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From the Bankruptcy Courts: The Application of Improvement of Position and Equitable Subordination Doctrines: Clark Pipe Reconsidered

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THE APPLICATION OF IMPROVEMENT OF POSITION AND EQUITABLE SUBORDINATION DOCTRINES: *CLARK PIPE* RECONSIDERED

A creditor with a perfected security interest in collateral usually rests easily knowing that its secured status will result in eventual payment if the debtor subsequently files a bankruptcy petition. This tranquility often disappears, however, when the collateral consists of inventory or accounts receivable and a trustee or debtor in possession commences an adversary proceeding seeking to recover preferences based on an improvement of the secured creditor's position vis-à-vis other creditors within the ninety-day period prior to bankruptcy. Add to the complaint a second cause of action seeking equitable subordination of the secured claim based on the secured creditor's control of the debtor's operations, and the secured creditor's problems are magnified.

Such challenges were defended by the secured creditor in *In re Clark Pipe & Supply Co.*, an unusual case in which a panel of the Court of Appeals for the Fifth Circuit first ruled against the secured creditor on both the preference and equitable subordination issues,[1] but later withdrew that decision and reversed itself in response to a request for a motion for a rehearing *en banc.*[2]

Clark Pipe & Supply Company (Clark) was in the business of buying and selling steel pipe used in the fabrication of offshore drilling platforms. In September 1980, Associates Commercial Corporation (Associates) and Clark executed various agreements under which Associates would make revolving loans secured by a security interest in accounts receivable and inventory. The agreements required Clark to deposit all collections from accounts receivable in a bank account belonging to Associates. As is typical in such financing arrangements, the amount Associates would lend was determined by a formula: Associates would advance a percentage of the amount of eligible accounts receivable plus a percentage of the cost of inventory. Associates reserved the right in its

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[1] 870 F.2d 1022 (5th Cir. 1989).

[2] 893 F.2d 693 (5th Cir. 1990).

discretion to reduce these percentages at any time.

"When bad times hit the oil field in late 1981, Clark's business slumped,"[3] and, as a result, in early 1982, Associates began reducing the percentage advance rates so that Clark would have just enough cash to pay its direct operating expenses, keep the business going, and sell inventory. The proceeds were used to pay off past advances made by Associates, although the court of appeals observed that Associates "did not expressly dictate to Clark which bills to pay. Neither did it direct Clark not to pay vendors or threaten Clark with a cut-off of advances if it did pay vendors."[4] Nonetheless, the new advances did not leave Clark with enough money to pay vendors or others whose services were not essential for continuation of the business.

After several unpaid vendors commenced foreclosure proceedings based on vendors' liens, Clark sought protection under chapter 11. The case was converted to chapter 7 soon thereafter. The relationship between Clark and Associates led the trustee in bankruptcy to institute an adversary proceeding that sought the recovery of preferences from Associates and equitable subordination of its claim. Following a trial, the bankruptcy court entered judgment against Associates in the sum of $370,505, representing payments found to be preferential, and subordinated Associates' claim. The district court and the court of appeals originally affirmed, but then the court of appeals substituted a different opinion, reversing and remanding.

The first issue before the court of appeals was whether the bankruptcy court was correct in finding that Clark, by selling its inventory and then turning over the realized accounts receivable that had previously been assigned to Associates, made a preferential transfer to Associates avoidable under Sections 547(b) and 547(c)(5) of the Bankruptcy Code.[5] "Under section 547(c)(5), a voidable preferential transfer occurred if Associates improved its position over the ninety-

[3] *Id.*, 893 F.2d at 695.

