

University of Colorado Law School

## Colorado Law Scholarly Commons

---

Publications

Colorado Law Faculty Scholarship

---

1991

### Lender Liability: The Dilemma of the Controlling Creditor

J. Dennis Hynes

*University of Colorado Law School*

Follow this and additional works at: <https://scholar.law.colorado.edu/faculty-articles>



Part of the [Agency Commons](#), [Business Organizations Law Commons](#), [Commercial Law Commons](#), and the [Torts Commons](#)

---

#### Citation Information

J. Dennis Hynes, *Lender Liability: The Dilemma of the Controlling Creditor*, 58 TENN. L. REV. 635 (1991), available at <https://scholar.law.colorado.edu/faculty-articles/891>.

#### Copyright Statement

Copyright protected. Use of materials from this collection beyond the exceptions provided for in the Fair Use and Educational Use clauses of the U.S. Copyright Law may violate federal law. Permission to publish or reproduce is required.

This Article is brought to you for free and open access by the Colorado Law Faculty Scholarship at Colorado Law Scholarly Commons. It has been accepted for inclusion in Publications by an authorized administrator of Colorado Law Scholarly Commons. For more information, please contact [rebecca.ciota@colorado.edu](mailto:rebecca.ciota@colorado.edu).

# HEINONLINE

Citation: 58 Tenn. L. Rev. 635 1990-1991

Provided by:

William A. Wise Law Library



Content downloaded/printed from [HeinOnline](#)

Tue Aug 8 18:42:26 2017

- Your use of this HeinOnline PDF indicates your acceptance of HeinOnline's Terms and Conditions of the license agreement available at <http://heinonline.org/HOL/License>
- The search text of this PDF is generated from uncorrected OCR text.
- To obtain permission to use this article beyond the scope of your HeinOnline license, please use:

[Copyright Information](#)

# LENDER LIABILITY: THE DILEMMA OF THE CONTROLLING CREDITOR

J. DENNIS HYNES\*

“[T]he venture is the principal’s, and . . . as the profits will be his, so should be the expenses.”

—*Justice, Learned Hand*<sup>1</sup>

A creditor who lends money to a business naturally has an interest in the way the business is conducted. The larger the loan, the more likely it is that the creditor will want information on and some control over the operation of the business in order to reduce the risk of default. Concomitantly, the larger a loan the more likely it is a creditor will be granted what it seeks.<sup>2</sup> This article will discuss the

---

\* Professor of Law, University of Colorado School of Law. I wish to thank Professors Cliff Calhoun, Homer Clark, Deborah DeMott, Mark Loewenstein, Kerry Macintosh, Tom Oldham, Charles Tabb, Art Travers, and Nort Steuben for their thoughtful comments on an earlier draft of this article. I also wish to acknowledge the valuable assistance of my research assistants Brian Connors and Greg Sopkin.

1. *Admiral Oriental Line v. United States*, 86 F.2d 201, 202 (2d Cir. 1936). The context of the quote is that of a claim by an agent for reimbursement of litigation expenses incurred in successfully defending a lawsuit related to discharge of its duties. The agent recovered its necessary and proper expenses on the above reasoning.

2. The above text assumes control is contracted for at the outset of a loan. A creditor also may contract for control (or increase the amount of existing control) after a loan has been made once it is discovered that the debtor is in economic trouble. The rights to control may be obtained as a condition of waiving events of default, of refinancing, or of further extension of credit, if the original contract did not anticipate the problem. The travails of Mr. Donald Trump provide a widely publicized example of this. See *N.Y. Times*, June 25, 1990, at C1, col. 5, noting that the terms of a bridge loan from his creditors to the fiscally strapped Mr. Trump would include “stringent restrictions on his personal and business finances.” The restrictions include limiting personal expenses to a monthly maximum and requiring him “to adhere to a clearly outlined business plan with month-to-month cash flow projections and item-by-item disbursements, and that a chief financial officer and a system of accounting controls be put in place by the Trump Organization by Sept. 30.” It was left unclear in the newspaper article whether the chief financial officer would be appointed by the banks or merely approved by them, but it is clear that Mr. Trump is no longer in sole charge of his business enterprise.

risks incurred under the common law of agency by a creditor exercising control over a borrower's business.<sup>3</sup>

The exercise of control may expose a creditor to non-agency common law liability for negligence<sup>4</sup> and other tortious conduct, such as interference with contractual relationships<sup>5</sup> or fraud.<sup>6</sup> This fault-based liability is well accepted.<sup>7</sup>

---

3. A number of statutes speak to the consequences of creditor control in particular situations. See Lundgren, *Liability of a Creditor in a Control Relationship with Its Debtor*, 67 MARQ. L. REV. 523, 540-46 (1984) (discussing a controlling creditor's liability under section 15 of the Securities Act of 1933, 15 U.S.C. § 77o (1982) and § 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t (1982) for the actions of debtors who are found guilty of violating the Acts). See also, Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343 (1975) (discussing a creditor's liability to its debtor and to third parties for improperly participating in the management of its debtor's business). A controlling creditor is vulnerable under bankruptcy law to the doctrine of equitable subordination. This doctrine allows a bankruptcy court to subordinate the claim of a controlling creditor who engaged in inequitable conduct. In addition, a creditor is also subject to the law of insider preferences, which increases the time for challenging transactions between the creditor and the bankrupt to one year under some circumstances. See Kunkel, *The Fox Takes Over the Chicken House: Creditor Interference with Farm Management*, 60 N.D.L. REV. 445, 471-86 (1984). The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. §§ 9601 to 9675 (1988), contains language exposing lenders to liability if they were "participating in the management" of a contaminated site. 42 U.S.C. § 9601(20)(A) (Supp. IV 1986). See Tom, *Interpreting the Meaning of Lender Management Participation under Section 101(20)(A) of CERCLA*, 98 YALE L. J. 925 (1989). Because these liabilities are statutory in nature, they will not be discussed further in this article. Also, while far from trivial, the liability each statute imposes does not amount to liability for all of the debts of the business subsequent to the creditor's exercise of control. Such liability is the focus of this article.

4. See *In re Franklin Nat'l Bank Sec. Litig.*, 445 F. Supp. 723 (E.D.N.Y. 1978) (holding the FDIC would be liable if it assumed control over a bank and acted negligently in running the bank). Liability for negligence arises because the power of control over an activity creates a duty of care with regard to the exercise of that power. This has been true for centuries. See PROSSER AND KEETON ON TORTS 384 (5th ed. 1984).

