands. It is enough to show (1) the exercise of control, which can only be for purposes of obtaining a benefit; (2) the debtor's insolvency during the period of control, which establishes the debtor's role as a conduit for the direct or indirect transfer of assets from the junior creditors to the controlling creditor; and (3) the incurring of costs that remain unpaid after the debtor's insolvency.

To illustrate that all costs incurred during the control period are properly chargeable to the controlling creditor, consider the hypothetical widget manufacturer, Debtor Corporation. Assume that at the moment Senior Creditor takes control and begins its collateral enhancement program, Debtor's outstanding payables increase from three million dollars (at the start of the control period) to five million dollars. Assume also that the face value of Senior Creditor's collateral, the inventory and receivables, increases in the same proportion. Now, however, assume that Senior Creditor's plan fails and after a few months an involuntary petition in bankruptcy is filed against Debtor. The control period ends. The inventory and receivables collapse in value; the work-in-process is scrap; the finished goods are unwanted because vendors will not pay full price unless a viable manufacturer is able to service warranty claims and stand behind nonconforming goods. Similarly, the receivables evaporate because the account debtors no longer have any incentive to maintain a good credit relationship with their defunct supplier. The benefit sought by Senior Creditor has largely disappeared. The debts remain.

Should Senior Creditor be held liable for two million dollars, the increase in net payables from three million to five million dollars? Or should the liability be five million dollars, the total of the new debt incurred during the control period? One approach is to look at the problem from the standpoint of the unpaid suppliers, none of whom had been owed a penny prior to the onset of control. Their five million dollars were spent to enable Senior Creditor to enhance its collateral (even though that enhancement disappeared as a result of Debtor's collapse). Some of that five million dollars is directly traceable to the newly created, albeit fragile, inventory and receivables. Some of it may have been used to generate cash, allowing Debtor to retire outstanding and aged payables to forestall hostile action by disgruntled creditors. All of it was used to enable Senior Creditor to attempt to enhance its collateral.

If the class of unpaid suppliers were in reality one entity, and if that same entity had been extending unsecured credit to Debtor both before and after the onset of control, then one might argue that Senior Creditor should be liable for no more than the amount of harm done to the monolithic unpaid vendor (that is, the net increase in the payables). The vendors are not a single entity, however; and it is no comfort to them to say that the former suppliers have been paid, thus reducing the recovery from five million (gross debt incurred) to two million dollars (net increase in payables). The injury to them is still five million dollars.

The preceding discussion assumed that the control-period unsecured creditors were distinct from the precontrol unsecured creditors. Now let us abandon that assumption; after all, it is very unlikely that there will be a rapid and complete turnover in the makeup of Debtor's vendors.

However, there is no reason to make any distinction based on the fortuity of prior dealings between Debtor and any given vendor. The new debt presumably represents new value given during the control period. It would indeed be anomalous if new value given by a new supplier were to be treated differently from new value given by an existing supplier. This different treatment would provide incentives for Debtor and Senior Creditor to purchase solely from existing vendors, even though the harm done would be the same. It follows, therefore, that the controlling creditor ought to be held liable for all debts incurred during the control period, regardless of the identity of any given unsecured creditor. Since all of those debts are attributable to the exercise of control, it would be inadequate to measure the controlling creditor's liability by any other standard.

The decision to hold the controlling creditor liable for all of the debtor's debts is not so Draconian, even if the costs greatly exceed the benefits sought or received. The total harm is the amount of debt remaining unpaid by the debtor, rather than the full face value of each debt at the time it was incurred. Upon the debtor's insolvency, the debtor is either reorganized[38] or liquidated.[39] In a liquidation the debtor's assets are aggregated by the trustee in bankruptcy and distributed to the unsecured creditors.[40] The same is true in a reorganization under the Bankruptcy Code. Although the junior creditors do not receive an immediate and final dividend, they are usually forced to accept

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[38] *See* 11 U.S.C. §§ 1101-1174 (1982).
[39] *See* 11 U.S.C. §§ 701-766 (1982).
[40] *See, e.g.*, 11 U.S.C. § 726 (1982).

a write-down of their claims against the estate.[41] If there are unencumbered assets available to satisfy the creditors' claims, then the controlling creditor's ultimate liability will be reduced *pro tanto.*

C. When the Disparity Between the Debtor's Unpaid Costs and the Controlling Creditor's Benefits Results From the Creditor's Retention of Less Than All Available Benefits, Should Liability Be Reduced Correspondingly?

Should a controlling creditor be held liable for all of the debtor's debts even if the creditor has sought or retained less than all of the available benefit? After all, a rational controlling creditor may well decide not to seize the maximum benefit in the shortest possible time, thus "killing the golden goose." Instead the rational controlling creditor may allow the debtor to keep some of its earnings, either for reinvestment in the debtor's business or for retirement of junior indebtedness. As indicated above, a policy of short-term restraint may enable all creditors to realize long-term gains. This restraint, however, should not insulate the creditor from liability or reduce the scope of liability in event of an unsuccessful workout.

Assuming the existence of control, the rational exercise of control does not invalidate the justifications for control liability. The net benefit sought or obtained by the controlling creditor is still derived from the assets contributed by, or made unavailable to, the junior creditors. To the extent that a controlling creditor has foregone some benefits, that creditor will have anticipatorily reduced the potential liability by providing additional working capital to enhance the debtor's chances of survival or to retire junior debt. The controlling creditor thus will already have mitigated the eventual claim for damages. To afford additional protection because the controlling creditor was less than rapacious would be to double the dollar impact of the anticipatory mitigation.[42]

Liability is not predicated on bad faith or poor judgment by the controlling creditor; it is predicated on the cold fact of control. Whether control is exercised recklessly or carefully is left to the controlling credi-

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[41] *See, e.g.*, 11 U.S.C. § 1123 (1982).

[42] Although a rigorous application of the rule presented in this Article would indicate that the sheer quantum of retained benefit should be wholly irrelevant to the issue of actual control *vel non*, it would be naive not to expect some evidentiary cross-contamination in the course of litigation. That is, the trier of fact probably would look favorably upon a defendant who has acted in apparent good faith, even though motive should be irrelevant.

tor's sense of enlightened self-interest. A prudent controlling creditor will pay down the junior debt during the course of the workout; a foolish or risk-preferring creditor will not. In either event, the outstanding balance of the debtor's unpaid obligations will have to be met if the workout fails. The prudent controlling creditor will have less to pay at that time because of the earlier payments.[43]

The preceding discussion raises a related problem. A creditor that had seized less than all available benefits might claim that the return of benefits should mitigate a subsequent damage award. Similarly, a controlling creditor forced to disgorge property to the debtor's trustee in bankruptcy under claims of preference, fraudulent conveyance, or equitable subordination might similarly claim some sort of offset. The flaw with this argument is that the involuntary disgorgement itself will operate to reduce the controlling creditor's ultimate exposure. The parties receiving the liquidation or reorganization dividend, the junior creditors, are the same individuals who would be the plaintiffs in a control liability case. Thus, the bankruptcy dividend derived from the disgorged benefits will mitigate the final award in the control case, just as the voluntary release of benefits during the control period will mitigate any eventual damage award.[44]

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[43] The same reasoning inexorably applies to a creditor that advances a new value to the debtor during the control period. Although that result is not palatable at first glance, there is no principled reason to distinguish between a decision to forego some benefits and a decision to advance new value. Both decisions are made to prop up the controlled debtor. The sole concern is the quantum of control. Once the threshold of liability has been reached, the manner in which control has been exercised will affect the issue of damages. *See infra* text accompanying notes 53-68.

[44] The idea that disgorgement to the trustee does not entitle the defendant to an offset creates some procedural awkwardness. Assume, for example, that unsecured creditors are involved in litigation against the controlling creditor, seeking affirmative relief in money damages; at the same time, the debtor's trustee in bankruptcy is seeking the return of preferences received by the controlling creditor. The damages awarded to the unsecured creditors in their own action will depend on the size of the bankruptcy dividend, which cannot be calculated until the trustee has received all of the debtor's assets (including disgorged preferences). Thus, if the unsecured creditors' suit goes to judgment before the dividend is calculable, calculation of the damage award in the plenary suit must be stayed or abated pending the winding up of the debtor's affairs.

One possible solution would be to award full damages to the plaintiffs immediately, and then to subrogate the defendant to the plaintiffs' claims against the debtor's estate. *See, e.g.*, 11 U.S.C. § 509 (1982). Thus, the net liability of the defendant will be the same in either case, since any eventual dividend from the estate will reduce the defendant's exposure *pro tanto*, regardless of who actually receives the dividend.

D. Should Liability Extend to the Debtor's Tort Obligations in Addition to Contractual Debts?

Is there any reason to differentiate between the debtor's junior creditors and its tort victims? In one sense, there is a significant distinction between unsecured creditors and tort victims: the unsecured creditors provide the raw material from which the debtor generates the benefits sought by the controlling creditor. Thus, if the sole purpose of control liability is to recapture benefits taken by the controller, then tort victims, who may provide no assets, should not recover from the controlling creditor.

Mere recapture is not the sole purpose of control liability, however. The purpose is also to force creditors to take into account the inevitable costs of control before deciding to exercise it. Control necessarily entails continuing the debtor's operation during the control period. Torts are likely to occur in most business operations. To allow the controlling creditor to reap the benefits of the debtor's operations without paying the concomitant costs again would provide false incentives to the creditor.[45] Further, the controlling creditor may have rendered the debtor less solvent, thus depriving tort creditors of a source of recovery.[46] There may also be extrinsic or overriding policy reasons for protecting tort creditors. However, it is sufficient to note that there is no reason to exclude them from the controlling creditor's burden.[47]

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[45] *See also* Calabresi, *supra* note 32, at 501-03 (discussing the diseconomy of allowing torts to go uncompensated when they are the inevitable concomitants of an enterprise).

[46] It must be noted, however, that tort creditors may not have relied upon the debtor's solvency. Thus, they may not be entitled to the same protection as contract creditors who chose to deal with the debtor based on an arguably false picture of financial well being. *But see, e.g.*, Minton v. Cavaney, 56 Cal. 2d 576, 580, 364 P.2d 473, 15 Cal. Rptr. 641, 644 (1961) (plaintiff in wrongful death action permitted to assert an alter ego claim against one of the founders of an undercapitalized corporation, even though victim did not rely on the entity's apparent solvency).

[47] In contrast to the position that tort creditors ought to be treated at least on par with contract creditors, see Note, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045, 1080-83 (1984) (advocating superpriority for tort creditors in order to encourage the tortfeasor's other creditors to "induce the debtor . . . to observe a higher standard of care and to obtain realistic insurance"). As to whether the distinction between tort victims and contract creditors is at all meaningful, see *infra* text accompanying notes 87-96.

E. Should the Controlling Creditor Be Liable for Any of the Debtor's Debts Incurred Prior to the Exercise of Control?

In the usual control case, the debtor will already have a full debt load by the time the controlling creditor begins to exercise control. It is the looming precontrol debt that prompts the onset of control. Should the controlling creditor be liable for the debtor's unpaid precontrol debts? A simplistic, mechanistic approach might suggest a negative answer. The creditor in seeking control does not seek the benefits of precontrol operations. The creditor may indeed have benefited from the debtor's precontrol operations, but any benefit received prior to the exercise of control must be inconsequential. Otherwise, anyone benefiting from the conduct of another would be liable for the other's debts, an absurd result.

The flaw in this simplistic approach is that it fails to take into account the time lag inherent in any firm's business cycle. The controlling creditor cannot properly be held for costs incurred prior to the onset of control when the benefits derived from those costs also accrue prior to the control. However, it does not follow that precontrol costs yielding postcontrol benefits are beyond the scope of liability. For example, if the rule were that precontrol costs were never chargeable to the controlling creditor, then the senior creditor would have a powerful incentive to monitor the debtor's activities and to assume control when the debtor's inventory had reached its cyclical peak.[48] If the controlling creditor could divert the resulting proceeds, the creditor could benefit greatly at the expense of precontrol inventory suppliers. Thus, the rule should require controlling creditor liability for all costs incurred during control, and for all precontrol costs directly traceable to benefits received during control.[49]

To illustrate the application of the tracing rule, let us return once more to the beleaguered widgetmaker. Suppose that Debtor Corporation has two suppliers: Oldco and Newco. In 1989, Oldco sells widget

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[48] *See, e.g., In re* Samuels, 526 F.2d at 1254-57 (describing conduct of the lender) (dissenting opinion).

[49] Policy is the sole justification for the liability of a controlling creditor for the debtor's precontrol obligations resulting in postcontrol debts; there is no direct precedent for such a rule. The debtor cannot be said to have acted on the controlling creditor's behalf in incurring the obligation, because the control relationship arises after the obligation is incurred. The controlling creditor is not a party to the original transaction and does not later assume it. *But see, e.g.*, CAL. CIV. CODE § 1589 (West 1982) ("A voluntary acceptance of the benefit of a transaction is equivalent to a consent to all the obligations arising from it, so far as the facts are known, or ought to be known, to the person accepting.").

subassemblies to Debtor in an unsecured credit transaction. Within a few weeks of the sale, the supplies sold by Oldco are processed into finished goods and sold on credit. The resulting accounts receivable become part of the collateral claimed by Senior Creditor. Senior Creditor then takes control of Debtor. If and when Senior Creditor is charged with control liability for Debtor's debts, the debt owed by Debtor to Oldco, which was incurred prior to the onset of control, would not be chargeable to Senior Creditor because the incurring of the debt did not result in any postcontrol benefit.

By contrast, Newco, another supplier of Debtor, sold supplies on credit shortly before Senior Creditor took control. The debt was incurred prior to control, but Debtor acquired no rights in the supplies until after Senior Creditor began to exercise control. After the onset of control, the supplies were processed into finished widgets. The widgets were sold, and the resulting receivables were added to the collateral. In the case of the debt to Newco, therefore, Senior Creditor would be liable for the precontrol debt because it resulted in an actual postcontrol benefit.

Admittedly, affording recovery to selected precontrol junior creditors will pose difficult accounting and evidentiary problems. But the alternative is to encourage precisely the type of short sighted, counter-productive self-serving control behavior that the proposed rule is intended to discourage. In practice, the tracing problem may be small, since the bulk of precontrol junior indebtedness will be paid down during the life of the usual control case. Controlling creditors will probably try to keep the debtor afloat for at least ninety days after taking control in order to insulate some of the earlier transfers from preference liability, while most accounts are payable on a shorter cycle such as thirty, forty-five, or sixty days. With specific reference to tort victims injured by the debtor's precontrol conduct, the requirement of corresponding postcontrol benefit would seem to preclude most liability for the debtor's precontrol torts, since it would be unusual for the commission of a tort to confer a delayed benefit.

F. If Junior Creditors Can Redistribute Risk, Why Impose Liability on the Controlling Creditor?

Up to this point, one major question has remained unasked: is this rule of liability necessary? The question does not go to the issue of the frequency or magnitude of the control problem. As the following discussion of case law demonstrates, the problem does arise, and it can involve a great deal of money. Instead, the issue is whether the junior

creditors can protect themselves or have already protected themselves from the risk of senior creditor control. It is clear that junior creditors cannot easily prevent senior creditors from taking control. But it is also clear that junior creditors as a class can increase the price of unsecured credit to compensate themselves for the risk that a senior creditor may take control. In fact, it is almost certain that they have already done so. The risk of creditor control is an element of the overall risk that a certain percentage of debtors will become insolvent. This is an existing factor in the credit market. Although control may affect the frequency of insolvencies and the size of the dividends paid out of bankruptcies, the aggregate actuarial risks inherent in extending unsecured credit are reflected in current rates of interest and in prices charged by credit providers of goods and services. Thus, it can be argued that junior creditors are already protected and need no additional help.[50]

There are several responses to that argument. First, and most compellingly, cost distribution is not the same as cost prevention. If the new rule discourages the diseconomic exercise of control, then it will avoid some of the costs now borne needlessly by junior creditors and thus will reduce the overall cost of credit.

Second, although the price of unsecured credit does reflect in a general way the risks created by control, the exercise of control in any given situation may exacerbate the risks to a point far beyond that subsumed by the credit market as a whole. In this case, the junior creditors probably did not foresee the exercise of control and would be unable to prevent it. The junior creditors might even be unaware of creditor control, and, in any event, could not adjust the credit prices charged to the specific debtor because the credit was extended before they knew of the control. Thus, even assuming that risk distribution is a sufficient reason to deny relief to the junior creditors, the unforeseen increase in risk caused by the exercise of control may negate the market theory of self-insurance in specific instances.

Third, just as generalized risk distribution may be inadequate to

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[50] For the seminal discussion of the interaction between rules of liability and patterns of cost distribution, see Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960). To oversimplify, Professor Coase theorized that in the absence of any transaction costs, it does not matter on whom the law places the risk of liability because parties can adjust their prices in order to compensate themselves for the risk and thus can redistribute those costs to society at large through prices and wages. *But see* Calabresi, *Transaction Costs, Resource Allocation, and Liability Rules — A Comment*, 11 J. LAW & ECON. 67 (1968), suggesting that the effects of transaction costs may often be so significant as to negate the practical validity of Coase's theorem. In other words, it actually does matter to whom and how liability is initially allocated.

handle specific instances of control, it may also be inadequate to protect junior creditors with limited resources. Particularly in cases in which the debtor has a number of dependent subcontractor/suppliers, the exercise of control may cause losses large enough to bankrupt some of the junior creditors. Those bankruptcies in turn may give rise to others. Controlling creditors, on the other hand, are far more likely to be solvent and capable of absorbing and redistributing costs.[51] While senior creditors should not wholly (or even primarily) bear the costs because they are solvent, relative solvency is relevant when evaluating risk distribution. The purpose of the rule proposed in this Article is to avoid the incurring of excessive costs, not to redistribute wealth.[52] Risk prevention, as discussed above, has little to do with "deep pockets."