[4] *Id.*

[5] Section 547(b) of the Bankruptcy Code, 11 U.S.C. § 547(b), contains five elements of an avoidable preference. Section 547(c) contains a list of the exceptions to § 547(b). Section 547(c)(5) provides:

> The trustee may not avoid under this section a transfer— . . . (5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of
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> (A)(i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or
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> (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or
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> (B) the date on which new value was first given under the security agreement creating such security interest.

day period between February 7 and May 7 to the prejudice of unsecured creditors."[6]

It is important to understand at the outset why a floating lien in inventory or accounts receivable may be vulnerable to preference attack under Section 547(b), despite the fact that the loan, security agreement, and filing of a financing statement have all occurred long before the ninety-day preference period. If a secured creditor has a lien on inventory which generally "turns over" every thirty or sixty days, it follows that all of the inventory owned by the debtor on the date of bankruptcy will be new inventory purchased within the preference period. Add Section 547(e)(3), which provides that a transfer for preference purposes does not occur until the debtor has rights in the collateral, and the result is that the "transfer" of the security interest regarding all the existing inventory took place within ninety days of bankruptcy, and, since the debt was incurred long ago, the transfer is one that secures an antecedent debt.

It is easy to see how the effect of Section 547(e)(3), standing alone, would wipe out the benefits of having a perfected lien in inventory or accounts receivable. However, Section 547(c)(5) at least partially rescues the secured creditor by insulating the floating lien from preference attack to the extent that the secured creditor's position did not improve during the ninety-day period at the expense of other creditors.

In order to determine whether Associates improved its position during the ninety-day preference period, the court applied the Section 547(c)(5) two-part test it had explained in *In re Missionary Baptist Foundation of America, Inc.*[7] In essence, this test requires a computation of (1) the loan balance outstanding ninety days prior to bankruptcy; (2) the value of the collateral on that day; (3) the loan balance outstanding on the day the bankruptcy petition was filed; and (4) the value of the collateral on that day.

A determination could be made as to whether Associates improved its position by a comparison of the loan balance minus the value of Associates' collateral on February 5 with the loan balance minus the value of Associates' collateral on May 7. Since the loan balances were not in dispute, the task facing the court was a determination of the value of the collateral.

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[6] See note 3 *supra*, 893 F.2d at 696, where the court observed that Associates did not raise the issue of whether Clark's liquidation of inventory and receivables and payment of proceeds to Associates worked to prejudice unsecured creditors. The court noted that the parties may have assumed that prejudice to the claims of vendors may have satisfied this requirement: "In any event we do not reach that issue here. We only note, however, that improvement in position, standing alone, does not establish a preferential transfer—the transfer must be 'to the prejudice of other creditors holding unsecured claims.' "

[7] 796 F.2d 752, 760 (5th Cir. 1986).

Going Concern vs. Liquidation Value

Resolution of the question of whether the secured creditor improved its position will often depend on the method of valuation used. Since the Bankruptcy Code offers no definition of value, the courts have been left to determine its meaning on a case-by-case basis.[8] Associates argued that the bankruptcy court should have employed the "going concern" method of valuation rather than the "liquidation" method. Examining the record to determine whether the bankruptcy court adopted the appropriate method of valuing the inventory, the court stated:

> The Code does not prescribe any particular method of valuing collateral, but instead leaves valuation questions to judges on a case-by-case basis . . . . Valuation is a mixed question of law and fact, the factual premises being subject to review on a "clearly erroneous" standard, and the legal conclusions being subject to *de novo* review . . . .[9]

The bankruptcy court had accepted the testimony of the trustee's expert that the debtor was in the process of liquidation throughout the ninety-day period from February 5 to May 7. This finding of fact was not clearly erroneous. Therefore, for the purpose of determining whether Associates improved its position at the expense of other creditors during the ninety-day period, the court of appeals held that the liquidation method of valuing the collateral was appropriate at both ends of the preference period.