5. This involves the tort of intentional interference with existing contractual relations. See RESTATEMENT (SECOND) OF TORTS § 767 (1981). For a representative case, see *Flintridge Station Assocs. v. American Fletcher Mortgage Co.*, 761 F.2d 434 (7th Cir. 1985) (borrower unsuccessfully claimed interference by interim creditor with borrower's contractual agreements with property developers and renters).

6. See *Stirling v. Chemical Bank*, 382 F. Supp. 1146 (S.D.N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir. 1975) (claim of fraud by stockholders against creditor—the claim related to fraudulent acquisition of control rather than fraudulent use of control, but the concept is the same). See also, *State Nat'l Bank v. Farah Mfg. Co.*, 678 S.W.2d 661 (Tex. Ct. App. 1984) (debtor sued creditor for damages, claiming fraud, duress, and interference with business relations based on creditor's threat to exercise its contractual rights to call loan if a change in the office of president and chief executive officer was deemed adverse to the interest of the banks—plaintiff recovered a \$12 million judgment in what appears to be a dubious

Authority exists for the proposition that the common law should go further and hold a creditor engaged in substantial control of a debtor's business liable for all debts of the business incurred subsequent to the exercise of control, as if the creditor owned the business and had a right to its profits. This authority is reflected in Section 14 O of the Restatement (Second) of Agency,<sup>8</sup> which 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.

Section 14 O was added to the second edition of the Restatement.<sup>9</sup> There are no reporter's notes to Section 14 O, and the American Law Institute proceedings recording the discussion of the drafts of the second edition contain no reference to it.<sup>10</sup>

Liability under Section 14 O, which attaches whether the business being controlled is operated in corporate, partnership, or sole proprietorship form, is neither expectation based nor fault related. Thus, there is no requirement that claimants be aware the controlling creditor even exists.<sup>11</sup> Also, liability attaches even if the creditor acted carefully and honestly—a form of strict liability. This poses a dilemma for the controlling creditor. The more critical the financial

---

application of law to facts); *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985) (good faith limitation imposed on lender's clearly express contractual power to demand repayment of loan). See Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131 (1989) (trenchantly criticizing both the *Farah* and *K.M.C.* cases); Tyler, *Emerging Theories of Lender Liability in Texas*, 24 HOUS. L. REV. 411 (1987).

7. See, e.g., Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343, 363 (1975).

8. Unless otherwise provided, all references to any Restatement or Restatement sections are to the RESTATEMENT (SECOND) OF AGENCY (1958).

9. The second edition was published in 1958. The first edition of the Restatement, published in 1933, contains no reference to the topic addressed in Section 14 O. No case or statutory authority from the 25-year period of time between the editions has been uncovered that would account for the promulgation of Section 14 O.

10. See *A Discussion of the Restatement (Second) of Agency*, 33 A.L.I. PROC. 314-98 (1956); *A Discussion of the Restatement (Second) of Agency*, 34 A.L.I. PROC. 224-43 (1957). These proceedings covered discussion of the fourth and fifth tentative drafts of the Restatement (Second) of Agency. The proceedings covering the first three tentative drafts were never published in bound volume format. Typewritten transcripts of those proceedings are available on microfilm only. The author has reviewed the microfilm transcripts and found no discussion of Section 14 O.

11. Under this circumstance the creditor would be classified as an undisclosed principal. See RESTATEMENT (SECOND) OF AGENCY §§ 186 to 211 (1958) (describing the legal status of the undisclosed principal).

condition of a business, the more control the creditor will want to assert in an effort to keep the business in a state of solvency and thus able to repay its debts. Yet the more control the creditor asserts, the greater risk it runs under the common law of agency of incurring personal liability for the debts of the business, which would benefit other, non-involved creditors and expose the creditor who is trying to keep the business solvent to potentially great liability. This article questions whether it is appropriate to expand liability to this extent on the basis of agency principles.

#### A CLOSER LOOK AT SECTION 14 O

Section 14 O is terse, but that fact does not mean the section is free of ambiguity. It contains several words or phrases that raise problems of interpretation.

#### *Control*

The word "control," standing alone, is ambiguous. Defining what is meant by control is one of the most frustrating questions one faces in agency law. For example, control means one thing when the issue is whether one party is liable for the physical tort of another.<sup>12</sup> It means something quite different when contract liability or the fiction of imputed knowledge is of central concern.<sup>13</sup>

What does "control" mean in the context posed by Section 14 O? Does it mean total control, where all decisions relating to a business are made by the creditor, with the owner occupying merely a passive role? Or does it mean any control, whether active or passive in nature, that has the potential to affect in a material way the operation of a business? Some light is shed on these questions by the comment to Section 14 O. Comment a to Section 14 O (there is no comment b) reads in full as follows:

- a. A security holder who merely exercises a veto power over the business acts of his debtor by preventing purchases or sales above specified amounts does not thereby become a principal. However, if he takes over 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 any principal for

---

12. See RESTATEMENT (SECOND) OF AGENCY § 2 (1958). See also, *Kane Furniture Corp. v. Miranda*, 506 So. 2d 1061 (Fla. Dist. Ct. App.), *reh'g den.*, 515 So. 2d 230 (1987) (discussing at length the distinction between a servant and an independent contractor).

13. See RESTATEMENT (SECOND) OF AGENCY §§ 1, 2, 10 (1958). See also, *Thayer v. Pacific Elec. Ry.*, 55 Cal. 2d 430, 360 P.2d 56, 11 Cal. Rptr. 560 (1961) (providing a graphic illustration of how attenuated the control element can be in a context where a court is strongly inclined to find an agency relationship).

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.

Where there is an assignment for the benefit of creditors, the latter may become the principals of the assignee if they exercise control over transactions entered into by him on their behalf.

The Comment suggests the word "control" means managing the business, which appears to be defined as directing what contracts may or may not be made by the business.<sup>14</sup> One might refer to this in a shorthand way as the power to initiate transactions. The possible origins and meaning of this interpretation will be discussed below following a brief treatment of several other words or phrases in Section 14 O. Case authority advancing a much broader interpretation of control then will be identified and discussed.

#### *For the mutual benefit*

The phrase "for the mutual benefit" contained in the text of Section 14 O is not developed further in comment a, perhaps because the drafter thought its meaning was self evident. The benefit to the creditor doubtless is enhancement of the prospects that the loan will be repaid with interest.<sup>15</sup> It is hard to see what other benefit a creditor obtains from incurring the expenditure of time and effort involved in controlling aspects of its debtor's business.<sup>16</sup>

---

14. The phrase "takes over the management," which implies that the debtor plays only a passive role in the business, if read literally, manifests a particularly narrow approach toward the definition of control. The text of Section 14 O, to which the comment is a mere appendage, has been read to adopt a much broader standard of liability. See *infra* notes 54-75 and accompanying text.