III. The Threshold of Control Liability

How much control should trigger liability?[53] Which of the debtor's

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[51] For an even-handed discussion of the merits of the loss spreading rationale, see generally G. Calabresi, The Costs of Accidents 40-42 (1970).

[52] As the court stated in Kaiser Steel Corp. v. Westinghouse Elec. Corp., 55 Cal. App. 3d 737, 747 (1976), "[J]udicial paternalism is to loss shifting what garlic is to a stew — sometimes necessary to give full flavor to statutory law, always distinctly noticeable in its result, overwhelmingly counterproductive if excessive, and never an end in itself." *See also* Ira S. Bushey & Sons v. United States, 398 F.2d 167, 171 (2d Cir. 1968) ("[T]he fact that the defendant is better able to afford damages is not alone sufficient to justify legal responsibility . . . .").

[53] As explained above, the justification for control liability is that the actual exercise of control inevitably imposes costs on the insolvent debtor's junior creditors to benefit the controlling creditor. It therefore follows that potential (but unexercised) control ought not give rise to liability because no extra benefits (and hence, no extra costs) will have arisen. Nevertheless, there is some authority for the notion that mere potential control, evidenced by covenants contained in the agreements between the controlled and controlling parties, ought to be sufficient per se to justify the imposition of liability, even (perhaps) in the absence of any actual exercise of control. *See, e.g.*, Nichols v. Arthur Murray, Inc., 248 Cal. App. 2d 610, 56 Cal. Rptr. 728 (1967) (contract action in which a franchisor was held to have been in control of its franchisee and hence liable as the principal). In affirming the trial court, the *Nichols* court first stated: "If, in practical effect, one of the parties has the right to exercise complete control over the operation by the other an agency relationship exists . . . ." *Id.* at 613. The court then quoted the trial judge's statement that "[a] reading of the contract here involved leads me to conclude that rigid effective controls over almost every aspect of the operation were retained by the licensor . . . ." *Id.* at 614. Describing the control provisions, *id.*

activities must be controlled?[84] The facile answer is that there can be

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at 615, the appellate court stated that "the agency relationship was created by the legal effect of those provisions." *Id.* at 616. The opinion is silent on the actual exercise of control: "Under the policy control provision of the subject agreement [the franchisor] could have foreclosed the practice [giving rise to the action] . . . ." *Id.* at 617. The implication is that the agreement itself gave the franchisor the right of control, and the failure to exercise that control contributed to the finding of liability. *Accord* Wickham v. Southland Corp., 168 Cal. App. 3d 49, 55-59, 213 Cal. Rptr. 825, 829-31 (1985).

See also Drummond v. Hilton Hotel Corp., 501 F. Supp. 29, 31 (E.D. Pa. 1980); Billops v. Magness Const. Co., 391 A.2d 196 (Del. 1978). *Hilton* and *Billops* both held that the detailed Hilton operating manual had reserved so much potential day-to-day control over the franchisees that a determination of the nonexistence of an actual agency relationship would be improper in the context of summary judgment. The implication is that the agreement alone might be sufficient to find agency liability, even absent the actual exercise of control. *Accord* Hayward v. Holiday Inns, Inc., 459 F. Supp. 634, 635-36 (E.D. Va. 1978). The danger of drawing analogies to the franchisor liability cases, however, is that they sometimes are contaminated by analytical crossover from the claims of apparent agency often raised by plaintiffs. *See, e.g.*, Brown, *Franchising — A Fiduciary Relationship*, 49 TEX. L. REV. 650 (1971); Note, *Liability of a Franchisor for Acts of the Franchisee*, 41 S. CAL. L. REV. 143 (1968); Note, *Franchisor's Liability for Acts of Franchisees*, 32 U. FLA. L. REV. 603 (1980).

But see Oberlin v. Marlin Am. Corp., 569 F.2d 1322 (7th Cir. 1979), in which the appellate court upheld a directed verdict against a party asserting that a manufacturer was the principal of its distributor. The plaintiff had asserted *inter alia* (1) that a marketing agreement had given the manufacturer the ownership of the distributorships created by the distributor in the event of the distributor's bankruptcy, and (2) that the manufacturer had actually controlled certain of the distributor's advertising practices, thereby creating an agency relationship. The court disagreed:

> The provision in the agreement transferring ownership of the distributorships in the event of [the alleged agent's] bankruptcy or default applied only in extraordinary circumstances, and the control of advertising was confined to the discrete area of use of the . . . trademark. Neither the contract nor . . . the advertising practice demonstrates the elements of constancy or detail characteristic of the control a principal exercises over his agent.

Id. at 1326.

The lending agreement in the context of a debtor/creditor relationship (as distinguished from a franchise) may contain various covenants conferring potential control. For more detailed discussions of the contents of lending agreements, see, *e.g.*, Nassberg, *supra* note 3; Simpson, *Drafting*, *supra* note 3; Simpson, *Structuring*, *supra* note 3. The debtor may be required to maintain the collateral and insure it, to make its business records available to the lender, and to submit financial reports to the creditor. Nassberg, *supra*, at 850-51. The debtor may be prohibited from alienating or encumbering the collateral on pain of default. *See, e.g.*, U.C.C. § 9-311 (1977).

The foregoing types of provisions do not appear to confer much control on the lender. On the other hand, provisions affecting either the debtor's management or the voting of the debtor's stock obviously vest more potential control in the creditor. *See,*

no simple test. The inquiry must be made on a case by case basis. That

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e.g., Enstam & Kamen, *Control and the Institutional Investor*, 23 BUS. LAW. 289, 319-23 (1968); Nassberg, *supra*, at 852; Koch, *Bankruptcy Planning for the Secured Lender*, 99 BANKING L.J. 788, 805-07 (1982); Simpson, *Structuring*, *supra* note 3, at 1664; *see also* Walton Motor Sales, Inc. v. F.H. Ross, 736 F.2d 1449, 1453 (11th Cir. 1984) (debtor and senior creditor executed an agreement granting the creditor " 'full, absolute, and complete control' over all fiscal affairs and credit policies" of the debtor).

Most courts hold that unexercised control covenants contained in lending agreements, no matter how Draconian or lopsided, do not by themselves confer liability on the creditor favored by those covenants. For example, in *In re* Prima, 98 F.2d 952 (7th Cir. 1938), *cert. denied*, 305 U.S. 658 (1939), a trustee sought to recover the bankrupt's losses from two banks, the major secured creditors, who had allegedly mismanaged the debtor by installing a manager at the debtor's place of business. At the creditor's behest, the debtor had executed an agreement with the manager at the debtor's place of business providing that the manager was "to be placed in complete control of the finances, manufacturing, distribution and management of the [debtor] . . .; being subject only, to the approval of the two [secured creditors]." *Id.* at 961-62 n.4.

Nevertheless, the court reversed the decision below that the creditors had been in control and were liable for the alleged mismanagement. The circuit court held that there was no evidence of "any effort on the part of the [creditors] to manage any part of the debtor's business after [the manager's] employment, except with respect to its financial problems." *Id.* at 966. The implication is that the potential control conferred by the agreement was immaterial in the absence of the actual exercise of control. *Accord* Canadair Ltd. v. Seaboard World Airlines, Inc., 43 Misc. 2d 320, 324, 250 N.Y.S.2d 723, 727 (Sup. Ct. 1964) (absent day-to-day management, covenants alone did not constitute control of air carrier by creditor so as to vest Civil Aeronautics Board with primary jurisdiction of the litigation).

A variation of the *Prima* situation appears in American Southern Trust Co. v. McKee, 293 S.W. 50 (Ark. 1927), in which the two bank/creditors also escaped liability for the alleged mismanagement of their handpicked manager installed on the debtor-bank's premises. The agreement between the creditor banks and the debtor bank provided that the manager would have "absolute authority in the granting of loans and accepting of collateral." *Id.* at 52. The court then held that "[i]f the [creditors] had authorized [the manager] to take charge of the [debtor] . . ., their liability would have been the same as if they had done the business in their own name; but whether these [creditors] became liable depends . . . upon the contract entered into." *Id.* at 55. The court believed that the agreement regarding the manager's "absolute authority" was not a contract authorizing the manager to take charge of the debtor. Thus, in *American Southern* the construction of the contract vitiated the actual exercise of control, whereas in *Prima* the contract did not constitute control in the absence of its actual exercise.

Although control clauses standing alone may not constitute control of the debtor, they may indicate the existence of control or may be part of the evaluation of the creditor's control. In *In re* T.E. Mercer, 16 Bankr. 176 (Bankr. N.D. Tex. 1981), a creditor sought summary judgment on the bankruptcy trustee's claim of equitable subordination. The court summarized the provisions of the "remarkable loan agreements" between the creditor and the debtor, including the right to joint control of bank accounts, the right to designate one of the debtor's directors, the right to install a manager in the debtor's business with full veto powers, and the right to set officers' and directors'

answer is as true as it is unhelpful, but some guidelines can be articulated.

There are several major areas of the debtor's operation that a creditor can control or is likely to want to control: (1) the debtor's expenses, (2) the debtor's transfers to the controlling creditor (a subset of expenses), (3) the debtor's income, (4) the debtor's personnel, and (5) the debtor's production procedures. These areas are, of course, closely related, but interference in each area raises distinct issues.

Interference with the debtor's expenses is the clearest indication of control, since the avoidance of costs and the compensation of junior creditors is the primary focus of control liability. Certainly, a decision by the creditor that the debtor should, for example, substantially increase credit purchases from the trade creditors raises the inference that the controlling creditor hoped to enhance the value of the collateral at the expense of the suppliers. Similarly, a command to delay payments to trade creditors is also a cost increasing decision, and it should be relevant to a showing that the creditor is in control.

A creditor may well argue, however, that a decision to decrease the

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salaries. *Id.* at 189. In denying the creditor's motion for summary judgment, the court stated:

> [T]he extensive creditor control evidenced by the loan agreement suggests that the debtor corporations were mere instrumentalities or the alter ego of [the creditor]. If [the creditor's] actual control was as dominant as the consolidated loan agreements indicate, such fact pattern may satisfy the inequitable conduct element of the trustee's subordination claim . . . .

Id. at 190.

[64] In Douglas, *supra* note 23, at 727, the author suggested that although showing total control at every phase of the debtor's enterprise might not be necessary to justify control liability, showing control of both income and expense items should be a prerequisite. The reason that both income and expense categories are supposedly necessary is that by increasing prices or cutting costs the controlling party can build up reserves to absorb the loss resulting from the imposition of liability; the controlling party is thus in the best position to distribute the risk. *Id.* at 726-27.

That analysis may be flawed in two respects. First, even if the controlling party can affect nothing other than the expense side of the ledger by determining which of the unsecured creditors are to be paid, the unpaid trade creditors are no less injured than they would be if the controlling party had the authority to determine prices as well. Second, Douglas' risk distribution analysis seems to depend on the assumption that the cushioning loss reserves will be accumulated within the confines of the enterprise of the controlled party, the primary debtor. At least in the case of a controlling secured lender, however, the controlling party has a separate business and thus has the opportunity to establish loss reserves within the creditor's own enterprise without reference to any individual debtor's business.

debtor's costs, for example, to reduce credit purchases,[55] ought to militate against a finding of control liability. The flaw in that argument is that although decisions to reduce costs may be rational, they evidence control. Hence, they should not go to the issue of liability, but instead are a form of anticipatory mitigation of damages. It is possible that despite the rule of liability, some creditors will still weigh the costs and benefits and will decide to exercise control and bear the consequences nonetheless. Their decision to do so rationally, and not recklessly, should not provide an absolute shield against liability, especially when the decision has proved to be incorrect after the fact.

Interfering with the debtor's transfers to the controlling creditor also may justify finding control, depending on the frequency and magnitude of the interference. The receipt of a preferential payment or a voidable transfer alone may be insufficient. But a continuing series of massive transfers that strip the debtor of vital assets surely must be sufficient to trigger liability.[56] Just as interference with the debtor's costs can affect the magnitude of the controlling creditor's benefit, interference with the pattern of benefits received can cause the debtor to incur extraordinary costs to compensate for the removal of assets.[57]

Occasionally, the senior creditor may interfere with the debtor's income, by affecting prices, marketing policies, or asset management. If the controlling creditor demands that the debtor sell its product for cash at a lower price instead of on credit, this will build up bank accounts instead of receivables, at the expense of long-term revenue. If the creditor interferes with overall pricing policy or if the debtor is forced to sell off assets to raise cash,[58] the interference also may impair the debtor's financial health for the benefit of the controlling creditor. This conduct is particularly indicative of control if the acts in question are inconsistent with the acts of an unfettered debtor in a similar situation. The reason for according great weight to unnatural or aberrant decisions is not that they evidence misconduct. Instead, they provide relatively un-

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[55] *See, e.g.*, Buck v. Nash-Finch Co., 102 N.W.2d 84 (N.D. 1960). In *Buck*, the creditor's attempt to reduce the debtor's purchases on credit apparently was unsuccessful. The reason for the creditor's suggestion may in part have been to encourage the debtor to purchase inventory solely from the creditor and no other source. *Id.* at 87.

[56] *See, e.g.*, *In re* Process-Manz Press, Inc., 236 F. Supp. 333, 336-44 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966), *cert. denied*, 386 U.S. 957 (1967).

[57] *See, e.g.*, *id.* (transfers to the controlling creditor were mirrored by a concomitant increase in the debtor's outstanding unsecured accounts payable).

[58] *See, e.g.*, *State Nat'l Bank of El Paso*, 628 S.W.2d 661; *see also Krivo*, 483 F.2d at 1112.

ambiguous evidence of the exercise of control.

It is not unusual for a senior creditor to install key personnel on the debtor's premises.[59] The presence of the creditor's representative should give rise to the inference of control; a showing that the creditor's surrogate acted in a strictly advisory capacity could rebut the inference.[60] But the threat implicit in the surrogate's presence should not be dismissed lightly.[61]

The same analysis applies to the creditor's influence on the debtor's production procedures. For example, a creditor attempting to rescue a failing debtor by paying for an independent consultant to analyze the efficiency of the debtor's operation ought not, by that fact alone, be subjected to liability.[62] However, a pattern of frequent and intrusive

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[59] Typical of such cases is Chicago Mill & Lumber Co. v. Boatmen's Bank, 234 F. 41, 43-44 (8th Cir. 1916), in which the creditor's assistant cashier was "elected" president of the debtor. The *Chicago Mill* case is discussed *infra* notes 129-31 and accompanying text.

[60] In *Krivo*, 483 F.2d at 1110-12, the court of appeals affirmed a directed verdict in favor of the allegedly controlling creditor. The court held that although the creditor had installed its own auditor on the debtor's premises to monitor and to provide "a centralized control over purchases and disbursements," *id.* at 1111, the court could not conclude that his activities justified a jury verdict finding control. *Id.* at 1112. The auditor "had the final decision as to which creditors were paid," *id.* at 1111; the plaintiffs were unpaid, unsecured junior creditors. *Id.* at 1101.

[61] *See, e.g.*, Credit Manager's Ass'n v. Superior Court, 51 Cal. App. 3d 352, 124 Cal. Rptr. 242 (1975) (allegations that the lender's handpicked consultant intentionally drained away the debtor's assets).

[62] *See, e.g.*, Commercial Credit Co. v. L.A. Benson Co., 184 A. 236, 237-38 (Ct. App. Md. 1936). *See also* United States v. Mirabile, No. 84-2280, (E.D. Pa., Sept 6, 1985) (available Apr. 15, 1986, WESTLAW, DCT database). In that complex case, the United States sought to recover toxic waste removal costs from various parties. Among the defendants was Mellon Bank, the successor to one of the polluter's secured creditors. The secured creditor moved for summary judgment on the ground that its alleged control of the polluter/debtor was insufficient to justify imposing liability under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), 42 U.S.C. § 9601-9657 (1982).

Construing and applying 42 U.S.C. § 9601 (20)(A), the court held that there was enough evidence of control to preclude summary judgment. The court noted that loan officers of the allegedly controlling creditor served on the polluter/debtor's Advisory Board, which supervised the debtor's operations. United States v. Mirabile, No. 84-2280, slip op. at 12. Although one loan officer did no more than discuss the debtor's financial affairs, *id.* at 17-18, his successor on the Advisory Board (who was also one of the secured creditor's loan officers) monitored the debtor's cash collateral account, visited the debtor's premises weekly, determined the order in which the debtor filled customer orders, demanded additional sales efforts, insisted on manufacturing changes, and influenced reassignment of personnel. *Id.* at 18-20. In addition, an attorney for the secured creditor forced the debtor to accept day-to-day supervision by the president of

advice might support a finding of control.[63]

Although substantial control of any areas mentioned above would warrant concluding that the creditor exercised control, a harder question is presented if the creditor has interfered infrequently and insubstantially in several areas. Simply compounding these isolated events might yield a trivial sum. However, the pattern of intervention, while seemingly insubstantial, may have served to intimidate the debtor into anticipating and satisfying the creditor's desires without overt acts of control. The creditor's occasional interference might establish both the capacity for control and the creditor's willingness to exercise it if displeased. It also might establish both the debtor's awareness of the consequences of that displeasure and the debtor's willingness to comply with the creditor's explicit or implicit wishes. For example, a creditor using its power to exercise an occasional veto over the debtor's decisions may seem on the surface to be exercising little or no control over the debtor.[64] Yet the intimidated debtor may heed too well and anticipate the desires of the powerful creditor.[65] Thus, the mere threat[66] of con-

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one of the debtor's principal customers. *Id.* at 19-22. The denial of the motion for summary judgment apparently forced Mellon Bank to settle the case. *See* Andresky, *Cover Your Assets*, FORBES, Mar. 24, 1986, at 117-18.