The court's use of the liquidation method was consistent with the opinion of authorities in the field. Two commentators, in an article on valuation in bankruptcy, have noted:

> If an asset is not used as part of a business, or if the business is not viable, the asset is valued at how much it will bring at a sale less the costs of disposition—a "liquidation value." Liquidation values assume no future or a limited future for an asset's relationship to a concern. The liquidation value of an asset will depend on how much time is available for its disposition, who is selling it, and how and where it is sold.[10]

Debtor's Perspective vs. Secured Creditor's Perspective

Associates also argued that assuming that the liquidation method was appropriate, the bankruptcy court improperly viewed the value of inventory from the debtor's perspective rather than the creditor's perspective. Associates complained that the bankruptcy court erred

[8] See 4 *Collier on Bankruptcy* (15th ed. 1989) ¶ 547.13 at 547-556: "The Code offers no guidance to determining the value to be used in calculating a creditor's improvement in position. In a liquidation case under chapter 7 it would seem that a liquidation value should be used, although other valuation standards may be appropriate under certain circumstances."

[9] Note 2 *supra*, 893 F.2d at 697.

[10] Fortgang & Mayer, "Valuation in Bankruptcy," 32 U.C.L.A. L. Rev. 1061, 1064 (1985).

when it subtracted out the debtor's operating costs that bore no relation to the liquidation of inventory. In other words, the value of the inventory to the secured creditor is the only significant factor in applying the improvement of position test; any cost or benefit to the estate of the continued use of the inventory is not important.

The court of appeals agreed with Associates' position that the bankruptcy court improperly valued the collateral from the debtor's perspective:

> The "ultimate goal" of the improvement in position test is "to determine whether the *secured creditor* is in a better position than it would have been had bankruptcy been declared ninety days earlier . . . . Cases that have addressed the valuation of inventory in the "improvement in position" test have repeatedly focused on value in the hands of the creditor.[11]

Once the court concluded that the bankruptcy court erred in focusing on the value of the inventory in the hands of the debtor instead of on the value in the hands of the secured creditor, the question of whether the bankruptcy court erred in deducting Clark's expenses that were unrelated to the cost of liquidation had become moot. The court emphasized, however, that, on remand, the only costs to be considered and deducted in determining the value of the inventory were those that would be incurred if a seizure and sale of the inventory by Associates had taken place.

The court of appeals also cautioned the bankruptcy court to consider "the specific economic realities surrounding a transfer" when valuing either inventory or accounts receivable.[12] In this connection, the bankruptcy court was criticized for valuing the collateral at 60 percent below cost. Even if the bankruptcy court was correct in valuing the collateral from the debtor's vantage point, it ignored economic realities in reaching its conclusion in the fact of credible evidence showing that, during the ninety-day preference period, (1) there was stability in the pipe market; (2) the fair market value of pipe was approximately 100 percent of cost; (3) the debtor actually liquidated inventory at 93 percent to 123 percent of cost; and (4) pipe vendors were willing to give credit for returned pipe at or near 100 percent of cost.

In remanding the matter on the valuation issue, the court of appeals suggested that the bankruptcy court might wish to consider upon request of either party whether an unexercised vendor's privilege, which under Louisiana law may prime the security interest, should be considered in valuing inventory from the perspective of Associates.[13] The court of appeals expressed no views on the possible answer. Whether the vendor holding a lien that had not been exercised lost its priority is an

[11] Note 2 *supra*, 893 F.2d at 698.

[12] *Id.* at 699.

[13] *Id.* at 698 n.4.

issue under Louisiana law that the court left for another day, but the effect of such loss would increase the value of the property when sold.

Equitable Subordination

The trustee had another arrow for his bow: a cause of action for equitable subordination under Section 510(c) of the Code.[14] Subordination would reclassify Associates' claim to the extent that its lien would be transferred to the estate and Associates would receive no dividend until general creditors were fully paid. A mere recovery of a preference without equitable subordination would not be as devastating to the secured creditor in that it would still leave Associates' with an unsecured claim deserving of equal treatment with other unsecured claims.

At the outset of its discussion in its second opinion on the issue, the court of appeals set forth the test for determining whether equitable subordination was justified:

> This court has enunciated a three-pronged test to determine whether and to what extent a claim should be equitably subordinated: (1) the claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.[15]

Regarding the first prong of the test—inequitable conduct—the court noted that three general categories of conduct have been recognized as sufficient to satisfy this prong: (1) fraud, illegality or breach of fiduciary duties; (2) undercapitalization; and (3) a claimant's use of the debtor as a mere instrumentality or alter ego.