15. A distinction may be drawn between ordinary commercial lenders, like banks and insurance companies, and trade creditors, who benefit from a trade relationship with the debtor in addition to receiving interest on the loan. Furtherance of the trade relationship with the debtor is unquestionably the primary incentive for a loan from a trade creditor, with the interest on the loan (which can arise out of a sale on open account or financing of inventory purchases, for example, as well as a straight loan of cash) of secondary concern. This distinction has been addressed only in vague, indirect terms by the courts. See *infra* notes 77-93 and accompanying text. Although the trade creditor in the usual case doubtless benefits more from the credit relationship than does a commercial lender, there nevertheless remains a fundamental distinction between actions benefiting a person and actions taken on behalf of a person. See *infra* text accompanying notes 17-22. It is worth noting that the Restatement makes no effort to distinguish between the two kinds of creditors.

16. The phrase in Section 14 O says "mutual" benefit. It is not as easy to identify the benefit to the debtor in this situation. Presumably nearly all debtors would find creditor control an irritation, not a benefit, because it interferes with the debtor's freedom to run its business as it wishes. The funds created by the loan

The word "benefit" is traditionally distinguished from the phrase "on behalf of" in the law of agency. As will be developed below, the strict liability imposed on principals occurs only when actions are taken on behalf of a principal.<sup>17</sup> People benefit<sup>18</sup> from the actions of other people in a vast variety of ways without incurring the responsibilities of a principal.<sup>19</sup>

Section 14 O states that a controlling creditor becomes a principal as a result of the assumption of control under circumstances where the parties deem it beneficial to do so. The text says nothing about the "on behalf of" element.<sup>20</sup>

This raises the question whether Section 14 O is consistent with other sections of the Restatement. Does Section 14 O recognize an agency relationship where other sections would not? In particular, Section 1 of the Restatement defines agency as involving several elements.<sup>21</sup> Control, though a necessary element under Section 1, is

---

are a benefit, of course, but doubtless that is not what Section 14 O was addressing. Perhaps the Restatement's view of benefit is paternalistic in nature. The assumption may be that the debtor's business is not doing well and that the restraint supplied by the controlling creditor is what is needed in order to avoid insolvency.

17. See, e.g., RESTATEMENT (SECOND) OF AGENCY § 13 comment b (1958), stating "the understanding that one is to act primarily for the benefit of another is often the determinative feature in distinguishing the agency relation from other relations." Acting "primarily for the benefit of another" is often utilized by the Restatement as a synonym for "on behalf of." It is not always easy to draw the line between actions merely benefiting someone and actions on behalf of someone. That can be a difficult, uncertain task under some circumstances. Those circumstances would not seem to include the situation being addressed by this article, however, in which the inference of mere benefit seems clear. That is, one can ask how an owner of a business could fairly be viewed as acting "primarily" for the benefit of a creditor when his goal is to generate profits for himself.

18. The word "benefit" is not a term of art in the law of agency. It is used in its ordinary sense to mean anything that promotes or enhances well-being, something helpful or advantageous. "On behalf of," on the other hand, means that one acts *primarily* for the benefit of another, which naturally entails a greater sense of responsibility on the part of the one on whose behalf the action is being taken.

19. An example of this can be drawn from the everyday act of delivering a newspaper. The person subscribing to a paper clearly is benefited by receiving delivery. The subscriber may be exercising some control as well, by specifying where the paper should be thrown, for example. Yet it is manifestly clear that the carrier is not acting on the subscriber's behalf. So far as appears, a mere subscriber has never been held vicariously liable for the negligence of a carrier.

20. An exception to the absence of any reference to the "on behalf of" element is contained in the last paragraph of comment a to Section 14 O. The comment states "where there is an assignment for the benefit of creditors, the latter may become the principals of the assignee if they exercise control over transactions entered into by him on their behalf." This exception, however, addresses a narrow and discrete matter, that of an assignment for the benefit of creditors. See *infra* notes 97-109 and accompanying text (specifically, *Cox v. Hickman*, 11 Eng. Rep. 431 (1860)).

21. Section 1 of the Restatement includes three elements:



not sufficient to establish an agency relationship. Section 1 also specifies that the actor must be acting on behalf of the other before an agency relationship is created.<sup>22</sup> One can characterize this as expressing a limitation fundamental to the moral foundation of agency law, in the sense that it is unfair to impose strict liability for the acts of others on a person unless, as a minimum, the acts are being taken on behalf of the person being held strictly liable.

It can be argued that use of a standard other than "on behalf of" reflects an intention of the drafter, Professor Warren Seavey, to create with Section 14 O a separate substantive basis of liability. Any evaluative discussion thus should be confined to the merits of holding creditors to such a standard, and should not address the

---

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. The one for whom action is to be taken is the principal. The one who is to act is the agent.

22. *Id.* See also, § 14 J, distinguishing an agent and a buyer, stating in part as follows: "[W]hether [one] is an agent for this purpose or is himself a buyer depends upon whether the parties agree that his duty is to act primarily for the benefit of the one delivering the goods to him or is to act primarily for his own benefit." Additionally, § 14 K distinguishes an agent and a seller by stating the actor is an agent "only if it is agreed that he is to act primarily for the benefit of the other and not for himself." In *A Discussion of the Restatement (Second) of Agency*, 32 A.L.I. PROC. 174 (1955) (microfilm), Professor Seavey, speaking as Reporter for the second edition of the Restatement, elaborated on the above standard in response to the following question from the floor: "Is there any authority in the cases for the proposition that the distinction between a buyer and his agent is the extent of his benefit?" Professor Seavey stated:

I'm sorry. I didn't use the word "benefit." I used "primarily for the benefit of." "Primarily for the benefit," but not the extent of the benefits which are received in any given case. It is a problem of loyalty. A buyer does not necessarily have loyalty to his seller. The agent necessarily does have loyalty. The buyer can prefer his own interests. That is what we mean, "acts for the benefit of," not that he receives in any given case specific benefits, but whether he is under a duty to prefer the interests of the other party or his own. In any case of conflict, an agent must prefer or at least must not ignore the interests of his principal. . . .

...  
We have only the factor of loyalty. That is important and you cannot get along without it. That is the thing beside which all others fade into insignificance. Once we have loyalty—or no loyalty as opposed—then we have agency or no agency. The difficulty comes when you determine whether or not that situation exists, and that is why we give these factors, to determine whether ultimately he has the duty of loyalty.