[63] *See, e.g., Krivo*, 483 F.2d at 1110-14 (describing many instances of "advice" offered by the creditor).

[64] In Douglas, *supra* note 23, at 731, the author stated that veto power ought not be viewed as control:

> A right to veto prices fixed or costs which have been determined upon is at its best a clumsy device for getting into force any policy desired. For practical purposes it probably even falls short of a backhanded way of fixing prices or determining costs. Theoretically a thousand nays might be as effective as one yea. Actually business is not and could not be run that way. The use to which such veto can best be put, and for which it is devised, is a check over improvident judgments, unwarranted acts, flagrant abuses of trust, etc. As a day-to-day business regulator it fails.

That argument ignores the practical effect of the veto, however clumsy it may be. *See, e.g.*, Kirby v. Alcoholic Beverage Control Appeals Bd., 71 Cal. 2d 1200, 1204, 81 Cal. Rptr. 241, 244, 459 P.2d 657, 660 (1969) (the veto is "an ultimate control"); Yeng Sue Chow v. Levi Strauss & Co., 49 Cal. App. 3d 315, 322, 122 Cal. Rptr. 816, 820 (1975) (stock repurchase agreements enable remaining shareholders to "control the corporation by preservation of veto power"); *see also infra* note 65.

[65] Certainly, the occasional exercise of veto power is enough to engender a wary deference in the debtor's heart. In Koppers United Co. v. SEC, 138 F.2d 577 (D.C. Cir. 1943), mere deference was held to be an indicator of controlling influence. There, a group of corporations sought a declaration from the SEC under the Public Utility Holding Company Act that a parent/subsidiary relationship did not exist among them due to a lack of control. The circuit court affirmed the SEC's refusal to grant the requested relief. Although the alleged parent owned slightly less than 24% of the sub-

trol, although unexercised, may be tantamount to actual control:

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sidiary stock, *id.* at 579, the circuit court stated there was evidence to "furnish independent support for an inference that [the subsidiary's] management will probably defer to the wishes of [the parent] in matters of importance. This is quite enough to constitute a controlling influence, if not control." *Id.* at 580-81. *Accord* American Gas & Elec. Co. v. SEC, 134 F.2d 633, 642 (D.C. Cir.), *cert. denied*, 319 U.S. 763 (1943) (" 'controlling influence may as spring readily from advice constantly sought as from command arbitrarily imposed' " (quoting Manchester Gas Co., 7 S.E.C. 57, 62 (1940)).

Similarly, in Toolco-Northeast Control Case, 42 C.A.B. 822 (1965), Toolco, a major shareholder and primary creditor of an airline, sought a determination by the Civil Aeronautics Board that Toolco had effectively divested itself of control by placing control in the hands of a trustee. The Board held, however, that as a result of the continuing financial domination of the airline by Toolco, the airline's "management, exercising reasonable caution, will defer to Toolco's wishes since Toolco may be Northeast's only significant source of further financial aid." *Id.* at 827.

One caveat must be added: *Koppers*, *American Gas*, and *Toolco-Northeast* are all regulatory cases in which affirmative liability was not in issue. As a result, the adjudicatory body could afford to find the existence of control based on a showing of mere deference. Were damages at stake, the outcome might have been different.

[66] Unfortunately, "threat" is a value-laden word. It is used here in the sense of "promising to assert remedies unless the debtor modifies its conduct as requested." A threat need not be wrongful or made with an evil intent. In the ordinary course of business, a secured lender may be entirely right to "threaten" to foreclose upon a defaulting debtor. Put another way, to forbid all such "threats" would force foreclosures without notice or opportunity to cure.

On the other hand, a threat is often the functional equivalent of the actual exercise of control. For example, in the context of criminal law, the fear experienced by the victim as a result of threats is often treated as equivalent to the use of actual force by the criminal. As the court in People v. Reyes, 153 Cal. App. 3d 803, 200 Cal. Rptr. 651 (1984), observed, "[f]ear has two common meanings . . . . 'a feeling of alarm or disquiet caused by the expectation of danger . . . .' A second definition of fear is also relevant to this case because of the special relationship between defendant and the victims [his stepdaughters]: 'Extreme reverence or awe, as toward a supreme power.' " *Id.* at 810, 200 Cal. Rptr. at 655 (quoting AMERICAN HERITAGE DICTIONARY 480 (1981)).

In re Falstaff Brewing Corp. Antitrust Litig., 441 F. Supp. 62 (E.D. Mo. 1977), provides an example of alleged threats against a debtor. In a securities fraud action, the plaintiff alleged that a major lender caused the debtor to take various steps favoring the lender by threatening to declare a default and to accelerate the loans. *Id.* at 65. The court, "in spite of its doubts that the lender's efforts to secure their loans through various commercially acceptable methods would make them controlling persons" nevertheless held that the allegation of control, achieved partly as a result of the threats, was sufficient to withstand a motion to dismiss ("although possibly difficult to prove"). *Id.* at 68.

Although cases discussing creditor control liability under securities, tax, and other statutes may be of some value by analogy, it must be pointed out that control liability statutes may have been enacted precisely because common law theories of liability were perceived as inadequate to remedy the targeted ills. Thus, the statutorily based cases

> [T]he best technique [for affecting the outcome of a workout] is one which accomplishes creditor objectives *without* control. This is directly related to leverage, and the ability to convey to other parties the potential for exercise of the leverage without doing so. This may require a combination of diplomacy, negotiations, forceful action at times, and subtle action at other times. It may be necessary to convey to other parties a mood, a flavor, a nudge, all of which are designed to cause the bringing about of events that the creditor would like to have occur but which cannot be directed or ordered without a serious risk of liability.[67]

Thus, the creditor's apparent lack of frequent, pervasive, and substantial acts of control may not necessarily negate the showing of control. Admittedly, the inference of substantial domination from infrequent control ought to be drawn cautiously in light of the inherently

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must be read with caution. The securities cases have received a great deal of scholarly scrutiny. *See, e.g.*, Bartlett & Lapatin, *The Status of a Creditor as a "Controlling Person"*, 28 MERCER L. REV. 639 (1977); *Creditor Liabilities*, *supra* note 28, at 352-63; Enstam & Kamen, *Control and the Institutional Investor*, 23 BUS. LAW. 289 (1968); Gottesman, *Brokers' Derivative Liability: Does Supervision Make a Difference?*, 41 BROOKLYN L. REV. 181 (1974); Nash & Shapiro, *Control Relationships Under the Bank Holding Company Act*, 92 BANKING L.J. 618 (1975); Comment, *Vicarious Liability of Controlling Persons Under the Securities Acts*, 11 LOY. L.A. L. REV. 151 (1977); Note, *The "Controlling Persons" Liability of Brokers-Dealers for Their Employees' Federal Securities Violations*, 1974 DUKE L.J. 824.

[67] Rome, *The Business Workout — A Primer for Participating Creditors*, 11 U.C.C. L.J. 183, 202 (1983) (emphasis in original); *see also* Greene, *supra* note 21, at 102 ("Years ago the banks could say, 'Your Comptroller's an idiot, you've got to get rid of this guy.' Now he says, 'There seems to be some trouble in your comptroller's department, you should look at some things for possible change.' You hope he gets the idea." (quoting an attorney representing lenders)).

In *In re* W.T. Grant, 699 F.2d 599 (2d Cir. 1982), the court observed: "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." *Id.* at 610. Rejecting the claim of equitable subordination, the court stated that those seeking subordination

> must show not simply that the banks proferred advice to [the debtor] that was unpalatable to management, even advice gloved with an implicit threat that, unless it were taken, further loans would not be forthcoming. They must show at least that the banks acted solely for their own benefit, . . . and adversely to the interests of others.

Id. at 610-11.

The common thread running through the foregoing materials is that threats do not constitute control when the entity making the threats is entitled to take the threatened action in event of default. That position focuses, however, on the procedural legitimacy of the threatened punitive action to be taken by the threatening entity, rather than on the actual goal of the threat. Clearly, a lender can always threaten to foreclose. Equally clearly, the lender cannot threaten to foreclose in order to force the debtor to transfer control of the debtor's business to the lender.

ambiguous evidence. In appropriate instances this inference may help to solve the evidentiary problem of proving specific instances of control. In many cases the sole witnesses to specific acts of control are the creditor's employees and the debtor's chief executive officer, who is sometimes the debtor's primary shareholder (and therefore sometimes the sole remaining solvent guarantor of the debtor's obligations to the controlling creditor).[68] This further complicates the evidentiary problem because the most likely witnesses may have a strong interest in not recalling specific instances of control. Thus, the inference of domination may be a vital link in imposing control liability.

In summary, the court's evaluation of the quantum of control exercised by the senior creditor should be a dispassionate search for acts directly or indirectly affecting the debtor's expenditures or costs. It should not be a search for "wrongful" acts, "unreasonable" control conduct, or other similarly value-laden terms. The rule proposed in this Article is not a traditional tort standard premised on fault or direct causation. Instead, the focus should be on whether the creditor exercised a degree of control sufficient to enable the controller to realize a substantial benefit from the exercise of control itself. Whether any benefit was actually realized may be relevant but is not determinative; the issue is whether the creditor exercised control so as to create the opportunity for benefit, which therefore necessarily triggers the risk of attendant costs. Benefit without the exercise of control is insufficient, as explained earlier, as is control without the opportunity of benefit.

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[68] For examples of guarantors who tried to rescue themselves and their creditors at the expense of the primary obligors, see, *e.g.*, Bullard v. Aluminum Co. of Am., 468 F.2d 11 (7th Cir. 1972); Pennington v. Leff, 183 F. Supp. 884, 891 (S.D. Ala. 1960); *see also In re* Ludwig Honold Mfg., 46 Bankr. 125, 127 (Bankr. E.D. Pa. 1985):

> A significant portion of these loans [made to the debtor by the major creditor], if not all of them, were guaranteed by the debtor's sole shareholder and chief executive officer, Ludwig Honold ("Honold") and his wife. Since he was a guarantor, Honold, as chief executive officer of the debtor, often directed the debtor's assets toward the satisfaction of [the major creditor's] debt prior to the cancellation of other obligations.

In Koch, *Bankruptcy Planning for the Secured Lender*, 99 BANKING L.J. 788, 803 (1982), discussing preference liability under the Bankruptcy Code, the author asserted that "the granting of a personal guaranty creates an identity of interest between the guarantor and lender, virtually assuring that the insider guarantor will exercise his control over the debtor for the lender's benefit. Arguably, this amounts to vicarious control by the lender."

IV. To What Extent is Control Liability Consistent With Traditional Agency Theory?

If the rule of control liability proposed in this Article is consistent with traditional agency concepts, then control liability can be implemented judicially within the framework of existing common law. The central premise of this rule is that the exercise of control, which enables the controller to receive benefits, entails liability. That premise is roughly congruent with the definition of agency found in the Restatement (Second) of Agency: "Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act."[69]

A. The Problems of Consent and Intent

The first problem in applying the Restatement definition to creditor control[70] is that the control relationship does not grow out of an arm's-length consensual transaction by which the debtor freely transfers control to the creditors. An element of economic compulsion usually exists. Further, it is safe to say that it is almost never the intent of the parties to create an agency relationship, with its attendant web of rights, duties, and liabilities.

Those problems are more apparent than real. As comment b to section 1 of the Second Restatement of Agency explained:

> The relation which the law calls agency does not depend upon the intent of the parties to create it, nor their belief that they have done so. To constitute the relation, there must be an agreement, but not necessarily a contract, between the parties; if the agreement results in the factual relation between them to which are attached the legal consequences of agency, an agency exists although the parties did not call it agency and did not intend the legal consequences of the relation to follow.[71]

Similarly, even artfully disguised agency relationships are a source of liability.[72]

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[69] Restatement (Second) of Agency § 1(1) (1958). "The one for whom action is to be taken is the principal." *Id.* § 1(2). "The one who is to act is the agent." *Id.* § 1(3).

[70] Readers familiar with the Second Restatement of Agency will recognize that § 14(O) deals directly (albeit imperfectly) with the creditor control problem. *See infra* note 112.

[71] Restatement (Second) of Agency § 1(1) comment b (1958).

[72] Northern v. McGraw-Edison Co., 542 F.2d 1336, 1343 n.7 (9th Cir. 1976), *cert. denied*, 429 U.S. 1097 (1977); *accord* Drummond v. Hilton Hotel Corp., 501 F. Supp.

The central issue is control: "If, in practical effect, one of the parties has the right to exercise complete control over the operation by the other an agency relationship exists . . . ."[73] Curiously, virtually all cases and treatises focus exclusively on control as the test of agency, without discussing whether the agent had been acting both under the principal's control and on the principal's behalf, as is required by section 1(1) of the Second Restatement.[74]

Although all the cases recite the litany of control as the test of agency, they are not unanimous on whether the mere possession of a right to control is sufficient,[75] or whether it must actually be exercised: "A finding of the right to and/or the exercise of control is one essential to a determination of the existence of an agency relationship . . . ."[76] There is some disagreement as to whether control must be absolute or merely sufficient.[77]

In the simplest terms, therefore, the common law definition of agency is roughly consistent with the control theory described in this Article. Unfortunately, agency law has long been a fabric woven from puzzling doctrines[78] and sometimes seems to be a collection of result-oriented

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29, 31 (E.D. Pa. 1980) ("The mere fact that there is express denial of the existence of an agency relationship is not in itself determinative of the matter.").

[73] Nichols v. Arthur Murray, Inc., 248 Cal. App. 2d 610, 613, 56 Cal. Rptr. 728 (1967).

[74] It would be unusual for one party to exercise control over another solely on behalf of a third party. Thus, the rarity of the fact pattern giving rise to that issue may have led to sloppiness in the cases and literature. Perhaps the "on behalf" requirement is designed to exclude imposing agency liability upon business executives who control the conduct of corporate employees but do not stand to gain personally from the employees' efforts. If that is an accurate reading of the Restatement test, then "on behalf" might be read to mean "for the principal's potential benefit."

In that context, the liability of a party as a principal ought not turn on whether the principal in fact benefited by the agency but whether he stood to benefit by it. Much agency litigation arises from agencies gone awry; the lack of profitability and the resultant damage to innocent third parties should, if anything, serve to cement the principal's liability.

[75] *See supra* note 53.

[76] Southern Pacific Trans. Co. v. Continental Shippers Ass'n, 485 F. Supp. 1313, 1316 (W.D. Mo. 1980), *aff'd*, 642 F.2d 236 (8th Cir. 1981) (applying both agency law and Interstate Commerce Commission standards).

[77] *See supra* text accompanying notes 53-68 (discussion of cases dealing with the requisite quantum of control).

[78] In the first of two lecture-articles, Justice Oliver Wendell Holmes, Jr. set out to show that agency law was at times contrary to common sense and was composed of many fictions and anomalies. Holmes, *Agency: I*, 4 HARV. L. REV. 345 (1891). Holmes concluded the second article as follows:

> I think I now have made good the propositions which I undertook at the

labels.[79] It is not the purpose of this Article to expose the underpinnings of agency law; it is enough to show that the rule of control liability is not a departure from the common law and can therefore be adopted judicially.

B. The Problem of the Undisclosed Principal

A controlling creditor, besieged by claims that control has given rise to a principal-agent relationship, may well contend that the junior creditors contracted solely with the debtor. The controlling creditor may further argue that the junior creditors were unaware of the controlling creditor's alleged role as principal, and that they cannot now seek to make the controlling creditor party to the original contract. After all, identification of the parties to the contract is one of the contract's essential terms.

The answer to that argument is the anomalous doctrine of the undis-

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> beginning of this essay to establish. I fully admit that the evidence here collected has been gathered from nooks and corners, and that although in the mass it appears to me imposing, it does not lie conspicuous upon the face of the law. And this is equivalent to admitting, as I do, that the views here maintained are not favorites with the courts. How can they be? A judge would blush to say nakedly to a defendant: "I can state no rational ground on which you should be held liable, but there is a fiction of law which I must respect and by which I am bound to say that you did the act complained of, although we both know perfectly well that it was done by somebody else whom the plaintiff could have sued if he had chosen, who was selected with the utmost care by you, who was in fact an eminently proper person for the employment in which he was engaged, and whom it was not only your right to employ, but much to the public advantage that you should employ." That would not be a satisfactory form in which to render a decision against a master, and it is not pleasant even to admit to one's self that such are the true grounds upon which one is deciding. Naturally, therefore, judges have striven to find more intelligible reasons, and have done so in the utmost good faith; for whenever a rule of law is in fact a survival of ancient traditions, its ancient meaning is gradually forgotten, and it has to be reconciled to present notions of policy and justice, or to disappear.