The bankruptcy court held that under the facts of the case, Associates' conduct warranted equitable subordination. The bankruptcy court found that, having realized Clark's desperate financial condition, Associates asserted "total control" over Clark and used Clark as a "mere instrumentality to liquidate Associates' unpaid loans" to the detriment of other creditors.[16] At first, the court of appeals agreed with that finding and affirmed the subordination of Associates' claim. However, on reconsideration, the court of appeals reversed itself and

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[14] 11 U.S.C. § 510(c) provides:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim . . .; or
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

See generally, B. Weintraub & A. Resnick, *Bankruptcy Law Manual*, ¶ 5.15 (rev. ed. 1986).

[15] Note 2 *supra*, 893 F.2d at 699. The court cited its decision in *In re* Missionary Baptist Foundation of Am., 71 F.2d 206, 212 (5th Cir. 1983).

[16] Note 2 *supra*, 893 F.2d at 699.

held that such subordination was not warranted under the facts of the case. The court of appeals stated:

> Upon reconsideration, we have concluded that we cannot say that the sort of control Associates asserted over Clark's financial affairs rises to the level of unconscionable conduct necessary to justify the application of the doctrine of equitable subordination.[17]

The "salient fact" that was the primary cause of the court's withdrawal of its prior decision was that, pursuant to the loan agreement between the parties, Associates had the right to reduce funding as Clark's sales slowed and all that it did was to exercise that right. There was no evidence that Associates exceeded its authority under the loan agreement nor that Associates acted inequitably. Furthermore, the agreement was negotiated at arm's length between the parties almost two years before bankruptcy, while their relationship was just beginning and while Clark was solvent. Clark was represented by an attorney, and the agreements were typical of the documents used in similar asset-based financing.

The loan agreement established a line of credit equal to 85 percent of the amount of eligible accounts receivable plus 60 percent of the cost of inventory. Clark was required to deposit all collections from the accounts receivable in a bank account belonging to Associates, and Associates would then re-advance the agreed-upon portion of those funds to Clark on a revolving basis. The agreement gave Associates the right to reduce the percentage advance rates at any time in its discretion.

With the decline in Clark's business, Associates reduced the advance ratio for the inventory loan by 5 percent per month beginning in January 1982. The company stopped buying new inventory after that time. Despite Associates' motive to obtain as much money for itself prior to the filing of the petition, the amount of new advances continued to be based on the applicable funding formulas.

The court of appeals noted that in its original opinion, it failed to focus sufficiently on the loan agreement that gave Associates the right to conduct its affairs with Clark in the manner in which it did, and was influenced by the "negative and inculpatory tone of [Associates' former loan officer's] testimony. Given the agreement he was working under, his testimony was hardly more than fanfaronading about the power that the agreement afforded him over the financial affairs of Clark."[18] On reconsideration, the court of appeals concluded that the record did not reveal any conduct on Associates' part that was inconsistent with the loan agreement:

[17] *Id.*

[18] *Id.* at 701. Associates' former loan officer testified that Associates' motive was "to get in the best possible position I can prior to the bankruptcy, i.e., I want to get the absolute amount of dollars as low as I can by hook or crook." *Id.* at 700.

> Through its loan agreement, every lender effectively exercises "control" over its borrowers to some degree. A lender in Associates' position will usually possess "control" in the sense that it can foreclose or drastically reduce the debtor's financing. The purpose of equitable subordination is to distinguish between the unilateral remedies that a creditor may properly enforce pursuant to its agreements with the debtor and other inequitable conduct such as fraud, misrepresentation, or the exercise of such total control over the debtor as to have essentially replaced its decision-making capacity with that of the lender. The crucial distinction between what is inequitable and what a lender can reasonably and legitimately do to protect its interests is the distinction between the existence of "control" and the exercise of that "control" to direct the activities of the debtor.[19]