*Id.* at 190, 193.

The above text relates the "on behalf of" element to the fiduciary aspects of the agency relationship: the agent must be loyal to the principal, and is under a duty to prefer the principal's interests. This underscores the inappropriateness of characterizing a debtor as an agent of its creditor; the duty of loyalty simply does not fit the debtor-creditor relationship.

consistency of Section 14 O with § 1 of the Restatement because no such consistency was intended.<sup>23</sup> The proceedings of the American Law Institute that contain the discussion of the second edition of the Restatement, although never directly addressing the topic of Section 14 O, make it clear, however, that there was no intention to depart from basic agency principles. Professor Seavey in the discussion expressly referred to the new subsections of Section 14 as mere corollaries to Sections 12 through 14 of the Restatement, which address the basic agency relationship.<sup>24</sup>

### *May*

The word "may" in the phrase "may become a principal" is ambiguous.<sup>25</sup> The use of it in the text of Section 14 O appears to be explained by the distinction drawn in the comment between different kinds of control. Courts have not confined analysis to that distinction, however, as will be developed below.

### *Security holder*

Finally, the comment discusses a "security holder." This is a

---

23. Indeed, it can further be argued that another term ("mutual benefit") was used in order to avoid inconsistency. Yet this argument is unconvincing. Why would the promulgators of the Restatement want to introduce in one subsection of its 528 sections an independent basis of liability? This would manifest a desire to single out creditors for special treatment that one does not see displayed in any other section of the Restatement.

24. See *A Discussion of the Restatement (Second) of Agency*, 32 A.L.I. PROC. 174 (1955) (microfilm). Chairman Buchanan introduced the topic by stating that "the Reporter will tell us about an entirely new Topic . . . headed Agency Distinguished From Other Relations . . ." *Id.* at 181. Professor Seavey, the Reporter, thereafter stated that

[t]he reason for putting these all in is to make distinctions which actually bother the courts, which are all included, if you like, in the preceding three sections. . . . Sections 12, 13 and 14, which remain as they were. I simply amplified in Sections 14 A to section 14 O; 12, 13, and 14 give the principles by which we decide whether a thing is Agency or Trust or something else.

*Id.* at 181-82. Sections 12, 13, and 14 have as their topics standard features of the agency relationship. Section 12 is titled Agent as Holder of a Power; section 13 is titled Agent as a Fiduciary; Section 14 is titled Control by Principal and is subtitled, "A principal has the right to control the conduct of the agent with respect to matters entrusted to him."

One can argue, considering this, that the function of Section 14 O was simply to warn undisclosed principals who happen to be creditors not to exercise too much control on penalty of being held liable for the debts of the business. This interpretation is invalid, however, because an undisclosed principal is liable for the debts of his business in any event, control or no control.

25. The language might better read "shall become" in place of "may," assuming "control" meets the standard in Comment a. Such change in language at least would state more directly and forcefully the potentially wide reach of Section 14 O.

narrower term than "creditor," which is the word used in the text of the section. With regard to the intended meaning, it seems likely that the wording of the text more accurately expresses the meaning of the section. It is true that holding a security interest may make more likely an inference of control because of the availability of the threat of foreclosure. It does not seem consistent with the tenor of Section 14 O, however, to confine liability to a secured creditor if an unsecured creditor also as a matter of fact exercises pervasive control over transactions.<sup>26</sup>

*The power to initiate transactions:  
A further look at control as defined by comment a*

As mentioned above, the comment draws a distinction between control by veto power<sup>27</sup> and the power to initiate transactions. Either type of control,<sup>28</sup> however, may be used in a way that will have a material effect on a business. So why distinguish between them? The Restatement does not explain this, apparently assuming its rationale is self-evident. It may have drawn inspiration from the law of partnership or from the "mere instrumentality" theory, each of which will be discussed below.

*The partnership analogy*

The distinction drawn by the Restatement between a veto power and the power to initiate transactions has been expressly utilized in the partnership context.<sup>29</sup> This distinction was the analytical linchpin in a famous partnership case, *Martin v. Peyton*.<sup>30</sup> In *Martin* a claim was made that the defendants by virtue of the actions described

---

26. It should be noted, however, that the title to Section 14 O reads as follows: "Security Holder Becoming a Principal."

27. Although a literal reading of the language of comment a confines the veto power limitation only to restrictions relating to purchases or sales above a certain amount, doubtless this was intended to be merely an example. It seems likely the text meant to immunize all veto powers, however defined. It would be strange to consign all other veto powers, however expressed, to the purgatory of liability suffered by the affirmative power to initiate transactions, particularly since the veto power mentioned in comment a is one of the more powerful ones imaginable.

28. Comment a can be read to define "control" only as the power to initiate transactions, exclusive of veto power. It seems obvious, however, that the holder of a wide-ranging veto power is in a position to exercise some control over the business involved, inviting a distinction between types of control.

29. The law of partnership seems a step away from the agency analysis which is the focus of this paper. Partners are general agents of each other, however, and this principle ties the laws of agency and partnership closely together. Further, the liability under Section 14 O bears some resemblance to ownership liability, which makes the question posed in this section directly relevant.

30. 246 N.Y. 213, 158 N.E. 77 (1927).

below had become de facto partners of an investment banking partnership, Knauth, Nachod & Kuhne (K, N & K).

The defendants were friends of Hall, a partner in K, N & K. The partnership was in great financial difficulty, having made some unwise speculative investments. At the request of Hall and pursuant to an elaborate agreement dated June 4, 1921, defendants loaned K, N & K \$2,500,000 worth of securities to be used as collateral to secure loans of \$2 million. The securities were to be returned on or before April 15, 1923. Defendants were to receive forty percent of the profits of the firm until the securities were returned, not exceeding \$500 thousand and not less than \$100 thousand.

Until the securities were returned the directing management of the firm was to be in the hands of Hall alone, whose life was to be insured for \$1 million and the insurance policies assigned as collateral for the loan of securities. The firm handed over to defendants as further collateral a large number of its own securities that were too speculative to be usable as collateral for bank loans.

Two of the defendants were designated as trustees and represented the other lender-defendants. They were to be kept informed of all transactions affecting the loaned securities and were to be paid all dividends accruing therefrom. In addition, they were to be kept advised as to the conduct of the business and consulted on important matters. The trustees could inspect the firm's books and were entitled to any information they thought important. They could veto any business they thought highly speculative or injurious.