Holmes, *Agency: II*, 5 HARV. L. REV. 1, 22-23 (1891) [hereafter Holmes II].

[79] In H. REUSCHLEIN & W. GREGORY, AGENCY AND PARTNERSHIP § 2 (1979), the authors state that, "Often, perhaps too often, liability depends upon classifying and labeling the persons involved . . . ." Some commentators, however, have attempted to rationalize the rules. *See, e.g.*, Douglas, *supra* note 23; Kornhauser, *An Economic Analysis of the Choice Between Enterprise and Personal Liability for Accidents*, 70 CALIF. L. REV. 1345 (1982); Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984).

closed principal.[80] Principals in an agency relationship fall into three groups. The principal may be disclosed (if she is known to third parties as the principal),[81] partially disclosed (if third parties know the agent is acting for someone else but do not know her identity),[82] or undisclosed (if third parties have no notice that the agent is acting for a principal).[83] In a typical creditor control case, in which outsiders are unaware of creditor control, the creditor is an undisclosed principal.[84]

An undisclosed principal is liable to third parties for the agent's contracts made in the course of the agency even though the agent has contracted in his own name.[85] Perhaps the reason for liability is that if the undisclosed principal could not be held liable for the agent's authorized acts, the principal would be able to accept those contracts later determined to be beneficial but could escape those that were not.

C. The Problem of Tort Liability

Thus far traditional agency law dovetails fairly well with the proposed control liability theory. The congruence ends, however, with the issue of the controlling creditor's liability for the debtor's torts. As explained earlier, there are good reasons why the controlling creditor ought to compensate tort victims injured during the control period.[86]

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[80] *See, e.g.*, Schiff, *The Undisclosed Principal: An Anomaly in the Laws of Agency and Contract*, 88 COMM. L.J. 229 (1983). Admittedly, the doctrine of the undisclosed principal is not aesthetically pleasing at first glance: "I assume that common-sense is opposed to allowing a stranger to my overt acts and to my intentions, a man of whom I have never heard, to set up a contract against me which I had supposed I was making with my personal friend." Holmes II, *supra* note 78, at 14. In the same vein, see H. REUSCHLEIN & W. GREGORY, *supra* note 79, § 95, at 158: "It is a basic principle of contract law that the identity of the parties is a term of the agreement. Thus it may be seen that the rule by which an undisclosed principal is made a party is quite inconsistent with the basic contract principle." The authors later add, "To say the least, the rules in this area reveal some delectable inconsistencies . . . . The rules governing the undisclosed principal have often been described as anomalous." *Id.* at 159.

[81] RESTATEMENT (SECOND) OF AGENCY § 4(1) (1958).

[82] *Id.* § 4(2).

[83] *Id.* § 4(3).

[84] The doctrine of the undisclosed principal must be carefully distinguished from apparent or ostensible agency. In the case of the undisclosed principal, there must be an actual agency even though third parties are unaware of it. In an apparent or ostensible agency, third parties must have a belief caused by the alleged principal that an agency exists, even though it does not. Associated Creditors' Agency v. Davis, 13 Cal.3d 374, 530 P.2d 1084, 118 Cal. Rptr. 772 (1975).

[85] Nels E. Nelson, Inc. v. Tarman, 163 Cal. App. 2d 714, 727, 329 P.2d 953, 959-60 (1958); *see also* RESTATEMENT (SECOND) OF AGENCY § 186 (1958).

[86] *See supra* text accompanying notes 45-47.

On the other hand, agency law may not permit tort liability in the usual creditor control case.

Under traditional agency theory, the principal's liability for the agent's torts depends on the degree of control that the principal is entitled to exert over the agent. If the agent's "physical conduct in the performance of the service is controlled or is subject to the right to control by the master," the agent is a servant,[87] and the master is usually liable for most of the agent's physical torts.[88] By contrast,

> [a]n independent contractor is a person who contracts with another to do something for him but who is not controlled by the other nor subject to the other's right to control with respect to his physical conduct in the performance of the undertaking. He may or may not be an agent.[89]

If the independent contractor is so independent as to be a nonagent, the party alleged to be a principal is not liable in any capacity.[90] If the agent is not a servant but is still subject to some control by the principal, the principal is liable for the agent's contracts made within the scope of the agency,[91] but not for the agent's torts.[92]

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[87] RESTATEMENT (SECOND) OF AGENCY § 2(2) (1958).

[88] *Id.* § 219.

[89] *Id.* § 2(3); Standard Supply Co. v. Reliance Ins. Co., 272 S.E.2d 394, 397 (N.C. App. 1980). Some courts seem to imply that independent contractor status and an agency relationship are mutually exclusive. *See, e.g.*, *Northern*, 542 F.2d at 1343 n.7; *Southern Pacific*, 485 F. Supp. at 1316. That taxonomy (which may be either mistaken or a minority view) may stem from worker's compensation cases, in which the issue is often simply whether the claimant is an employee (servant) or independent contractor. The tripartite taxonomy thus is not at issue in those cases, and the resultant analytical blurring may carry over to other cases as well. *See also* RESTATEMENT (SECOND) OF AGENCY § 14(n) comment a (1958).

The "independent contractor" rubric may give rise to another problem. Section 2(3) of the Second Restatement of Agency seems to imply that an independent contractor/agent must have actually contracted with the principal, as does § 14(n). *Id.* § 14(n) ("One who contracts to act on behalf of another and subject to the other's control except with respect to his physical conduct is an agent and also an independent contractor."). Comment b to § 1(1) states that the agreement between the principal and the agent need not rise to the dignity of a contract. Comment b gives the following example of noncontractual agency: "Thus, when one who asks a friend to do a slight service for him, such as to return for credit goods recently purchased from a store, neither one may have any realization that they are creating an agency relation . . . ." *Id.* § 1(l) comment b. The relationship created in the example appears to be an independent contractor/agent relation under § 2(3) rather than a master/servant relationship under the more stringent § 2(2), even though there is no actual contract between the friends.

[90] With some exceptions; *see, e.g.*, RESTATEMENT (SECOND) OF AGENCY §§ 212-14 (1958).

[91] *Id.* § 140.

[92] *Id.* §§ 250-51. In support of the idea that the requirements for tort liability are

In the context of creditor control, the tripartite taxonomy of servants, independent contractor-agents, and independent contractor-nonagents may mean that the tort victims[93] of a controlled debtor cannot seek recovery from the controlling creditor. This results because the control relationship will rarely, if ever, be a master-servant relationship. Few creditors will immerse themselves so deeply into the debtor's business that they exercise actual physical control. The controlling creditor may be able to characterize the relationship as an "independent contractor-agency" and thereby avoid compensating the debtor's tort victims.

Although the exclusion of tort victims would seem doctrinally correct under traditional agency theory, it is poor policy in the creditor control context. There are many good reasons for affording recovery to the controlled debtor's tort victims.[94] These reasons apply with equal force

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more stringent than those for agency and contract liability, see, *e.g.*, A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285, 294 (Minn. 1981) (holding that it was not reversible error to give a jury instruction on a principal's liability in tort when case involved contract liability because the tort standard was more stringent than the contract standard; hence the error favored the appellant who was still found liable under the more stringent standard).

[93] For present purposes, the primary inquiry is whether people physically injured by the debtor's business operations ought to be able to recover from the controlling creditor. If they are so entitled, it would follow that victims of the debtor's nonphysical torts should also be able to seek relief from the controlling creditor because those torts are more likely to have been committed in order to obtain a commercial advantage for the debtor.

[94] *See supra* text accompanying notes 45-47. The real reasons underlying the master's liability for his servant's torts are not entirely clear. The Second Restatement of Agency's explanation is noteworthy primarily because it explains so little:

> [I]t may be said that a servant is an agent standing in such close relation to the principal that it is just to make the latter respond for some of his physical acts resulting from the performance of the principal's business.
>
> The conception of the master's liability to third persons appears to be an outgrowth of the idea that within the time of service, the master can exercise control over the physical activities of the servant. From this, the idea of responsibility for the harm done by the servant's activities followed naturally. The assumption of control is a usual basis for imposing tort liability when the thing controlled causes harm. It is true that normally one in control of tangible things is not liable without fault. But in the law of master and servant the use of the fiction that "the act of the servant is the act of the master" has made it seem fair to subject the non-faulty employer to liability for the negligent and other faulty conduct of his servants. It is probably true that before the nineteenth century the master was not normally responsible for the uncommanded acts of the servant, at least for those which did not enure to the master's benefit. However, with the growth of large enterprises, it became increasingly apparent that it would be unjust to permit an employer to gain from the intelligent cooper-

whether or not the creditor has exercised a "master-servant" level of control.

The thrust of the argument for the proposed rule is that control and consequent attempts to gain extra benefits give rise, directly or indirectly, to the debtor's costs. By contrast, the reason for the distinction between the master's liability for the servant's torts and the principal's nonliability for the nonservant-agent's torts is the perception that the master has substituted the servant's conduct for her own and thus should be liable in tort. Whether that distinction makes sense in the broader area of agency law is arguable.[95] However, it makes no sense if one accepts the arguments for creditor control liability. Therefore, under traditional agency law this issue poses a significant problem. If it is really necessary to force the creditor control theory into the Procrustean bed of agency law, then tort liability may have to be lopped off, as were the feet of Procrustes' taller victims.

Disregarding the problem of tort liability, however, it would seem to be fairly easy to apply agency law to the typical creditor control fact pattern. It is surprising, therefore, that so few courts or litigants have done so.[96]

V. To What Extent Does Precedent Validate or Conflict with the Rule of Control Liability?

Although no court has expressly held that a controlling creditor is liable for its debtor's obligations solely as a result of the exercise of

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> ation of others without being responsible for the mistakes, the errors of judgment and the frailties of those working under his direction and for his benefit. As a result of these considerations, historical and economic, the courts of today have worked out tests which are helpful in predicting whether there is such a relation between the parties that liability will be imposed upon the employer for the employee's conduct which is in the scope of employment.

RESTATEMENT (SECOND) OF AGENCY § 219 (l) comment a (1958). In essence, the preceding passage states that it seems just, natural, and fair to impose liability. For possible explanations of why liability may be just, natural, fair, and efficient, see Calabresi, *supra* note 32; Kornhauser, *supra* note 79; Sykes, *supra* note 79. For descriptions of more conventional rationalizations for vicarious liability, see J. HYNES, AGENCY AND PARTNERSHIP 48-51 (2d ed. 1974).

[95] *See, e.g.*, Calabresi, *supra* note 32. Dean Calabresi compellingly argues that enterprises ought to bear the inevitable costs of their operations. It would seem to follow that a principal should bear the inevitable costs of her enterprise, whether or not she conducts it herself or through her agent. If the principal directly manages the enterprise instead of using a surrogate, the odds of torts occurring remain the same.

[96] *See* cases discussed *infra* text accompanying notes 97-227.

control, several decisions hint at this result under agency law and other theories. The following examination of the case law is intended to accomplish two results. First, this discussion shows that the control liability theory proposed by this Article is not wholly unprecedented and therefore may be implemented judicially. Second, the discussion shows that those cases which superficially seem to cut against the control theory are either inapposite or unpersuasive.

A. The Agency Cases

A few decisions discuss the possibility of a controlling creditor becoming the debtor's principal, the most useful of which is *A. Gay Jenson Farms Co. v. Cargill, Inc.*[97] In *Cargill*, the Minnesota Supreme Court affirmed a jury verdict in favor of eighty-six farmers who had sued a major grain dealer on the theory that the dealer had controlled its debtor, a grain elevator, and thereby had become the elevator's undisclosed principal.[98] The grain elevator was primarily in the business of purchasing grain from local farmers and reselling it.[99] In 1964, after the elevator had been in business for some time, it applied to Cargill for financing.[100] Cargill agreed to provide the financing. In return, the elevator agreed *inter alia* to give Cargill the right of first refusal to purchase some of the elevator's grain.[101] In 1967, the original agreements were amended to include various ordinary clauses requiring the debtor to make certain financial reports and records available to the secured creditor, prohibiting major expenditures without the creditor's consent, and prohibiting further encumbrances or stock transactions without the creditor's consent.[102] At that time, the Cargill officer in charge of the debtor's account received an internal memorandum stating that the elevator " 'needs *very strong* paternal guidance.' "[103] In 1970 and 1971, the elevator agreed to act as Cargill's agent in growing, packaging, and selling seeds.[104]

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[97] 309 N.W.2d 286 (Minn. 1981), *noted in* 58 N.D.L. REV. 835 (1982); 32 U. KAN. L. REV. 497 (1984).

[98] 309 N.W.2d at 288.

[99] *Id.*

[100] *Id.*

[101] *Id.* The fact that the elevator was also its creditor's supplier may skew the analysis slightly, since the relationship was more than merely debtor/creditor.

[102] *Id.*

[103] *Id.* at 288-89 (emphasis in original).

[104] *Id.* at 289. Although the court implicitly held that the existence of an express agency in one context (the sale of seeds) was not relevant to the existence of an unrelated implied agency in another (the purchase of grain), *id.* at 294, it was unnecessary

During the life of the debtor-creditor relationship, Cargill took the following steps, among others, indicative of control. Cargill made a number of suggestions about day-to-day operations, which were not implemented.[105] Cargill began to contact the elevator daily.[106] Cargill's headquarters told its regional office that Cargill had the right to make critical decisions on the use of the elevator's funds.[107] When the elevator began to have serious financial problems, Cargill told several worried farmers that there would be no problem with payment.[108] Finally, Cargill sent an officer to supervise the final days of the debtor's operation.[109]

The court first stated that agency results from the manifestation of consent by one person that the other shall act on his behalf and be subject to his control, with consent by the other so to act.[110] The court then held that

> [b]y directing [the elevator] to implement its recommendations, Cargill manifested its consent that [the elevator] would be its agent. [The elevator] acted on Cargill's behalf in procuring grain for Cargill as the part of its normal operations which were totally financed by Cargill. Further, an agency relationship was established by Cargill's interference with the internal affairs of [the elevator], which constituted de facto control of the elevator.[111]

Citing the Second Restatement of Agency,[112] the court listed the factors

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to mention the seed agency. The jury possibly may have improperly linked the two transactions, thus further distinguishing this case from the archetypal lender control model and weakening the precedential value of the case. There is some evidence of cross-contamination. The trial judge himself ruled that Cargill was a disclosed principal, *id.* at 290, and the appellate court in effect rescued the decision by holding that Cargill's liability would have been the same whether it was deemed a disclosed or undisclosed principal. *Id.* at 293.

[105] *Id.* at 289 n.4.

[106] *Id.* at 289.

[107] *Id.* The opinion does not indicate directly that Cargill's view of its rights had been communicated to the debtor, but it is at least evidence of Cargill's intent.

[108] *Id.* Once again, the element of direct misrepresentation to the unsecured creditors is outside the scope of the classical control model, in which the controlling creditor remains entirely behind the scenes.

[109] *Id.*

[110] *Id.* at 290-91.

[111] *Id.*

[112] *Id.* RESTATEMENT (SECOND) OF AGENCY § 14(O) (1958) states: "A creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business." Comment a to § 14(O) states:

> A security holder who merely exercises a veto power over the business acts

indicating Cargill's control. These included the various recommenda-

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

Id. § 14(O) comment a.

The rule proposed in this Article differs from § 14(O) in form, content, and purpose. The Restatement seems to require that the control be "for the mutual benefit of [the creditor] and his debtor." However, that language sounds more like a partnership arrangement than a pre-insolvency salvage plan in which the creditor's primary (if not exclusive) goal is enhancement of the collateral or reduction of the debt. Often, the control assumed is not even potentially for the benefit of the debtor, except to the extent that any reduced indebtedness may indirectly benefit the debtor. The requirement of "mutual benefit" is also odd because agency law does not require it. In contrast, the rule proposed in this Article is based on the idea that potential benefit to the controlling creditor is both the motivation for control and the justification for liability (because of the concomitant costs inevitably engendered). Actual benefit, either to the creditor or the debtor, is not required.

The standard proposed in this Article also differs from the Restatement in that the Restatement says that a controlling creditor "may" become the debtor's principal. One may read the word "may" as lawyerlike circumlocution, or as meaning that the creditor cannot become the principal, despite control. If the latter were the intended meaning, the Restatement fails to say when or why a controlling creditor escapes agency liability. The standard proposed by this Article is unequivocal: control yields liability for the debtor's debts.