The court distinguished Associates' conduct from that of the creditor in *In re American Lumber Co.*,[20] a decision in which the claim of a bank was equitably subordinated. The court of appeals commented that "the facts of that case are significantly more egregious than we have here."[21] In *American Lumber*, the bank "controlled" the debtor through its controlling interest in the debtor's stock. The bank exercised control over all aspects of the company's finances and operations. Despite the bank's decision to prohibit further advances to the company and to use all available funds of the company to offset the company's obligations to the bank, the bank made two misrepresentations to a credit association when it assured the association that the debtor was not in a bankruptcy situation and that current contracts would be fulfilled. Only two days later, the bank gave notice of foreclosure of its security interests in the inventory and equipment, which were sold shortly thereafter, and the bank applied all of the proceeds to the bank debt.

In contrast to *American Lumber*, the court of appeals indicated that Associates held no stock in the debtor, made no management decisions, did not place any of its employees as officers or directors of Clark, never influenced the removal of employees from office, nor requested Clark to take any particular action at a shareholders' meeting. Associates did not expressly dictate to Clark which bills to pay, nor did it direct Clark not to pay vendors or threaten a cutoff in advances if it did pay vendors. Clark handled its own daily operations and, during the ninety-day period, did not change its basic procedures regarding reporting of collateral, calculation of availability of funds, and advancement of funds.

> Unlike the lender in *American Lumber*, Associates did not mislead creditors to continue supplying Clark . . . [and] perhaps most important . . . Associates did not coerce Clark into

[19] *Id.* at 701.
[20] 5 Bankr. 470 (D. Minn. 1980).
[21] Note 2 *supra*, 893 F.2d at 701.

> executing the security agreements after Clark became insolvent. . . .[22]

The court concluded that Associates did not engage in inequitable conduct. The earlier opinion of the court assumed that Associates knew that Clark was selling pipe to which suppliers had a first lien, but, in its second opinion, the court recognized that that priority issue was not decided by the court until a later date. Although the trustee made much of the point that Associates encouraged Clark to remove decals from the pipes in its inventory, the court's reexamination of the record reveals that it did not support such finding. The court also found that the record was devoid of evidence that Associates misled creditors to their detriment.

Having held that equitable subordination was inapplicable in the case, the court of appeals opted to avoid addressing the question whether avoiding the transfer and equitable subordination are duplicative or complementary remedies.[23]

Conclusion

The *Clark Pipe* case demonstrates the complexity of resolving valuation issues in bankruptcy proceedings. The facts reveal a paradox of the valuation syndrome, where the debtor was open for business as a going concern while at the same time liquidating its inventory. The court's use of liquidation value was correct, especially in view of its decision to measure value from the secured creditor's standpoint. Clearly, in the hands of the secured creditor, the inventory would have been liquidated. We also are confident that the court's decision to view the improvement of position test from the creditor's vantage point was correct. From the secured creditor's perspective, the inventory usually would have brought less if it had seized and sold the inventory at a foreclosure sale and deducted the costs of seizure and sale.

Secured creditors should take comfort in the court's discussion of equitable subordination. The first opinion of the court had the secured creditor worrying about whether it had the right to use procedures and remedies clearly provided for in loan documents negotiated at arm's length and in accordance with typical commercial practice. The second opinion correctly distinguished between, on the one hand, exercising too much control over the internal operations of the debtor coupled with deceptive practices and, on the other hand, relying on aggressive but traditional secured creditor remedies found in garden variety asset-based lending agreements.

Since the court of appeals held that equitable subordination was not applicable to the case, it did not address the question of whether avoiding the transfer as a preference and equitable subordination are duplicative or complementary remedies. There is nothing in Section 510(c) which indicates that it is du-

[22] *Id.* at 702.

[23] *Id.* at 695.

plicative of Section 547 on preferences. Equitable subordination of claims is a concept that may be applied independently and in addition to remedies provided under Section 547.