Each member of K, N & K assigned to the trustees his interest in the firm and placed his resignation in the hands of Hall. If at any time Hall and the trustees agreed, the resignation would be accepted and the member would "retire." Defendants were given the option to become partners if they or any of them expressed a desire to do so before June 4, 1923. The amount of money each partner could draw from the firm was fixed. No loans to partners by the firm were allowed.

The court held there was nothing in the behavior of the parties after the agreement that detracted from or modified the language of the agreement, nor were there any facts raising a partnership by estoppel claim.<sup>31</sup> Thus the court confined its inquiry to the agreement of the parties in deciding whether the defendants were co-owners of the business and therefore liable as partners for its obligations as claimed by plaintiffs, who were creditors of K, N & K.

The court held the defendants had not become partners as a result of the privileges and powers they enjoyed under the terms of

---

31. See UNIFORM PARTNERSHIP ACT § 16, addressing the concept of liability as a partner by estoppel. The concept protects persons who reasonably assume from manifestations made or explicitly or implicitly authorized by the person being estopped that such person is a partner of a firm.

the agreement. In its discussion of the wide-ranging veto power the trustees held, the court stated: "[W]e hold this but a proper precaution to safeguard the loan. The trustees may not initiate any transaction as a partner may do. They may not bind the firm by any action of their own."<sup>32</sup>

The *Martin* court thus clearly distinguished between a veto power and the power to initiate transactions.<sup>33</sup> As noted above, the court was deciding whether the defendants before it were co-owners or creditors. Power to initiate transactions was deemed to resemble ownership, and mere veto power was deemed to be consistent solely with creditor status.<sup>34</sup>

It may be significant that the defendants in *Martin* possessed more than a wide-ranging veto power. Defendants also required that the business be managed by Hall, who had a close association with them. They shared in the profits of the business. They had the resignations of the other owners in hand. They contemplated the acquisition of personal ownership of the business and made detailed

---

32. 246 N.Y. at 221, 158 N.E. at 79.

33. As mentioned previously, this distinction is what may have caught the eye of the drafters of comment a to Section 14 O, who drew a similar distinction, although in a context that did not directly involve the drawing of inferences concerning ownership. With regard to the test of power to initiate transactions, see Douglas, *Vicarious Liability and Administration of Risk II*, 38 YALE L.J. 720 (1929), advancing the thesis that the risk of ownership liability should be placed on those parties in an enterprise who share the power to set prices and to control costs of the enterprise because such persons can best distribute the risks of the enterprise. A shorthand way to express this is to say that those who have the capacity to initiate transactions should bear the risk of liability. Thus it appears at first glance that Douglas can be cited as supporting comment a. Douglas also notes in his discussion, however, that "[w]hile it is true that the presence of the profit earmark is not essential for the purpose of creating the capacity to distribute risks, it is important for another purpose. That purpose is compensation for risk bearing." *Id.* at 737.

34. Although not cited by the court in support of its decision, the Official Comment to UNIFORM PARTNERSHIP ACT § 6(1) states that, "Ownership involves the power of ultimate control. To state that partners are co-owners of a business is to state that they each have the power of ultimate control." The Comment does not develop the point further but it seems likely that the "power of ultimate control" means the power to initiate transactions. It is through the exercise of such power that prices are set, markets defined, insurance obtained, suppliers identified, and so forth. All of this bears directly on the profitability of the business. Exercise of the power may not make one an owner of the business, it can be argued, but it subjects one to the liabilities of an owner. Thus the Official Comment to Section 6(1) can be cited as supporting Comment a and may have served in part as its inspiration. It is probable, however, that the drafters of the Official Comment were impliedly assuming that persons enjoying the "power of ultimate control" were persons who have a financial stake in the partnership, often through a capital contribution and always through a right to profits. It seems highly unlikely the drafters intended to impose ownership liability on a person who has no equity or profit stake in the business.

plans for that eventuality.<sup>35</sup> All of these factors would make the power to initiate transactions a matter of significance because of the substantial involvement of the defendants in the business. The defendants were far more involved than the typical creditor.

Under the circumstances present in *Martin*, possession and use of the power to initiate transactions might have tipped the scale toward liability for the debts of the business. But one is left with the question whether such power standing alone, which Section 14 O seems to contemplate, would have been sufficient to impose ownership liability on the defendants in the eyes of the court.

### *The "mere instrumentality" analogy*

The "mere instrumentality" (or "alter ego") doctrine has been invoked a number of times, usually unsuccessfully,<sup>36</sup> in efforts to impose liability upon controlling creditors.<sup>37</sup> *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*,<sup>38</sup> is the leading case setting forth the parameters of the instrumentality doctrine in the context of a debtor-creditor relationship between two corporations.

In *Krivo* ten creditors of Brad's Machine Products, Inc., ("Brad's") brought suit against National Distillers and Chemical Corporation ("National"), the major creditor of Brad's. The creditors claimed National had so dominated Brad's that the debtor became National's mere instrumentality.<sup>39</sup>

---

35. *Martin*, 246 N.Y. at 220-23, 158 N.E. at 79-80.

36. See Lundgren, *supra* note 3 at 533, observing that courts are "extremely reluctant" to impose alter ego liability on a creditor who assumes control over a debtor.

37. The doctrine is not used exclusively or even primarily in attacks on controlling creditors who have no ownership interest in the debtor. In the more typical case control is being exercised by one corporation (the parent) over another (the subsidiary). The control stems from ownership by the parent of the stock of the subsidiary. The parent need not be a creditor of the subsidiary. The doctrine is a corporate veil piercing tool, addressing a failure by the parent to respect the separate corporate existence of the subsidiary. The plaintiff is attempting to break through the corporate veil of the subsidiary corporation and hold the parent liable for the debts or misconduct of its subsidiary as a result of the improper exercise of control by the parent. See CLARK, CORPORATE LAW 71-85 (1986); W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 41.10, 42.50 (1990). The doctrine does not have sharp edges and sometimes seems to be used simply as a synonym for control. The phrases "mere instrumentality" and "alter ego" are used interchangeably in the law. A subsidiary is characterized as a mere instrumentality of its parent or it is claimed that the parent has become the alter ego of the subsidiary. The doctrine will be referred to as the instrumentality doctrine in this article.

38. 483 F.2d 1098 (5th Cir. 1973), *modified and reh'g denied*, 490 F.2d 916 (5th Cir. 1974).

39. *Krivo*, 483 F.2d at 1101.