This Article is also at odds with comment a to § 14(O). As noted earlier, the exercise of the veto power may indicate creditor control. Comment a disagrees, without giving any reason for that position. More crucially, comment a implies that a creditor will not be liable unless the creditor directly intervenes in the making of the debtor's contracts. There are at least two flaws in that position. First, as noted earlier, there are various ways in which the creditor can exercise control; contracting is only one of them. Second, agency law does not require that the agent be a mere puppet or pawn of the principal before liability will attach; it is unnecessary to show the principal has directly caused the agent to take the act that forms the basis of the plaintiff's claim against the principal. The plaintiff need only show that the obligation was incurred within the scope of the agency relationship. The notion that a principal is not liable unless she directly causes the agent to incur each debt is wholly unsupported by precedent or policy. Finally, comment a to § 14(O) suggests that once control is assumed, the creditor/principal is liable for debts incurred "thereafter." By contrast, the proposed control liability rule would encompass certain precontrol debts as well. *Accord* Save Way Oil Co. v. Mehlman, 496 N.Y.S.2d 537 (A.D. 1985); *see supra* text accompanying notes 48-49. Restatement § 14(O) was cited in Plymouth Rock Fuel Corp. v. Leucadia, Inc., 100 A.D.2d 842, 474 N.Y.S.2d 79, 81 (N.Y. App. Div. 1984), which held that a mortgagee,

tions made to the elevator, the right of first refusal, the affirmative and negative covenants regarding financial disclosures and stock transactions, Cargill's internal communications showing intent to control, and Cargill's financial dominance.[113] The court held that Cargill's reason for financing the elevator "was not to make money as a lender but, rather, to establish a source of market grain for its business."[114]

The presence of the buyer/supplier relationship significantly complicates the creditor/debtor analysis in the case,[115] diluting its precedential value. However, *Cargill* stands for the proposition that a creditor exercising control may be held liable as the debtor's undisclosed principal. The case is particularly important because the creditor's liability was not grounded primarily upon proof of actual misconduct.[116]

The opinion, however, has a few troubling features. Particularly questionable is the court's emphasis on the creditor's unimplemented recommendations and on the innocuous financial reporting covenants included in the agreements. Unless one can infer that the debtor somehow deferred to the creditor's unimplemented recommendations, it is hard to see how these show control. Further, the mere existence of fi-

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Talcott, was liable for certain of the mortgagor's obligations, because "[the mortgagor and his employees] were in constant communication with Talcott, and all of their expenditures have been subject to Talcott's approval. Talcott has drawn all checks and made all disbursements on account of expenses incurred in the operation of the properties and has even paid [the mortgagor's] payroll account."

Although the court's application of § 14(O) seems straightforward, the fact pattern is somewhat unusual for two reasons: First, the mortgagee's control appears to have been exercised over a period of 10 years following the mortgagor's initial default. *Id.* at 80-81. Second, although the plaintiff (an unpaid fuel supplier) may not have been aware of the full extent of the control by the mortgagee, at the time the debt was incurred the plaintiff was aware that the mortgagee was paying the mortgagor's bills. *Id.* at 80. Thus, the plaintiff's reliance on the mortgagee's payments might have created a basis for recovery independent of the § 14(O) theory, although the court did not discuss that issue.

[113] 309 N.W.2d at 290-91.

[114] *Id.* at 293. The court seems to imply that some type of ulterior motive is required to make a lender liable for control. As discussed earlier, under ordinary agency principles, a "dual motive" test would not make sense. Control alone is sufficient.

[115] The court explicitly noted: "There was a unique fabric in the relationship . . . which varies from that found in normal debtor-creditor situations." *Id.* at 293; *see also* Butler v. Bunge Corp., 329 F. Supp. 47 (N.D. Miss. 1971), another grain elevator case in which the entanglement of the creditor/supplier and debtor/purchaser was far more extensive than in *Cargill*.

[116] On the other hand, perhaps the court's emphasis on the dual relationship (debtor/creditor and buyer/supplier) indicates that the court felt that the creditor attempted to reap an unfair advantage, a species of misconduct.

nancial reporting covenants does not enable the creditor to dictate the debtor's policy. If a creditor actually manages the debtor's affairs, as Cargill apparently did, that is another matter. However, facts that alone carry no weight can add little to the overall determination.

Even more disturbing is the court's mishandling of agency law. Although the court found liability in this case, it did so by a circuitous and erroneous route. By holding that the creditor was liable because it sought a collateral benefit in its dual role as lender and supplier, the court implicitly adopted a more stringent test of liability than agency law requires. Agency theory does not require that the alleged principal both control the agent and seek a side benefit.[117] All that is necessary is control on the principal's behalf.[118] Thus, a creditor in control of its debtor should be held as the debtor's principal, even if the creditor is simply a creditor, that is, not also a supplier or customer. In the court's defense, it must be noted that the odd fact pattern of the case may have led the court into doctrinal error; rigorous analysis was not required because the facts were so egregious.

In contrast to *Cargill*, several opinions hold against agency liability on fairly similar facts. In *Buck v. Nash-Finch Co.*,[119] a wholesale supplier of grocery items financed one of its supermarket customers.[120] The creditor/supplier insisted on the debtor's use of the creditor's own accountant to prepare the debtor's financial reports and to countersign the debtor's checks.[121] The creditor's representatives visited the debtor weekly to give advice,[122] installed a "store manager" on the debtor's premises,[123] discouraged buying from sources other than the creditor,[124] and demanded the firing of certain employees.[125] When the supermarket ceased operation, the unpaid unsecured creditors sought relief from the financing creditor. The trial court awarded judgment to the plaintiffs.[126] However, the North Dakota Supreme Court reversed, holding that although evidence existed of an assumption of creditor control in

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[117] *See supra* text accompanying notes 69-79.

[118] *See id.*

[119] 102 N.W.2d 84 (N.D. 1960).

[120] *Id.* at 85.

[121] *Id.*

[122] *Id.* at 86.

[123] *Id.* The debtor understood that failure to accept the creditor's selection would result in foreclosure. The creditor's credit manager used the term "store manager." *Id.*

[124] *Id.* at 87.

[125] *Id.*

[126] *Id.* at 84.

certain phases of the debtor's business,[127] the "clear preponderance of the evidence is against the finding of an implied mutual agreement that [the debtor] would act under the control and supervision of [the creditor] in his purchases of merchandise."[128]

The facts of *Buck*, including the dual role of the creditor/supplier, parallel *A. Gay Jenson*. In some respects *Buck* presents a stronger case for liability (for example, the interferences with personnel). While both cases cite and discuss Restatement section 14(O), and a few superficial distinctions can be made between them, the cases are probably inconsistent. *Buck*, however, is less doctrinally sound than *Cargill*. *Buck* holds that the creditor cannot be liable under an agency theory unless the creditor exercised control over the precise activity giving rise to the plaintiff's claim (in *Buck*, the purchase of merchandise). Just as *Cargill* may have erred in requiring a "dual capacity" relationship, the *Buck* court's requirement of direct and narrowly focused control is contrary to established agency law. Once the fact of sufficient control has been established, any act of the agent within the scope of the agency may be imputed to the principal. By requiring minutely particularized control as a precondition of liability, the *Buck* court has blurred the distinction between master/servant relationships, which involve tight control, and ordinary agency.

Chicago Mill & Lumber Co. v. Boatmen's Bank[129] is another agency case that cuts against controlling creditor liability as the debtor's principal. However, the opinion is riddled with analytical error and should not be permitted to impair agency theory in the creditor control context. In *Chicago Mill*, the creditor went so far as to cause the transfer of management and ownership of the debtor.[130] Nevertheless, concluding

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[127] *Id.* at 89-90.

[128] *Id.* at 91. Curiously, the court does not explain why control of the purchasing phase of the business was essential to liability, although the plaintiffs were unpaid sellers of merchandise. *Id.* at 84. The court seems almost to have adopted a mosaic or compartmentalized theory of agency, in which the principal is liable only for those portions of the debtor's conduct over which the principal exercised control. The usual threshold test holds the principal liable, once having assumed control, for all of the agent's acts except those clearly beyond the scope of the agency. This reversal of the usual presumptions of agency liability almost approaches direct liability because it places the burden of proof on the plaintiff.

[129] 234 F. 41 (8th Cir. 1916).

[130] *Id.* at 43-46. In *Chicago Mill*, a bank that loaned money to a lumber mill became dissatisfied with the mill's management. *Id.* at 43. The bank arranged a transfer of ownership and management from one shareholder to another, and installed its own assistant cashier as president of the debtor, and picked another person to be the debtor's general manager. *Id.* at 43-44. The new shareholder transferred one-third of his shares

that the creditor's conduct was "a legitimate and customary practice," the Eighth Circuit held that the almost complete usurpation of control did not give rise to agency liability.[131] Taken literally, *Chicago Mill* seems to stand for the proposition that a controlling creditor should not be liable unless it virtually executes an express agency agreement with the debtor. Thus, *Chicago Mill* is such a great departure from traditional agency law that it should be given no weight.

Not all cases denying affirmative agency liability for creditor control reach questionable results, although most do contain odd reasoning. In *Wasilowski v. Park Bridge Corp.*,[132] a factor (accounts receivable financier) made payments directly to the debtor's subcontractors[133] and

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each to the new president and the new general manager. *Id.* at 44. Representations were made to various people that the bank was in control of the mill. *Id.* The debtor's new president (the bank's former assistant cashier) conferred frequently with the bank's president. *Id.* Finally, the new owner of the mill took no part in the debtor's affairs. *Id.*

After the debtor's bankruptcy, one of the debtor's unsecured creditors sought to hold the bank liable for the debtor's obligations. *Id.* at 44-55. The unsecured creditor's claim was raised as a counterclaim to the bank's action on a note given by the unsecured creditor to the mill and held by the bank as security. *Id.* The appellate court affirmed a directed verdict against the unsecured creditor, holding first that it was "of little importance" that the bank may have paid for the transfer of the shares from the old owner to the new one, since the new owner also gave his own consideration for the stock. *Id.* at 45. Second, the court held that there was nothing odd about the owner's gift of two-thirds of the stock to the new officers picked by the bank since "it is a very common thing in business to stimulate the zeal of employes [sic] by giving them an interest in the business." *Id.* Third, the court held that the bank's injection of its employee into the debtor's business did not constitute control because "the bank was a large creditor, and as such largely interested in the prosperity of the company, and most naturally should desire to keep an oversight over its doings." *Id.* at 45-46. Fourth, the court held that the admissions of the bank's president were not enough to support a finding of intent to control. *Id.* at 46. Finally, the court held that the statements of the debtor's president (the bank's assistant cashier) that the debtor's "property was to be run by the bank" and that he was " 'in charge . . . of the property in order to protect the bank's interest,' " *id.* at 44, were "manifestly so outside the general usage, custom, and course of dealing of banks and banking as to fall without the scope of his employment as assistant cashier . . . ." *Id.* at 46. Ironically, this latter observation came in the paragraph after the court had held that the act of installing the cashier as the debtor's president was a natural outgrowth of the bank's desire to maintain oversight. Other than citing cases for the proposition that a corporation that controls another is responsible for the latter's debts, *id.* at 45, the court cited no authority to support its decision. *Id.* at 46.

[131] *Id.*

[132] 156 F.2d 612 (2d Cir. 1946).

[133] *Id.* at 614.

sought to take over the debtor's affairs,[134] but was prevented by the debtor.[135] The debtor agreed to the factor's "complete supervision,"[136] but the opinion contains no evidence of the actual exercise of creditor control. The Second Circuit reversed a jury verdict in favor of an unpaid subcontractor on the grounds that no control was exercised. The court also held, however, that unless complete control is assumed by the creditor, the debtor-creditor relationship cannot be translated into an agency relationship:

> [T]his change in relationship does not occur so long as the party whom the factor was financing retains any interest in the contract and has not abandoned its completion . . . . If the party who was being financed retains an interest in the profits or losses which may result from completing the contract, pro tanto he will not be the factor's agent but will be acting for his own account.[137]

Arguably, the circuit court's statement that the debtor's retention of any control negates an agency relationship is dictum, as the debtor in *Wasilowski* retained total control. The statement is troubling nonetheless. It seems to be a rejection of the Restatement's tripartite taxonomy of servant, independent contractor-agent, and non-agent, in favor of a two-level analysis: either the alleged agent is totally controlled (a servant), or else she is not an agent at all.[138]

The other troubling aspect of *Wasilowski* is its implication that the debtor's retention of any interest in the profits negates an agency relationship. First, Restatement section 14(O) states that the creditor and debtor may mutually benefit during the course of the agency relationship.[139] Second, the debtor's purported interest in profits is more apparent than real when, as is often the case, the debtor's accounts receivable are fully encumbered, the debtor is in default, the debtor is deeply insolvent, and the secured creditor is undersecured. In that situation, the only party realizing a benefit from the debtor's "profit," which in this context must mean the markup on goods sold, would be the secured creditor (because of the appreciation, if any, of the collateral).[140] To say that the debtor under those circumstances has an interest in the "prof-

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[134] *Id.* at 614-15.

[135] *Id.* at 615.

[136] *Id.*

[137] *Id.* at 614.

[138] For a discussion of the three levels of agency and their consequences, see *supra* text accompanying notes 87-95.

[139] RESTATEMENT (SECOND) OF AGENCY § 14(O) (1958). The text of § 14(O) appears *supra* note 112.

[140] *See supra* text accompanying notes 21-27.

its" is to distort the meaning of the term.[141]

In another agency case, *Commercial Credit Co. v. L.A. Benson*,[142] an unpaid supplier of a manufacturing firm sought to hold the manufacturer's lender liable for the manufacturer's debts on the theory that the lender was an undisclosed principal. Reversing a jury verdict for the plaintiff, the Maryland court of appeals noted that the lender had installed two representatives on the insolvent debtor's premises to oversee materials ordering, purchases, and expenditures.[143] However, the court held that no agency resulted because the consultants' services "were rendered in an advisory, co-operative, and consulting capacity, with no actual authority on their part to compel obedience to their orders . . . ."[144] The court later added: "The [lender's] act of . . . placing its representatives at the plant of its debtor reflected only the natural instincts, interest, and solicitude of any other creditor then in its position . . . ."[145]

Because there were no other indicia of control in the case, the court may have reached the right result. Yet one must challenge the court's implication that a creditor's "suggestions" cannot constitute control. As other authorities have noted, a gentle word from the senior creditor to an insolvent debtor may be spoken as a whisper but heard as a shout.[146] The court also referred to the lender's "natural instincts," to show that no control existed. That reasoning is questionable given some of the cases examined above.

Ford v. C.E. Wilson & Co.[147] is another agency case in which a lender installed its representative on the debtor's premises.[148] When an unpaid supplier of the debtor sought to hold the lender liable for the debtor's obligations, the Second Circuit affirmed a directed verdict for the lender. The circuit court acknowledged that the representative took possession of part of the debtor's premises, set up a special account for

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[141] That is not to say, however, that the term, as used colloquially, is used rigorously. *See, e.g.*, Calabresi, *supra* note 32, at 500 n.4.

[142] 184 A. 236 (Md. App. 1936).

[143] *Id.* at 238.

[144] *Id.* at 239. The court relied heavily on testimony of the debtor's president to reach this conclusion. *Id.* The debtor's primary shareholders often are liable to the lender on personal guaranties (although there is no indication that was true in *Commercial Credit*); thus, testimony favorable to the lender by one personally in debt to the lender may occasionally be tainted. *See also supra* text accompanying note 68.

[145] 184 A. at 240.

[146] *See supra* text accompanying notes 64-67.

[147] 129 F.2d 614 (2d Cir. 1942).

[148] *Id.* at 615.

the debtor's proceeds, and countersigned checks used to pay bills.[149] Yet the court held *inter alia* that the lender did not exercise enough control to become the debtor's coprincipal or partner: "It merely installed an agent in a part of [the debtor's] premises to protect its security. This was necessary under the rule of *Benedict v. Ratner* . . . in order to insure preservation of its lien."[150]

The court is certainly correct in stating that mere oversight of the collateral is not equivalent to control. But the real value of the case is in its reference to *Benedict*[151] as a justification for tight supervision of the debtor. *Benedict* held, in effect, that as against other creditors, a secured creditor could not enforce a secret lien on the debtor's property when the debtor had been given unfettered dominion over the collateral; the underlying theory was that the debtor might thereby mislead junior creditors into believing that the property was not encumbered.[152] Article 9 of the Uniform Commercial Code, with its emphasis on record notice in lieu of physical possession, was designed in part to free creditors from the *Benedict* burden of overpolicing their debtors.[153] To the extent, therefore, that the justification for overpolicing was removed by the enactment of Article 9, a creditor seeking to avoid control liability can no longer claim that the law of secured transactions mandates control. Those cases predating the enactment of the Uniform Commercial Code that characterize control as "natural" are therefore questionable because they are implicitly premised upon the now-repudiated *Benedict* rule.[154]

Together, the agency cases, particularly recent ones, demonstrate several things. First, they hint at a rational standard of liability based primarily on the cold facts of control rather than more subjective notions of misconduct. Second, they show the potential for injury to unsecured creditors when a senior creditor takes control. Third, they show that the control liability theory is not completely without precedent. Finally, their lack of careful reasoning and absence of policy analysis demonstrate the need for a more explicit, rational standard of creditor control liability.

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[149] *Id.*

[150] *Id.* at 617 (citing Benedict v. Ratner, 268 U.S. 353 (1925)).

[151] 268 U.S. 353.

[152] *Id.* at 363.

[153] *See, e.g.*, U.C.C. § 9-205 comment 1 (1977).

[154] For a discussion of *Benedict*, see, *e.g.*, Note, 39 HARV. L. REV. 253 (1925).

B. Partnership and Joint Venture Cases

The partnership and joint venture cases also point to a control standard for liability. For example, in some cases, unpaid junior creditors have attempted to assert that the debtor's controlling creditor should be liable as the debtor's partner.[155] Those cases are valuable because they both support the agency precedent by analogy and provide independent precedent for creditor liability. Many of the creditor-as-partner cases arise in the context of extrajudicial creditors' arrangements, extensions, compositions, or assignments for the benefit of creditors, in which the creditors' claims are often compromised in exchange for various promises from the debtor.[156]

In *Purvis v. Butler*,[157] a fish broker agreed with three of his secured creditors that one of them would "have entire and sole control of the finances" of the debtor's business for a period of four years, during which the profits would be used to pay down all of the secured debt.[158] The other two creditors were given the right to examine the financial records of the business.[159] The managing creditor made representations to some fishermen that the creditors had formed a company engaged in the fish industry.[160]

When the business collapsed, the fishermen sued one of the inactive creditors on the theory that he had become a partner of the business by virtue of the agreement with the debtor. The trial court directed a verdict for the inactive creditor. The Michigan Supreme Court reversed, holding that all three of the secured creditors, and not just the creditor in control, were liable for the value of the fish purchased:

> [T]he parties who had advanced and who agreed that they would advance money for the business were to receive and apply the profits in liquidation

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[155] Arguably, the creditor-as-partner cases should be considered together with the creditor-as-principal cases, as partnership may be described as a mutual agency. *See, e.g.*, Uniform Partnership Act § 9. Partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit." Uniform Partnership Act § 7. The creditor as joint venturer cases are considered together with the partnership cases, because joint ventures are very similar to partnerships. Shinn v. Edwin Yee, Ltd., 57 Haw. 215, 219, 553 P.2d 733, 736 (1976).

[156] *See, e.g.*, Shapiro, *Assignments for the Benefits of Creditors*, in CALIFORNIA REMEDIES FOR UNSECURED CREDITORS 429-66 (1957); *see also* Poscover, *The Business in Trouble — A Workout Without Bankruptcy*, 39 BUS. LAW. 1041 (1984) (an entertaining and informative simulation of workout negotiations).

[157] 87 Mich. 248, 49 N.W. 564 (1891).

[158] *Id.* at 251-52, 49 N.W. at 564-65.

[159] *Id.* at 251, 49 N.W. at 565-66.

[160] *Id.* at 256, 49 N.W. at 566.

> of the indebtedness to them; in other words, for a series of years they were to receive the whole avails of the business . . . . This gave to the parties the entire proprietorship of the business, and rendered them liable as partners . . . .[161]

This reasoning is somewhat conclusory; the opinion also contains unexplained references to liability based on the inactive creditor's "implied contract."[162] Further, one statement by the court, read literally, seems to mean that almost every creditor participating in a composition might thereby be deemed a partner: "Here was a community of interests, an enterprise in which the secured indebtedness of the second and third parties and the labor and business of the first party were embarked as capital, and the profits arising were to be shared and applied to a definite purpose."[163]

The one factor distinguishing the *Purvis* creditors' arrangement from the norm was the debtor's yielding of control to the creditors. Had the defendant been the managing creditor, liability would have been much clearer. To read *Purvis* as holding liable all creditors involved in compositions as the debtors' partners is to take the case far beyond any limits of liability set in the agency cases.

The control issue was the key to *Minute Maid Corp. v. United Foods, Inc.*[164] In *Minute Maid*, a supplier unsuccessfully sought to hold a purchaser's creditor liable for unpaid debts on a partnership theory. On appeal of the adverse trial court judgment, the Fifth Circuit reversed. The supplier's purchaser had entered into an agreement with a warehouse under which the warehouse would advance money to the purchaser. The purchaser would then order from the supplier large quantities of goods and store them in the warehouse. These large purchases entitled the purchaser to volume discounts; credit terms given to the purchaser by the warehouse were very favorable. In return, the warehouse received interest payments, warehouse fees, and half of the savings generated by the discounts.[165] The circuit court found that this arrangement constituted a joint enterprise or partnership. This was because the purchaser and the warehouse jointly controlled the purchasing program: the warehouse had the right to determine whether each proposed purchase would be acceptable collateral for the loan.[166]

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[161] *Id.* at 259, 49 N.W. at 567.

[162] *Id.* at 258, 49 N.W. at 567.

[163] *Id.*

[164] 291 F.2d 577 (5th Cir.), *cert. denied*, 368 U.S. 928 (1961); *accord* Interpetrol Bermuda Ltd. v. Kaiser Aluminum Int'l Corp., 719 F.2d 992 (9th Cir. 1984).

[165] 297 F.2d at 581-82.

[166] *Id.* at 583.

In comparison with some of the cases discussed above, the degree of control exercised by the warehouse in *Minute Maid* was fairly mild. Construed broadly, the holding would endanger most credit agreements in which the creditor's compensation is in any way contingent. The case is significant, however, because it holds that shared control is sufficient to impose partnership liability.[167] Thus, *Purvis* and *Minute Maid* both suggest a control standard of liability. Both cases contain language that would hold creditors liable under a broad range of circumstances. Nevertheless, a careful examination of both cases shows that control was the crucial factor.

In contrast to *Purvis* and *Minute Maid*, a creditor participating in a profit-sharing arrangement was held not to be a partner in the famous British case of *Cox v. Hickman*.[168] The creditors of a distressed manufacturing firm agreed to avoid foreclosure and instead put the firm in the hands of trustees for the debtor and the creditors. When the firm nevertheless failed, an unpaid supplier sought to hold liable as partners two creditors who had subscribed to the composition, but who had not acted as managing trustees at the time that the plaintiff's goods were ordered. The House of Lords reversed the judgment for the plaintiff.[169] Baron Pollock first observed that the dormant creditors would be liable "if the trustees be merely managers, on behalf of the creditors, of a new concern, and the business be carried on under their direction and for their entire benefit . . . ."[170] He concluded, however, that the agreement was just a continuation of the old concern and that the dormant creditors could not be held liable for a variety of reasons. One of these reasons was that "they have no power to interfere and take the management into their own hands . . . ."[171] Later in the decision, Lord Wensleydale noted that "the trustees certainly are liable, because they actually contract by their undoubted agent; but the creditors are not, because the trustees are not their agents."[172]

Cox did not hold the senior creditor liable. Although it is inconsistent with a broad reading of *Purvis* and *Minute Maid*, it is certainly consistent with a control standard of liability. *Cox* rejected liability not be-

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[167] *See also In re* Simpson, 222 F. Supp. 904 (M.D.N.C. 1963), in which a creditor's claim was equitably subordinated in bankruptcy, because the creditor had become the debtor's joint venturer by means of shared control of the enterprise.

[168] 8 H.L.C. 268 (1860).

[169] *Id.* at 268-69.

[170] *Id.* at 299.

[171] *Id.* at 300.

[172] *Id.* at 314; *accord* Wells-Stone Mercantile Co. v. Grower, 7 N.D. 460, 75 N.W. 911, 912 (1898).

cause creditors never can be liable, but because, as in *Purvis*, the creditor in *Cox* did not exercise control.

A much narrower view of creditor liability was expressed in *In re Hoyne*.[173] In *Hoyne*, a distressed brokerage firm entered into an agreement with some of its creditors, under which a committee of creditors would have total control of the debtor's business.[174] The business failed despite their efforts. The plaintiff, apparently an unpaid creditor, sought a determination that the creditor's committee and the dormant creditors were the bankrupt's partners.[175] A special master determined that no partnership existed, and the Seventh Circuit affirmed, holding that the issue was whether the testimony failed to support the master's report.[176] The court raised, but did not discuss, the effect of the committee's control over the debtor.[177] Instead, the court held that the composition agreement itself, which gave total control to the committee, was sufficient to support the master's report because the document itself recognized the relation of debtor and creditor, rather than a partnership.[178]

Hoyne is of limited value because of the court's deference to the master's report. More importantly, however, the opinion is doctrinally unsound. *Hoyne* holds that creditors controlling the debtor cannot be liable as partners as long as they execute the proper documents containing magic language. This holding is fundamentally inconsistent with partnership law. Partnerships do not depend on the presence or absence of magic language, but on the reality of the relationship.[179]

Just as *Cox* and *Hoyne* provide a counterpoint to *Purvis*, *Edwards v. Northwestern Bank*[180] may contrapose *Minute Maid*. *Edwards* is also doctrinally unsound. In *Edwards*, a state court receiver asserted *inter alia* that the debtor's bank had become the debtor's joint venturer by virtue of the bank's control over the debtor's affairs.[181] In affirming

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[173] 277 F. 668 (7th Cir.), *cert. denied*, 258 U.S. 623 (1922).

[174] *Id.* at 671-72 n.1.

[175] *Id.* at 669-70.

[176] *Id.* at 671. Naturally, such a lax standard of review vitiates the weight of the appellate opinion.

[177] *Id.* at 673.

[178] *Id.*

[179] *See, e.g.*, *In re* Foreman's Estate, 269 Cal. App. 2d 180, 188-89, 74 Cal. Rptr. 699, 705-06 (1969); Sandberg v. Jacobson, 253 Cal. App. 2d 663, 667, 61 Cal. Rptr. 436, 439 (1967); Greene v. Brooks, 235 Cal. 2d 161, 165-66, 45 Cal. Rptr. 99, 102 (1965).

[180] 39 N.C. App. 261, 250 S.E.2d 651 (1979), *aff'd on appeal after remand*, 53 N.C. App. 492, 281 S.E. 2d 86 (1981).

[181] The appointment and powers of the receiver were not explained. 39 N.C. App.

a summary judgment in favor of the bank, the appellate court held that although the bank allegedly "exercised a substantial degree of control over checks drawn against [the debtor's] checking account," there was insufficient evidence of the sharing of profits and control, both of which are required for a joint venture.[182] There was no profit sharing because the lender was entitled to receive only repayment of the sums loaned and the normal rate of interest.[183] There was insufficient control because "the evidence fail[ed] to show the Bank exercised an equal degree of control over the means employed by [the debtor] to carry out the venture."[184]

The court's holding must be disassembled in order to appreciate its import. First, the opinion states that the receipt of interest is not the receipt of profits. In earlier commentary, Justice Douglas also attached great importance to that distinction.[185] He stated that a creditor who controls the debtor but who does not receive the profits should not be liable for the debtor's obligations.[186] This was not only because the absence of profit impairs the ability to distribute risks, but more significantly, because the absence of profit means that liability would be imposed without compensation for the risk of liability.[187]

This reasoning, however, is questionable. It is true that a controlling creditor not sharing in the profits generally receives no compensation beyond that set out in the initial agreement.[188] However, to view the contractually established compensation as both a ceiling and a floor is to ignore the realities of the typical control situation. As the cases discussed thus far show, control rarely arises at the time the debtor firm is established. Typically, once the debtor encounters financial difficulties, its existing major secured creditor decides to salvage as much as possible rather than to foreclose immediately on inadequate and depreciated collateral. At the time the decision to assume control is made, the creditor is almost always badly undersecured. The compensation for control, indeed the motivation for control, is the prospect that the salvage opera-

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at 263, 250 S.E.2d at 652.

[182] *Id.* at 275, 250 S.E.2d at 661.

[183] *Id.* at 276, 250 S.E.2d at 661.

[184] *Id.*

[185] *See* Douglas, *supra* note 23, at 726-28.

[186] *Id.* at 736-38.

[187] *Id.* at 737-38. For a discussion of Justice Douglas' risk distribution analysis and its possible flaws, see *supra* note 23 and accompanying text.

[188] There are, of course, other ways to make money during a control relationship, beyond the initial agreement, especially if there is a supplier/buyer relationship atop the debtor/creditor relationship.

tion will increase the value of the collateral before the debtor collapses.[189] The benefit sought by the creditor — the net enhancement of the collateral or paydown of the debt during the period of control — often is far more substantial than profit sharing would be, especially when the debtor is deeply insolvent and unprofitable. Thus, the shibboleth of profit sharing ought not be determinative of liability.

The *Edwards* court went on to impose two further requirements for joint venture liability. First, both parties must have equal control. Second, both must control the means employed to carry out the venture.[190] The implication in *Edwards* was that although the lender controlled the debtor's checking account, it did not control the entire business of the debtor and hence would not be liable. The irony is apparent. Some cases, such as *Buck v. Nash-Finch Co.*,[191] deny liability on an agency theory because the creditor controlled most of the debtor's business but not the precise phase giving rise to the unpaid debt. In *Edwards*, however, the lender controlled only the checking account, thereby presumably affecting the trade creditors championed by the plaintiff receiver. If one accepts both rules, one might conclude that domination must be total, again bringing the debtor down to the status of servant before creditor control liability can attach. Neither agency law nor partnership doctrine requires so stringent a standard.

Thus while the partnership cases do not all point in the same direction, they do suggest a control standard of liability. As shown above, the cases that do not suggest a control standard may rest on a faulty foundation.

C. The Alter Ego Cases

Although it may seem odd to consider alter ego cases in conjunction with agency and partnership cases, a strong linkage exists among the three doctrines. Viewing the creditor control cases on a spectrum of creditor conduct, the cases involving shared control and (perhaps) shared profit, the partnership cases, are at one end of the spectrum. The true agency cases, involving substantial but not overwhelming control, are in the middle. The alter ego cases, involving allegations of complete domination of the debtor, are at the end opposite the partner-

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[189] Under some circumstances, an undersecured creditor whose collateral position improves immediately before the debtor's bankruptcy, thereby harming the unsecured creditors, may have to disgorge the incremental increase in value as a voidable preference. *See* 11 U.S.C. § 547(c)(5) (1982).

[190] 39 N.C. App. at 276, 250 S.E.2d at 661.

[191] 102 N.W.2d 84, 90 (1960) (discussed *supra* text accompanying notes 119-28).

ship cases. The alter ego cases occupy a position roughly equivalent to that occupied by the master-servant classification in the Restatement's tripartite taxonomy discussed above.

In *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*,[192] the major supplier of a manufacturing firm changed the manufacturer's debt from an unsecured obligation to a secured note.[193] Later, when the manufacturer began to experience financial difficulties, the creditor agreed to provide additional funding and internal financial management assistance.[194] The creditor sent one of its internal auditors to the debtor's premises to oversee the debtor's finances.[195] After the debtor's collapse, some of the unpaid unsecured creditors alleged that the debtor had become the major creditor's alter ego. The trial court directed a verdict for the defendant and the Fifth Circuit affirmed.[196] The circuit court outlined the alter ego or "instrumentality" standard, noting "[f]irst, the dominant corporation must have controlled the subservient corporation, and second, the dominant corporation must have proximately caused plaintiff harm through misuse of this control."[197]

Examining the first requirement, control, the court said that in the context of a debtor/creditor relationship, alter ego liability ought not attach unless "the creditor assumed actual, participatory, total control of the debtor. Merely taking an active part in the management of the debtor corporation does not automatically constitute control . . . ."[198] Later, the court added that "the subservient corporation [must] manifest . . . no separate corporate interests of its own and function . . . solely to achieve the purposes of the dominant corporation."[199]

The control test set out by the *Krivo* court is far more stringent than the agency or partnership standards set out earlier in this Article. Even without the second requisite of the alter ego doctrine (misuse of the subservient corporation), plaintiffs would face a formidable barrier.

As to the misuse test, there is a curious inconsistency in *Krivo*: the

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[192] 483 F.2d 1098 (5th Cir. 1973), *modified and reh'g denied*, 490 F.2d 916 (5th Cir. 1974).

[193] *Id.* at 1107.

[194] *Id.* at 1108.

[195] *Id.*

[196] *Id.* at 1101.

[197] *Id.* at 1103.

[198] *Id.* at 1105; *accord* Japan Petroleum Co. (Nigeria) v. Ashland Oil, 456 F. Supp. 831, 841 (D. Del. 1978). In dictum the *Japan Petroleum* court also stated: "The fact that a creditor corporation takes an active part in the management of a debtor corporation does not indicate the necessary control." 456 F. Supp. at 841.

[199] 483 F.2d at 1106.

court first requires misuse that proximately harms the plaintiff,[200] but in a brief subsequent discussion the court notes that the misuse test is met whenever recognition of the corporate form would produce injustice or inequity.[201] It is therefore unclear whether tortious conduct and causation is necessary, or whether some sort of unfairness is enough. However, actual fraud clearly is not required.[202]

Applying those standards to the facts in *Krivo,* the court held that the creditor's admission that it had " 'taken an active role in the management and control' "[203] of the debtor was not inconsistent with the idea that the debtor had "voluntarily *shared* control."[204] Although the creditor wanted to affect the selection of management personnel, it did not do so.[205] The auditor whom the creditor installed on the debtor's premises had the power to veto expenditures, but only did so when the proposed expenditures were improper.[206] The auditor had the final de-

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[200] *Id.* at 1103; *see also In re* Washington Med. Cent., Inc., 10 Bankr. 616, 622 n.13 (Bankr. D.D.C. 1981) (claim for subsidiary's debt asserted against bankrupt parent corporation; for alter ego liability to attach, " 'control of one corporation by another is a necessary element and the control must be a proximate cause of the alleged injustice at issue' ").

[201] 483 F.2d at 1106.

[202] *Id.* The court's treatment of the misuse requirement is both vague and ambiguous, which is surprising in light of the court's earlier warning of the "dangers of a legal analysis based upon ambiguous metaphors" and "the trap of mere definitionalism." *Id.* at 1103. Some alter ego cases arising in the parent/subsidiary context do, however, require a showing of bad faith. *See, e.g.*, Luis v. Orcutt Town Water Co., 204 Cal. App. 2d 433, 443-44, 22 Cal. Rptr. 389 (1962).