National was a major supplier of brass to Brad's, which used large quantities of the metal in manufacturing fuses for munitions for the federal government. Brad's became heavily indebted to National and was unable to make its payments as they became due.<sup>40</sup> National, which had a considerable interest in continuing to supply Brad's with brass, agreed to provide financing. Thus the *Krivo* case involves a trade creditor as defendant.

National loaned Brad's more than \$2 million over a period of time. It contracted for control over some aspects of the business by requiring that Rudd, an internal auditor of National, oversee the finances of Brad's, establish control procedures for managing cash and investments, and assist in the disposal of nonproductive assets. Rudd's signature was mandatory on all checks from Brad's accounts. No purchase orders could be sent out without his approval. He also designated the order in which creditors would be paid and negotiated the settlement of disputed claims. He provided centralized control over purchases and disbursements.

The court in *Krivo* held two elements are essential for liability under the instrumentality doctrine. "First, 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."<sup>41</sup> "Control" is defined by the court to mean "actual, participatory, total control of the debtor."<sup>42</sup> It is this definition of control that may have caught the attention of those drafting comment a to the Restatement (Second) of Agency Section 14 O.<sup>43</sup>

The *Krivo* court stated that "[m]erely taking an active part in the management of the debtor corporation does not automatically

---

40. It seems the financial problems primarily were caused by unwise personal spending by John Bradford, the principal owner of Brad's and an inventive and skilled machinist. Bradford did not confine his interests to the machinist business. When his business began to prosper, Bradford developed a fondness for race horses, speed boats, and airplanes. He also formed a motion picture company that produced a film featuring himself as a singer. All of these adventures were funded by income from Brad's. *Id.* at 1107.

41. 483 F.2d at 1103.

42. *Id.* at 1105.

43. The second edition of the Restatement was published before the *Krivo* case, but the standard articulated in *Krivo* was based on ample precedent, some of which long predated the Restatement. Comment a to Section 14 O discusses "tak[ing] over the management" of the debtor company and "direct[ing] what contracts may or may not be made" by the debtor. This may reflect the influence of the strict control standard of the instrumentality doctrine. Case authority has not read the comment in such a limited manner, however. See *infra* text accompanying notes 55-76. Nevertheless, troubling and difficult questions emerge when the control of a creditor is total and all-encompassing. See *infra* text accompanying notes 54-76.

constitute control . . . .”<sup>44</sup> “[T]he control required for liability under the ‘instrumentality’ rule amounts to total domination of the subservient corporation, to the extent that the subservient corporation manifests no separate corporate interests of its own and functions solely to achieve the purposes<sup>45</sup> of the dominant corporation.”<sup>46</sup>

The court noted Rudd’s controls were strong and that he “was not afraid to exercise his power.”<sup>47</sup> It conceded National took an active role in the management and control of Brad’s, but noted this meant only that “Brad’s voluntarily *shared* control with National Distillers.”<sup>48</sup> At no time, said the court, did National “assume actual, participatory, total control of Brad’s.”<sup>49</sup> “The evidence shows that, at most, National Distillers shared managerial responsibility for some but not all aspects of the Brad’s operation. That is not enough.”<sup>50</sup> The court made this finding as a matter of law, resolving that the evidence was insufficient to create a jury question on the issue of control.<sup>51</sup>

---

44. 483 F.2d at 1105.

45. See *Irwin & Leighton, Inc. v. W.M. Anderson Co.*, 532 A.2d 983 (Del. Ch. 1987).

When the cases extending liability to a *creditor* in control of a corporation are reviewed, two generalizations emerge. First, in most of those cases, the creditor or its affiliate was active in the formation of the debtor corporation and was not simply an arms-length extender of credit. Second, in each of those instances, I have found, the corporation was from the outset operated as an arm of the creditor’s (or an affiliate’s) business.

*Id.* at 989.

This language closely parallels the limitation expressed above with regard to the achievement of the purposes of a dominant corporation. In both instances the limitation being expressed is analytically similar to the “on behalf of” element in the agency relationship. That is, both *Krivo* and *Irwin* appear to be limiting creditor control liability to situations where the controlled party is doing the business of the controlling party. To the extent this is true, liability is properly imposed on the controlling party.

46. *Krivo*, 483 F.2d at 1106. The court later quoted several times the following language from W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 43 (1963), stating control consists of “such domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal.” *Id.* An example of this might be if National had used its control to require Brad’s to buy brass from it at prices far in excess of the market price prevailing at the time. Under such circumstances it would be fair to infer that Brad’s had no “independent existence” of its own and instead was simply furthering the business interests of National. The court in its opinion directly addressed this concern, resolving after a lengthy review of several complex transactions that no such exercise of control had taken place. *Id.* at 1112-14.

47. 483 F.2d at 1112.

48. *Id.* at 1110 (emphasis in original).

49. *Id.*

50. *Id.* at 1112.

51. *Id.*



The relationship between Brad's and National was more than a simple debtor-creditor relationship. National also sold materials to Brad's and wanted to continue that profitable relationship. Yet the court's opinion gave no indication that National's status as a trade creditor exposed it to greater vulnerability than that experienced by an ordinary commercial lender, such as a bank.

The *Krivo* case establishes a high threshold for liability under the instrumentality doctrine. The court noted at the conclusion of its opinion that:

Although National Distillers' position as a major creditor undoubtedly vested it with the capacity to exert great pressure and influence, we agree with the District Court that such a power is inherent in any creditor-debtor relationship and that the existence and exercise of such a power, alone, does not constitute control for the purposes of the "instrumentality" rule.<sup>52</sup>

As mentioned above, one can speculate that the instrumentality doctrine, with its emphasis on participatory control, may have served as the inspiration for comment a to Section 14 O.<sup>53</sup> The instrumentality doctrine casts a smaller net than Section 14 O in two respects, however. First, it seems to require more control by the creditor than does Section 14 O. Mere participation in control, even active management, is not enough. The control must be total. Second, even if such control is present the plaintiff must prove misuse of the control, causing harm to plaintiff.

Section 14 O is much broader in its scope of liability. The threshold for proof of control appears to be lower and to be satisfied by having the power to initiate transactions. Furthermore, there is no requirement that misuse of control must also be proved. Instead, once control is established, liability for debts incurred thereafter

---

52. *Id.* at 1114.