The equitable subordination doctrine used by the bankruptcy courts may provide yet another twist. At least in the context of creditor control, equitable subordination is analogous to the alter ego doctrine. Both can result in treatment of creditors as if they were part of the debtor entity, although the resulting remedies differ. Under equitable subordination, the claimant must have (1) engaged in inequitable conduct, and (2) the misconduct must have (a) injured other creditors, or (b) conferred an unfair advantage on the claimant. *See, e.g., In re* American Lumber Co., 5 Bankr. 470, 478 (Bankr. D. Minn. 1980). Thus, the misconduct requirement under equitable subordination appears on the surface to be more stringent than misconduct required under the alter ego theory. On the other hand, equitable subordination does not require a showing of control as stringent as that of alter ego. For discussion of a possible link between the doctrines of equitable subordination, fraudulent conveyance, and alter ego, see Clark, *supra* note 12, at 553.

[203] 483 F.2d at 1110.

[204] *Id.* (emphasis in original). One may wonder whether the sharing was truly voluntary and whether control is any less significant when it is consensually imposed rather than forcibly imposed.

[205] *Id.*

[206] *Id.* at 1111.

cision as to which creditors would be paid and he negotiated with the trade creditors, "attempting to forestall or to settle their demands."[207] Nevertheless, the court held that the auditor's activities could not have justified a jury verdict finding control, since he "limited the scope of his position to overseeing the finances of [the debtor]" and did not have substantial influence or control in other managerial decisions.[208]

The court went on to discuss various other control allegations. These included allegations that the major creditor decided which of the debtor's assets to liquidate,[209] gave production advice to the debtor,[210] and may have received some advantages from the debtor in the course of their buyer/supplier relationship.[211] The court concluded that although the creditor's position "vested it with the capacity to exert great pressure and influence, . . . such a power is inherent in any creditor-debtor relationship and . . . the existence and exercise of such a power, alone, does not constitute control for the purposes of the 'instrumentality' rule."[212] Perhaps the court was correct in stating that many creditor/debtor relationships involve the capacity or potential to exert great pressure and influence. However, the suggestion that the actual exercise of that influence is either common or proper is questionable.

In *John G. Lambros Co. v. Aetna Casualty & Surety Co.*, another case in which an unsecured creditor asserted that the debtor's secured creditor had become the debtor's alter ego, the district court held that the security agreement alone did not give rise to alter ego liability.[213] The court stated:

> It is not unusual for either a surety or a secured creditor advancing large sums of new capital to become "intimately involved in [the debtor's] financial affairs." Such involvement does not "merge" the identities of the creditor and debtor . . ., nor does it expose the creditor to contract liability on obligations of its debtor. . . .[214]

As in the agency cases, the court conclusorily stated that intimate in-

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[207] *Id.*

[208] *Id.* at 1112.

[209] *Id.*

[210] *Id.*

[211] *Id.* at 1112-14.

[212] *Id.* at 1114.

[213] 468 F. Supp. 624 (S.D.N.Y. 1979).

[214] *Id.* at 628 (footnote omitted) (brackets in original) (quoting Stowers v. Mahon (*In re* Samuels & Co.), 526 F.2d 1238, 1256 (5th Cir.), *cert. denied*, 429 U.S. 834 (1976) (en banc) (dissenting opinion)). ***But see*** V-J Corp. v. Mid-Continent Sys., No. CV 81-593 (1984), *noted in* 28 American Trial Lawyers Association L. Rep. 315 (1985). *V-J Corp.* is an Alabama trial court decision in favor of unpaid supplier that recovered from the debtor's senior creditor on an "instrumentality" theory.

volvement is "not unusual" to justify finding no liability (although in *Lambros* the secured party exercised so little control that liability would have been doubtful under any theory).

The implication of *Krivo* and *Lambros* is that even the actual exercise of great pressure and influence or intimate involvement in the debtor's affairs is insufficient to justify alter ego liability of a creditor. In light of most alter ego cases, which arise primarily in the parent/subsidiary rather than debtor/creditor context, *Krivo* and *Lambros* may be correct in their application of the alter ego doctrine: mere control is probably not enough.[215]

It may seem strange that less than pervasive control will not justify alter ego liability but is sufficient to justify agency liability. The difference may stem from two factors. First, alter ego liability is comprehensive. The defendant may be held responsible for the nominal debtor's obligation, arising at any point, whether in tort or contract.[216] By contrast, agency liability ordinarily does not include tort liability.[217] Even

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[215] *See, e.g.*, Baker v. Raymond Int'l, Inc., 656 F.2d 173, 180 (5th Cir. 1981), *cert. denied*, 456 U.S. 983 (1982) ("Ownership of a controlling interest in a corporation entitles the controlling stockholder to exercise the normal incidents of stock ownership, such as the right to choose directors and set general policies, without forfeiting the protection of limited liability.").

[216] *See, e.g.*, IA H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAW § 296.01 n.5 (1949).

[217] Whether the principal *ought* to be liable for the nonservant agent's torts is another issue; *see supra* text accompanying note 95. Some courts have tended to equate alter ego and agency liability. *See, e.g.*, Fidenas AG v. Honeywell, Inc., 501 F. Supp. 1029, 1037 (S.D.N.Y. 1980) ("The tests for finding agency so as to hold a parent corporation liable for the obligations of its subsidiary . . . are virtually the same as those for piercing the corporate veil."). Other courts have tried to distinguish the two without adding to the clarity of the distinction. *See, e.g.*, Northern Natural Gas Co. v. Superior Court, 64 Cal. App. 3d 983, 994, 134 Cal. Rptr. 850, 857 (1976) ("Agency and alter ego are two different and distinct concepts. In the case of an alter ego, the court pierces the corporate veil. In the case of an agency, the corporate identity is preserved but the principal is held liable for the acts of its agent.").

It may be that the English language is partly to blame for the confusion, as the court noted in *Raymond Int'l*:

> The imposition of liability on a principal for the debts of the corporation has been summed up by attractive metaphors like "piercing the corporate veil" and "holding a corporation liable for the acts of its alter ego." These gnomic phrases are used interchangeably, although literally they suggest different concepts. Moreover, they describe results, but not the reasoning that leads to those results; they tell us nothing about the basis for the imposition of liability. The use of such phrases as a basis for decision occasioned Cardozo's famous warning: "Metaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often

under the proposed control liability standard, the controlling creditor's liability would extend only to those tort and contract obligations incurred during the control period (except for precontrol obligations resulting in the actual receipt of postcontrol benefits).[218] Thus, the increased scope of liability may justify the commensurately higher threshold required under the alter ego doctrine.

The second reason for the anomalous stringency of the alter ego doctrine may be historical. The alter ego rule evolved in corporate law. Arguably, the shareholder/corporation relationship is unique and deserves idiosyncratic rules governing control conduct. Perhaps the social utility of the doctrine of limited liability is reason enough to justify the anomaly;[219] perhaps the web of statutory and administrative regulation affecting corporate governance has preempted the judicially developed standards of conduct. While the justifications for the alter ego doctrine in the shareholder/corporation context are beyond the scope of this Article, the alter ego doctrine is far more hostile to potential plaintiffs in creditor control cases than are the other theories of liability discussed above.

If one accepts the stringency of the alter ego doctrine, there will still be rare instances in which a creditor will be involved so deeply with the debtor as to justify total alter ego liability. Further, whenever creditor/alter ego liability is successfully invoked, a fortiori the creditor will be liable under an agency theory. Thus, given that a party bringing an alter ego claim against a creditor is almost always implying that the equivalent of a master-servant relationship exists, *Krivo* and *Lambros* are somewhat surprising. In both cases the plaintiffs, as unsecured creditors, could have used an agency theory. The agency theory might have rendered the controlling creditors liable for some, if not all, of the debtor's obligations. The plaintiffs may have saddled themselves with a needlessly heavy burden by neglecting to assert simple agency claims.

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by enslaving it."

Id. at 174 n.5 (quoting Berkey v. Third Ave. Ry., 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926) (Cardozo, J.)).

[218] *See supra* text accompanying notes 48-49.

[219] *See* Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976). *But see* Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975).

D. Cases Grounded Upon Other Theories Related to Control Liability

The agency, partnership, and alter ego cases discussed above all involved allegations of creditor control as the primary bases of liability. There are, however, cases involving creditor liability based on theories of fiduciary duty and negligence, in which liability is predicated partly on control and partly on other allegations, usually of misconduct. Those cases are useful to consider because they provide contrasts that illuminate the boundaries of the rule of control liability. Despite the substantial differences encountered when comparing the formal requisites of fiduciary and negligence theories to those required under the rule proposed in this Article and ordinary agency liability, the factual allegations in the fiduciary and negligence cases are similar to those in the agency and partnership cases. To classify these cases separately may be to create illusory differences.

1. The Fiduciary Cases

Few, if any, cases have held a controlling creditor liable as the fiduciary of the debtor's other creditors. In cases implying that a creditor may become a fiduciary,[220] and in those contradictory

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[220] *See, e.g.*, Commons v. Schine, 35 Cal. App. 3d 141, 110 Cal. Rptr. 606 (1973). In *Commons*, a trustee in bankruptcy sought to hold Schine and two of his corporations liable for a preference allegedly received from a bankrupt limited partnership. The trustee had alleged that Schine organized a corporation which became the general partner of a limited partnership. The limited partnership later became insolvent, but not before Schine (through yet another entity) loaned money to the bankrupt and repaid himself without paying the bankrupt's other creditors. *Id.* at 143-44, 110 Cal. Rptr. at 607-09. Schine allegedly controlled all three of the entities (the corporate general partner, the limited partnership, and the lending corporation) and became the alter ego of some or all of them. *Id.*

The Schine defendants asserted that because alleged preferences had occurred outside the period provided by applicable federal law, the preference was not voidable under state law. The trial court granted defendants' motion for judgment on the pleadings. The appellate court reversed, holding that although the preference would indeed have been immune from attack in the absence of fraud, the alleged control by the defendants rendered the preference voidable:

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

Id. at 144, 110 Cal Rptr. at 608.

cases,[221] courts generally agree that a showing of complete domination by the creditor is required to create a fiduciary duty. The courts do not

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The court went on to hold that the alleged preference could be recovered upon proof of dominance and control. *Id.* at 145, 110 Cal. Rptr. at 609. The precedential value of the case as it pertains to creditor control is not clear. Defendants' liability may not have been predicated solely on the control exercised in the defendants' capacity as creditors of the bankrupt, but may have included issues of shareholder interference and misconduct. Further, the court did not articulate the precise basis of defendants' control; it stated that:

> The complaint . . . alleges dominance and control by Schine and his alter ego, Schine & Co., of the corporation which is the general partner of the bankrupt limited partnership. It alleges . . . that Schine personally and through his alter ego received preferential repayment of loans to the bankrupt partnership as a result of Schine's exercise of his power over the corporation general partner.

Id.

Nevertheless, the case arguably stands for the proposition that a party (including a creditor) who dominates and controls an entity may become the fiduciary of its other creditors. As the cases discussed earlier have demonstrated, a senior secured lender may dominate and control the debtor. On the other hand, the court in *Commons* seemed to require a level of domination and control tantamount to a finding of alter ego. Such pervasive control apparently is very rare in the context of a typical creditor/debtor relationship, but there is authority equating creditor/fiduciary liability with creditor/alter ego liability. *See, e.g., In re* Teltronics, 29 Bankr. 139, 171 (Bankr. E.D.N.Y. 1983):

> [A] non-insider creditor will be held to a fiduciary standard only where his ability to command the debtor's obedience to his policy directives is so overwhelming that there has been, to some extent, a merger of identity. Unless the creditor has become, in effect, the *alter ego* of the debtor, he will not be held to an ethical duty in excess of the morals of the marketplace.

Unlike the alter ego cases, however, the fiduciary rules do not expressly make misconduct a precondition to the creation of a relationship. That distinction may be more apparent than real, for three reasons. First, the judicial determination that a controlling party inadvertently has become a fiduciary is made long after the events giving rise to liability have taken place, thus making it likely that the creditor's acts (which once appeared innocent) will be viewed as misconduct under a more rigorous hindsight standard. Second, the plaintiff is much more likely to attempt to assert fiduciary liability in the presence of provable misconduct. Third, the trier of fact is far more likely to make the prerequisite finding of control in the presence of misconduct evidence, not only because the misconduct may taint the perception of the control evidence but also because the misconduct itself may be evidence of control.

[221] *See, e.g.*, Edwards v. Northwestern Bank, 39 N.C. App. 261, 250 S.E.2d 651, (N.C. App. 1979) (discussed in connection with the partnership/joint-venture materials *supra* text accompanying notes 180-91). In *Edwards*, the secured lender received regular reports on the debtor's inventory, accounts payable, and expense budgets, and exercised a "substantial degree of control" over the debtor's checking account. *Id.* at 274-75, 250 S.E.2d at 660-61. In an action by the debtor's receiver, asserting *inter alia* that the

say if, or why, that standard differs from the alter ego standard. It ought to differ, however, because the consequences of a finding of fiduciary duty may be even more dramatic than those of alter ego liability. An alter ego is merely responsible for all of the debtor's obligations, whenever incurred. A fiduciary, however, may be required to undo its former dealings with the controlled entity and also may be liable in tort for breach of the newly imposed duty.[222] This greater exposure merits a higher threshold of liability.[223]

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secured creditor had a fiduciary duty to the unsecured creditors, the appellate court affirmed the summary judgment for the lender on the issue of fiduciary liability. The court observed that "fiduciary duty arises only when the evidence establishes that the party providing financing to a corporation completely dominates and controls its affairs" and that the lender's conduct in *Edwards* "simply does not amount to control, domination, and spoilation [sic] of [the debtor's] affairs." *Id.* at 277, 250 S.E.2d at 662.

[222] A fiduciary is held to a much higher standard than a principal in control of an agent. In Pepper v. Litton, 308 U.S. 295 (1939), the Supreme Court commented on the scope of the controlling directors' or shareholders' fiduciary duty:

> Their powers are powers of trust . . . their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on [them] not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.

Id. at 306-07 (footnotes omitted). The Court went on to state that "those interested therein" included the "entire community of interests in the corporation — creditors as well as stockholders." *Id.* at 307 (footnote omitted). The fiduciary duties of a totally dominant creditor should be the same as those of a director. Although the director is a corporate insider and the creditor is nominally an outsider, there is authority equating the two. *See, e.g.*, 11 U.S.C. § 547(b)(4)(B)(i) (1982) (imposing an extended period of preference liability on the "insiders" of the bankrupt). Under 11 U.S.C. § 101(25)(B)(iii), the term "insider" includes a "person in control of the debtor," just as directors and officers are deemed an insider for preference purposes under appropriate circumstances. *See, e.g., In re* King's Place, 6 Bankr. 305, 308 (Bankr. E.D. Pa. 1980); *In re* Jefferson Mortgage Co. 25 Bankr. 963, 970 (Bankr. D.N.J. 1982); *see also* Koch, *Bankruptcy Planning for Secured Lender*, 99 BANKING L.J. 788, 797-807 (1982); Note, *Banks as Insiders Within the New Bankruptcy Code*, 9 J. CONTEMP. LAW 247 (1983). *But see, In re* Yonkers Hamilton Sanitarium, Inc., 22 Bankr. 427, 430 (Bankr. S.D.N.Y. 1982), *aff'd*, 34 Bankr. 385 (Bankr. S.D.N.Y. 1983) (dicta questioning whether a creditor can ever be deemed an insider in the absence of voting control).

[223] The imposition of fiduciary liability (as distinguished from agency liability) on a controlling creditor may also cause some practical problems. In Weinberger v. Kendrick, 698 F.2d 61 (2d Cir. 1982), *cert. denied*, 104 S. Ct. 77 (1983), certain junior creditors in the W.T. Grant insolvency proceedings challenged the settlement of class actions against the bankrupt's largest creditors. Affirming the approval of the settlement, the appellate court cast doubt on the junior creditors' theories that the senior creditors should be liable on a fiduciary theory:

> Plaintiffs would have faced serious difficulties in establishing the existence

Because of the dearth of creditor-as-fiduciary cases, their sometimes questionable reasoning, their focus on misconduct rather than on control, and the comparative severity of the remedies flowing from liability, the fiduciary cases are not particularly helpful. They neither explain the basis of creditor control liability nor supply precedent for the proposed rule. They are not necessarily inconsistent, however; in an appropriately egregious case, it is possible that a given creditor would be held liable under both the fiduciary and control theories.

2. The Negligence Cases

A few courts have discussed negligence liability for lenders or creditors to third parties for debtor obligations, usually as a result of allegedly poor supervision of the debtor's business.[224] Just as with the fidu-

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> of a fiduciary relationship between a lending bank and the security holders of a borrowing corporation. While such a development is not beyond the realm of possibility, it would have required a significant extension of existing procedures . . . . [A]ppellants have cited to us no decisions in which a fiduciary relationship was found to exist between a bank and its borrower's security holders. Moreover, the extension of fiduciary principles to this relationship would face serious obstacles, such as arguments that lending relations between banks and large corporations are the product of arm's-length bargaining and that it would be anomalous to require a lender to act as a fiduciary for interests on the opposite side of the negotiating table.

Id. at 78-79 (footnote omitted).

In fairness to the junior creditors in *Weinberger*, it must be noted that the appellate court may have slightly mischaracterized plaintiff's theory: they did not contend that all senior lenders are fiduciaries but rather that a controlling creditor may be a fiduciary. The latter proposition is not as revolutionary as the court implied. Nevertheless, any injection of fiduciary principles into the lending relationship will create great upheavals. *See* Commercial Cotton Co., Inc. v. United Cal. Bank, 163 Cal. App. 3d 511, 516, 209 Cal. Rptr. 551 (1985) (holding that the relationship of bank to depositor is at least "quasi-fiduciary" because banking is a highly regulated industry performing a vital public service and the depositor is totally dependent on the bank's honesty to protect the deposited funds). Perhaps *Commercial Cotton* can be restricted to its facts (negligent payments on unauthorized checks followed by spurious defenses to the outraged depositor's claims). Nevertheless, *Commercial Cotton* was cited, followed, and expanded in Barrett v. Bank of Am., 178 Cal. App. 3d 960, 967-68, 224 Cal. Rptr. 76, 80-81 (1986). In *Barrett*, a bank had become involved in its borrower's affairs. The court held that the bank had thereby become the debtor's principal and fiduciary and could be held liable on a theory of constructive fraud for having allegedly made false promises to release the debtor's guarantors following a proposed merger.

[224] The leading case is Connor v. Great Western Sav. & Loan, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968). In *Connor*, a lender financed a developer's purchase of land in return for the lender's right to make home construction loans and

ciary cases, the application of the negligence cases to the proposed control liability rule is limited; the focus in the negligence cases purportedly is on the creditor's misconduct,[225] while the primary inquiry

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long term loans to the buyers. The lender sent a geologist to inspect the land. The lender also investigated the developer's financial condition and found it weak, but accepted without complaint the developer's financial statement that reflected unorthodox accounting practices. In a departure from the lender's procedure, it received the developer's building plans, but the lender did not examine the foundation plans nor make recommendations about the design. However, the lender suggested price increases, and the developer agreed. During construction, the lender's inspectors visited the property weekly. The lender had the right to withhold funds in the event of unsatisfactory work. *Id.* at 858-62, 447 P.2d at 372-75, 73 Cal. Rptr. at 612-15.

After the homes were built and sold, the foundations buckled as a result of defects in the foundations and the soil. *Id.* at 856, 447 P.2d at 611, 73 Cal. Rptr. at 371. The homeowners brought actions against the developer and the lender, and the California Supreme Court reversed a judgment of nonsuit granted in favor of the lender. The court held that although the lender did not become the developer's joint venturer by reason of its conduct, its relationship with the developer made it liable in negligence to the homeowners. According to the court, the lender

> became much more than a lender content to lend money at interest on the security . . . . It became an active participant in a home construction enterprise. It had the right to exercise extensive control of the enterprise. Its financing, which made the enterprise possible, took on ramifications beyond the domain of the usual money lender. It received not only interest on its construction loans, but also substantial fees for making them, at 20 per cent capital gain for "warehousing" the land, and protection from loss of profits . . . .

Id. at 864, 447 P.2d at 616, 73 Cal. Rptr. at 376.

The court then held that the lender negligently discharged its duty "to its shareholders to exercise its powers of control over the enterprise to prevent the construction of defective homes." *Id.* at 864-65, 447 P.2d at 616-17, 73 Cal Rptr. at 376-77. Most crucially, the court then extended the scope of that duty to include the injured homeowners, based on several policy considerations. The lender's acts were intended to affect the homeowners; the risk of harm was reasonably foreseeable; the homeowners were injured; the injury was closely connected with the lender's conduct. Finally, the lender's acts were morally blameworthy, and the policy of preventing future harm favored the imposition of liability. *Id.* at 866-67, 447 P.2d at 617-18, 73 Cal. Rptr. at 377-78.

One may fairly question the court's assertion that the lender's conduct was closely connected with the harm inflicted. The lender "not only financed the development . . . but controlled the course it would take." *Id.* at 867, 447 P.2d at 618, 73 Cal. Rptr. at 378. That statement is a little bit disturbing since the court earlier concluded that the lender's *failure* to exercise control was a factor giving rise to liability. Justice Mosk noted in dissent: "[T]his control was mythical; it consisted merely of the power to refuse to lend money for the project. In this respect all lenders may be held to 'control' the projects they finance." *Id.* at 875, 447 P.2d at 623, 73 Cal. Rptr. at 383 (Mosk, J., dissenting).

[225] *Connor* seems to require a showing of negligence or incompetence, while the agency cases require no more than control. *Connor* set out a number of facts showing

under the control liability rule is the quantum of control.

On the other hand, examination of some of the negligence cases may show that the alleged misconduct was more apparent than real, and that the true basis for liability was simply the creditor's control.[226] Even in cases finding no creditor negligence, the inquiry appears to focus on the nature and propriety of the control relationship rather than on specific acts of misconduct.[227]

Again, the creditor negligence cases are of limited utility to the present inquiry. Although they confirm that creditor control may yield lia-

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the lender's poor judgment. The lender dealt with an inexperienced and undercapitalized developer, failed to discover the soil problem or the structural defects, and relied on unknown building inspectors. By contrast, the agency cases describe highly competent creditors who ruled the debtors firmly. *See supra* text accompanying notes 97-154.

[226] In *Connor*, the court seemed to predicate liability on "the right to exercise extensive control," 69 Cal. 2d at 864, 447 P.2d at 616, 73 Cal. Rptr. at 376. Yet even the most liberal of the agency cases require the actual exercise of control, as distinguished from mere potential control. *See supra* text accompanying notes 97-154. Then, while the *Connor* court mentioned the ways in which the lender had reaped benefits beyond the normal receipt of interest, the court did not explain that extra compensation's relevance. The extraordinary benefits did not rise to the level of profit sharing, as the court held in denying the existence of joint venture liability. At best, the extra money showed the lender's unusual dominance, although the court did not characterize it as such.

For further analysis of *Connor*, see Comment, *Indirect Liabilities of Construction Lenders in a Development Setting*, 127 U. PA. L. REV. 1525 (1979).

[227] In Armetta v. Clevetrust Realty Inv., 359 So. 2d 540 (Fla. App.), *cert. denied*, 366 So. 2d 879 (1978), a group of condominium purchasers asserted a *Connor* claim against the construction lender. The appellate court affirmed dismissal because there were insufficient factual allegations of control, stating that there was nothing in the supervisory "terms of the loan agreement which makes the lender an active participant in the development beyond the traditional role of mortgage lender." *Id.* at 543.

Although the court probably reached the right result on the facts given, one may question the statement that the lender was not negligent simply because it acted in the "traditional role." Under ordinary negligence doctrine, custom and usage in the industry are certainly relevant to (but not determinative of) the issue of negligence. " 'General negligence cannot be excused on the ground that others in the same locality practice the same kind of negligence.' " Leonard v. Watsonville Community Hosp., 47 Cal. 2d 509, 305 P.2d 36 (1956).

Beyond concluding that the lender was not negligent, however, the *Armetta* court also made clear that *Connor* must be carefully limited: "We reject *Connor* to the extent that it is interpreted as broadly holding a lender liable to third party purchasers of dwelling units constructed and sold by the developer-borrower." 359 So. 2d at 543. The *Armetta* court may have alarmed itself unduly; even the broadest reading of *Connor* would not result in holding all lenders liable. To the extent that one can distill an articulable standard from *Connor*, liability would seem to depend on extensive lender involvement, a pervasive right to control, and some type of improper conduct during the course of the lending relationship.

bility, their questionable reasoning and result-oriented preoccupation with ephemeral acts of misconduct serve more to highlight the need for a rational, intellectually honest theory of control liability than to demonstrate the underpinnings of a new theory.

VI. Effects and Unresolved Problems

The preceding review of creditor control case law serves several purposes. It demonstrates that precedent neither authoritatively nor persuasively contradicts the proposed rule; it may even support or presage the rule. Further, it demonstrates that most of the relevant cases suffer from poor reasoning and an irritating lack of policy analysis.

One theme that emerges from the cases is that creditors should not be liable for control because it is "customary" or "normal" for creditors to control their debtors.[228] Both factually and logically, this assertion is highly questionable. Courts surely are not saying that control is not control; the courts' cryptic policy message must be that because of the practical consequences, liability ought not attach.

The courts' concern is, arguably, well founded. Imposed under the standard set out in this Article, the threat of creditor control liability would alarm secured creditors and thus undoubtedly increase the price of secured credit (offset to some extent by a corresponding decrease in the price of unsecured credit) and decrease the overall availability of secured credit.[229] In some instances, control liability may discourage creditors from undertaking loan workouts, resulting in defaults and insolvencies that might have been avoided.[230]

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[228] *See, e.g.*, Chicago Mill & Lumber Co. v. Boatmen's Bank, 243 F. 41, 46 (8th Cir. 1916).

[229] *See, e.g.*, *Connor*, 69 Cal. 2d at 875, 447 P.2d at 623, 73 Cal. Rptr. at 383 (Mosk, J., dissenting). It is conceivable, although unlikely, that a creditor contemplating control might protect itself from the risk of control liability not only by seeking compensation (increasing the price of credit), but also by extracting agreements from the controlled debtor's unsecured creditors to the effect that the junior creditors will not assert claims of control liability. *See* R. Posner, Economic Analysis of the Law (2d ed. 1977) (suggesting that if the rule of limited shareholder liability were abolished, the shareholders might then demand a limitation of liability from each creditor of the corporation in exchange for an increase in the interest rates paid by the corporation to each creditor).

[230] In one case denying creditor alter ego liability in a workout context, the court stated that even though the lead creditors were "intimately involved" in the debtor's financial affairs, that very involvement permitted the debtor to generate additional revenue instead of defaulting immediately, thus benefiting the other creditors. *See John G. Lambros*, 468 F. Supp. at 628. Other courts have extolled the virtues of workouts. *See, e.g.*, *In re* Colonial Ford, 24 Bankr. 1014 (Bankr. D. Utah 1982) (although that case

The real question is not whether those negative consequences will ensue; they are certain to occur. The issue is the magnitude of those effects. If creditor control is a universal practice, then a rule of control liability will have significant effects throughout the credit industry. It appears, however, that control is not now the norm. Many of the opinions characterizing creditor control as normal, customary, usual, and ordinary predate the Uniform Commercial Code. Under pre-Code law, tight supervision of the debtor was virtually a necessity and thus may have been customary.[231] The law has changed, and the relative dearth of recent cases describing egregious creditor control indicates that custom has changed, too. Therefore, the negative impact of the proposed standard is relatively small.

Although the cost of imposing control liability is small, the benefit would be substantial. The primary beneficiaries will be the unsecured creditors. Control liability may discourage dominant creditors from engaging in a variety of abusive practices.[232] But what of control situations in which those misdeeds have not been committed? Are the costs of liability still justified?

There are three justifications for liability even in the absence of misconduct. First, assuming that preventing abuse is one goal of control liability, some relatively innocent or harmless conduct will nevertheless result in liability as a result of imprecision in the judicial process. However, this is almost always the price paid for deterring abuse. In this case, the risk of abuse is so extreme that all control should be discouraged.

Second, a controlling creditor will be greatly tempted to exercise control, however subtly, to its own advantage. The advantage may not constitute actionably tortious misconduct under current tort law, yet the purpose and effect of control are the reaping of benefits that inevitably result from transfers of wealth from the unsecured creditors to the secured creditor. The imposition of control liability without reference to

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did not involve control liability, it contains an articulate and persuasive discussion of the benefits of extrajudicial workouts). Still others have stated that to impose liability on creditors involved in workouts ought to be avoided if possible, so as not to discourage attempts to salvage failing debtors. *See, e.g.*, American Southern Trust Co. v. McKee, 293 S.W. 50 (Ark. 1927); Wells-Stone Mercantile Co. v. Grower, 7 N.D. 460, 75 N.W. 911, 913, (1898); *see also In re* Mid-Town Produce Terminal, Inc., 599 F.2d 389, 392 (10th Cir. 1979) (equitable subordination case expressing sympathy for the debtor's shareholders who had attempted to revive a failing entity).

[231] *See supra* text accompanying notes 150-54.

[232] *See supra* text accompanying notes 7-12.

specific acts of misconduct will curb that sub-threshold self-dealing.[233]

Third, liability in the absence of misconduct may be justified because of the inequality of information available to the senior and junior creditors. If both unsecured and secured creditors had access to the same information, then the parties could accurately estimate, shift, and establish reserves for the risks. Thus, initial allocation of risks and liabilities would be relatively unimportant. However, the inequality between creditors, which is always present even in the absence of control, is exacerbated greatly by the secured creditor's assumption of command. That is particularly true if, as is often the case, the unsecured creditors are not aware of the control relationship.[234]

One other side benefit of control liability ought to be mentioned. Control liability will give the debtor greater leverage in dealing with its major creditor. Even if the debtor cannot later assert its own indemnity claim against the creditor, the debtor can invoke the specter of claims raised by its unsecured creditors. Thus, the debtor may be able to blunt the senior creditor's appetite for control, both at the outset of the credit relationship and during a subsequent workout. The threat of third party liability may therefore help check overreaching.

Were the proposed rule adopted, fewer creditors would attempt to exercise control unilaterally. That does not mean the end of all workouts or a hastier demise of failing debtors, however. Instead, creditors likely will attempt to arrange compositions or extensions with junior creditor consent. The other creditors may agree to control by a creditor's committee or by the lead creditor with committee oversight. Con-

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[233] The self-interested silence of the creditor's employees and the debtor's shareholder/guarantor, which may make it difficult to prove the existence of misconduct, may also weigh in favor of a somewhat more objective rule of control liability. *See supra* text accompanying note 68.

[234] *But see supra* note 224. In *Connor*, 69 Cal. 2d at 850, 447 P.2d at 609, 73 Cal. Rptr. at 369, the majority declined to extend the lender's negligence liability to include the debtor/tortfeasor's junior secured creditors. The majority stated that the junior secured creditors "as substantial investors were in a position to protect themselves," even though they had no power to control the debtor. *Id.* at 871, 447 P.2d at 621, 73 Cal. Rptr. at 381. Taken to an extreme, the court's lack of sympathy for the junior creditors may indicate a willingness to let the chips fall where they may. On the other hand, the junior creditors in *Connor* were well secured and appear to have been closely connected with the debtor/tortfeasor. *Id.* at 871 n.12, 447 P.2d at 621, 73 Cal. Rptr. at 381; *see also* J'Aire Corp. v. Gregory, 24 Cal. 3d 799, 808, 598 P.2d 60, 66, 157 Cal. Rptr. 407, 413 (1979), in which recovery for negligent interference with prospective economic advantage was limited to instances in which "the injury is not part of the plaintiff's ordinary business risk." The risk that a senior creditor will take control of the debtor may not be an "ordinary" risk.

sent from the debtor's current creditors, and perhaps from future creditors as more debt is incurred, may involve a waiver of claims against the controlling creditor or committee in exchange for the right to supervise the conduct of the workout. The oversight would protect against self-dealing and mismanagement, the primary dangers inherent in unsupervised unilateral control.[235] In the event of dissatisfaction with the workout, creditors still could file an involuntary petition in bankruptcy against the debtor.

Upon bankruptcy of the debtor subjected to unilateral control (as distinguished from control by a creditors' committee under an extrajudicial composition), it is possible that the debtor's trustee in bankruptcy can assert a claim against the controlling creditor. This Article has assumed that the typical plaintiff will be an individual junior creditor. Although a trustee in bankruptcy cannot assert claims accruing to individual creditors,[236] she can assert the debtor's claims.[237] If we view the control liability rule as a species of agency liability, then the trustee might be able to assert the debtor/agent's claim for indemnity from the creditor/principal.[238] The trustee's standing to assert a claim for damages based on creditor control would probably magnify the commercial impact of the rule.

CONCLUSION

The fundamental justification for control liability is that the costs now borne by the controlled debtor's junior creditors are attributable to the benefit sought by the controlling creditor. An objective standard of control liability will be more effective in discouraging control than one based on showing various types of misconduct.

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[235] *See, e.g.*, Poscover, *The Business in Trouble — A Workout Without Bankruptcy*, 39 BUS. LAW. 1041 (1984) (sample workout agreements appended).

[236] *See, e.g.* Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 434 (1972).

[237] *See generally* 11 U.S.C. §§ 323, 541 (1982).

[238] RESTATEMENT (SECOND) OF AGENCY § 438 (1958) (agent's right to indemnity from the principal). A trustee asserting a credible claim against a controlling creditor would enjoy greatly enhanced bargaining leverage. The mere pendency of a control liability claim might encourage the defendant creditor to settle any outstanding preference, fraudulent conveyance, or equitable subordination claims, for fear that the trustee or other parties would attempt to use findings in those initial actions to establish control in subsequent actions. Whether that effect is desirable is another question. *See, e.g.*, Parklane Hosiery Co. v. Shore, 439 U.S. 322, 355-56 (1979) ("today's decision [to permit the use of nonmutual offensive collateral estoppel] will have the result of coercing defendants to agree to consent orders or settlements . . .") (Rehnquist, J., dissenting).

Even if the proposed rule is not adopted, this Article provides a principled basis for the imposition of agency liability in the context of creditor control: The exercise of control may be viewed as the creation of an implied agency, with the controlling creditor in the role of undisclosed principal. Although the creditor control cases are flawed and conflicting, they point to a rule of liability based not on murky notions of creditor misconduct but rather on the objective, dispassionate facts of control.