53. The court in *Japan Petroleum (Nigeria) Ltd. v. Ashland Oil*, 456 F. Supp. 831 (D. Del. 1978), appears to read Section 14 O as requiring "control" to meet the standard articulated in the *Krivo* case and thus can be cited in support of the above sentence. In its opinion, the court in *Japan* appears to confuse agency liability with liability under the instrumentality doctrine, a confusion Section 14 O invites. For a comment on the distinction between these two concepts, see the following language of Judge Learned Hand in *Kingston Dry Dock Co. v. Lake Champlain Transp. Co.*, 31 F.2d 265 (2d Cir. 1929):

There are numerous cases in which a parent corporation has been held liable because of control over its subsidiary. . . . To become so it must take immediate direction of the transaction through its officers, by whom alone it can act at all. At times this is put as though the subsidiary then became an agent of the parent. That may no doubt be true, but only in quite other situations; that is, when both intend the relation to arise, for agency is consensual. This seldom is true, and liability must normally depend upon the parent's direct intervention in the transaction. . . .

*Id.* at 267 (citations omitted).

follows as a matter of course. It is curious that the persons drafting Section 14 O defined controlling creditor liability in such sweeping terms if the instrumentality doctrine indeed served as its inspiration.

LIABILITY BEYOND THE STANDARD IMPOSED BY  
COMMENT A TO SECTION 14 O

The text of Section 14 O can be read to define control so that the exercise of any control, whether affirmative or negative in character, which affects or has the potential to affect in a material way the operation of the controlled business, may subject the creditor to liability. Several cases support this reading.<sup>54</sup>

One of the major cases in support of a broad reading of Section 14 O is *A. Gay Jenson Farms Co. v. Cargill, Inc.*<sup>55</sup> Defendant Cargill, a large international grain dealer, was sued for \$2 million by eighty-six farmers who had sold grain to Warren Grain & Seed Company (Warren), which operated a grain elevator.<sup>56</sup> The plaintiffs claimed Cargill had assumed control of Warren's business and thus became liable under Section 14 O as principal for the acts of Warren in connection with the business.<sup>57</sup>

In 1964 Cargill began to loan money as working capital to Warren on an "open account" basis.<sup>58</sup> The loan was secured by a second mortgage on Warren's real estate and a security interest on its grain and merchandise inventories. The initial loan was for \$175 thousand and increased gradually to \$1.25 million by 1976.

54. It may be that comment a to Section 14 O addresses a situation that would almost never actually occur in the business and financial world. That is, it is difficult to imagine anyone other than an owner or employee possessing the power to initiate transactions, except perhaps in creditor-receivership or instrumentality situations. See Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 934-35 (1986), explaining why creditors rarely assume operational control over their debtors. If that is true, then the Comment, read literally, would so limit the text of Section 14 O as to render it of little practical importance.

55. 309 N.W.2d 285 (Minn. 1981).

56. One of the main functions of a grain elevator is to purchase grain from farmers and sell it on the open market, often to terminal grain companies such as Cargill. Warren also stored grain for local farmers, sold chemicals and fertilizers to farmers, and operated a seed business. *Cargill*, 309 N.W.2d at 288.

57. The suit alleged an implied actual agency relationship between Cargill and Warren. Plaintiffs did not pursue estoppel or apparent authority as alternative theories of liability. 309 N.W.2d at 290 n.6.

58. *Cargill*, 309 N.W.2d at 288. The court does not define the phrase "open account." The briefs for the parties indicate that it functioned like a line of credit. Warren was free to draw funds on request up to the maximum amount, replenish the account by sales made to Cargill, then draw it down again, and so forth. Respondents' Brief at 3, *Cargill* (No. 50744). In fact Warren's withdrawals greatly exceeded the maximum contracted for with Cargill. The contractual limit was raised to \$1.25 million in 1976. When it ceased operation in early 1977, Warren owed Cargill \$3.6 million. 309 N.W.2d at 289.

In the loan agreement executed by the parties in 1964, Cargill was given a right of first refusal to purchase grain to be sold by Warren to the terminal market.<sup>59</sup> By 1976 Warren was shipping Cargill ninety percent of its cash grain.

A new loan agreement was executed in 1967, increasing the credit line to \$300 thousand. The new agreement contained several additional covenants to protect Cargill. Warren was to provide Cargill with annual financial statements; Cargill would keep the books for Warren or an audit by an independent firm would be conducted, and Cargill was given the right to inspect Warren's books. In addition, Cargill's consent was required before Warren could make capital improvements or repairs in excess of \$5 thousand, guarantee another's indebtedness, encumber its assets, declare a dividend, or purchase stock.<sup>60</sup>

Officials from Cargill visited Warren shortly after the 1967 loan agreement was executed. They conducted an examination of the operation and wrote an internal memorandum stating "[Warren] needs *very strong* paternal guidance."<sup>61</sup> Following this examination, Cargill suggested that Warren take a number of steps to improve inventory control and collection of accounts receivable, reduce withdrawals made by officers, and prohibit its bookkeeper from issuing her own salary checks.<sup>62</sup> None of these ideas were ever implemented.

Warren's financial position steadily worsened over the years. The opinion leaves the impression that the problem was caused primarily by excessive personal withdrawals from undistributed earnings by the Hills, a father and son who together operated the grain elevator.<sup>63</sup> In early 1977 Cargill discovered Warren had falsified its financial statements and was over \$4 million in debt. Warren's request for additional financing was refused, and it ceased operations.

The Minnesota Supreme Court affirmed a trial court judgment for plaintiffs in an opinion that relied heavily on Section 14 O. The

---

59. The opinion does not describe the terms of the right of first refusal. It is stated in appellant's brief that "Hill [an officer of Warren] testified that he would negotiate with Cargill and either accept or refuse Cargill's highest bid." Appellant's Brief at 14. This statement is not contradicted or commented on in Respondents' Brief. There is no indication in the facts that Warren received only a commission on the sales to Cargill. Instead, it appears Warren received as its profit the difference between what it paid farmers for the grain and the price it received when it sold the grain to Cargill.

60. 309 N.W.2d at 288. The restriction on the purchase of stock applied to shares of Warren stock. Respondents' Brief at 6.

61. 309 N.W.2d at 289 (emphasis added).

62. *Id.* at 289 n.4.

63. *Id.* at 288 n.3. The business was operated as a corporation. Lloyd Hill, his wife and son were the sole shareholders, officers and directors of the corporation. Appellant's Brief at 5.

court found sufficient evidence of control to support the jury verdict that Warren was Cargill's agent.<sup>64</sup>

The *Cargill* court did not confine its opinion to the definition of control contained in comment a to Section 14 O. There is no indication in the facts that Cargill took over the management of Warren nor that it had any power to initiate transactions during the period of time that plaintiffs' claims arose. Yet the court found Cargill liable for the debts of Warren amounting to \$2 million. In this respect, *Cargill* can be read as a leading case for a broad interpretation of Section 14 O.<sup>65</sup>

---

64. The court identified

[a] number of factors [that] indicate Cargill's control over Warren, including the following:

(1) Cargill's constant recommendations to Warren by telephone; (2) Cargill's right of first refusal on grain; (3) Warren's inability to enter into mortgages, to purchase stock or to pay dividends without Cargill's approval; (4) Cargill's right of entry onto Warren's premises to carry on periodic checks and audits; (5) Cargill's correspondence and criticism regarding Warren's finances, officers salaries and inventory; (6) Cargill's determination that Warren needed "strong paternal guidance;" (7) Provision of drafts and forms to Warren upon which Cargill's name was imprinted; (8) Financing of all Warren's purchases of grain and operating expenses; and (9) Cargill's power to discontinue the financing of Warren's operations.

309 N.W.2d at 291.

Although it is not central to the thesis of this article, the court's assumption that Cargill possessed and exercised great control over Warren seems highly doubtful. As noted in the text, the recommendations made repeatedly by Cargill concerning the operation of Warren's business were ignored by Warren, hardly a sign of dominance by Cargill.

65. See also, *Plymouth Rock Fuel Corp. v. Leucadia, Inc.*, 100 A.D.2d 842, 844, 474 N.Y.S.2d 79, 81 (1984). In this case suit was brought against Leucadia, formerly known as Talcott (the name used by the court in its opinion), a creditor, for the price of heating oil delivered to three buildings. The buildings were managed by Silverman, their owner. Leucadia had to approve all expenditures and earlier had invoked an assignment of rents clause following a default on its loan to Silverman. There was no evidence of any takeover of management or the making of contracts by Leucadia. The court expressly relied on Section 14 O in its decision holding Leucadia liable.

Although Silverman and his employees did the day to day work of managing the building, they 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 Silverman's payroll account. . . .

The circumstances set forth indicate to this court that due to the degree of control exercised by Talcott over Silverman's operation, Silverman became Talcott's agent for the purpose of ordering fuel. Talcott is thus liable for the fuel delivered to the buildings . . . .

*Id.* See also *Save Way Oil Co. v. Mehlman*, 115 A.D.2d 721, 722, 496 N.Y.S.2d 537, 538 (1985), involving a suit to recover damages for fuel oil delivered to premises upon which defendant bank held a mortgage. The facts were not developed in the

The court also addressed the "on behalf of" element in agency law, stating "Warren acted on Cargill's behalf in procuring grain for Cargill as the part of its normal operations which were totally financed by Cargill."<sup>66</sup> This analysis is factually unsound. It overlooks the fact that Warren made a profit on its sales of grain to Cargill. The profit was not shared with Cargill.<sup>67</sup> The court does not address this point, but the language of the briefs on both sides of this case makes it clear Warren *sold* grain to Cargill and did not *procure* grain for Cargill.<sup>68</sup>

---

opinion. Section 14 O was cited as a main source of authority. There was no evidence of any power of the bank to initiate transactions, nor did the court suggest an inquiry into that on remand. The court remanded for a trial on the fact question "as to whether appellant [Jamaica Savings Bank] acquired sufficient control over the management of the premises to warrant holding it liable as a principal on contracts entered into by . . . the managing agent of the premises." Apparent authority was raised, apparently as an alternative ground of liability, at the conclusion of the opinion.

66. *Cargill*, 309 N.W.2d at 291. Section 14 O does not require that the debtor act on behalf of the creditor. *See supra* text accompanying note 20. The court's discussion of this topic thus seems superfluous. All of the briefs submitted in the case argued at length on this point, however. Doubtless, this drew the attention of the court. The discussion of the court on this point nevertheless was summary in nature and is entirely contained in the sentence quoted above.

67. The court opinion and the briefs of the parties indicate Warren's compensation was not based on commission, but rather on the spread between the price it paid for the grain and the price it received from Cargill. *See supra* note 59.

68. *See* Appellant's Brief at pages 13-14, *Cargill* (No. 50744) stating that: Warren received for its benefit any profit from its purchase [from the farmers] and resale of grain by way of margin or the difference between the price at which Warren purchased and the price at which it could sell. . . . Warren neither accounted to Cargill for profits derived nor losses sustained. . . . Further evidence that Warren was dealing on its own account and not on behalf of Cargill was that while Warren sold approximately 90% of its market grain to or through Cargill, when higher prices could be obtained elsewhere for greater profit to Warren, it sold to others at the higher prices.

These factual statements were not challenged in the Respondent's brief. The sales for greater profit elsewhere appear inconsistent with Cargill's right of first refusal. Perhaps such sales took place only after Cargill had declined to pay the higher price, or perhaps Warren simply ignored the right of first refusal whenever it could profit by doing so.

A useful test for distinguishing a buyer-seller relationship from an agency relationship is contained in RESTATEMENT (SECOND) OF AGENCY § 14 K, comment a. The comment reads in relevant part as follows:

Factors indicating that the one who is to acquire the property and transfer it to the other is selling to, and not acting as agent for, the other are: (1) That he is to receive a fixed price for the property, irrespective of the price paid by him. This is the most important. (2) That he acts in his own name and receives title to the property which he thereafter is to transfer. (3) That he has an independent business in buying and selling similar property.

All three of these factors support the characterization of Warren as a seller to

In support of satisfaction of the "on behalf of" element, plaintiffs argued the action of selling grain to Cargill benefitted Cargill because Warren earned income through which it could pay off its loan to Cargill.<sup>69</sup> This is unquestionably true. But doesn't the argument prove too much? It equates receiving payments under a loan with receiving profits from a business. It transposes actions that benefit another into actions on behalf of another through mere recitation of the fact of benefit. It carries strict liability well beyond the foundations of traditional agency law.<sup>70</sup>

It is true that Cargill was the primary lender to Warren, that the loans were substantial in nature and appeared to be essential to the ongoing operation of the business. The court mentioned Cargill's "aggressive financing" of Warren and noted Cargill had the "power to discontinue the financing of Warren's operations."<sup>71</sup> This is not uncommon in debtor-creditor business relationships.<sup>72</sup> Of what legal significance, however, is it that one creditor is so important to a business? Surely that fact alone cannot fairly support an inference that the debtor's business is being run on the creditor's behalf. Instead, it serves only as a basis for inferring control.

Finally, the court stated Cargill "kept Warren in existence,"<sup>73</sup> and that the reason for Cargill's financing of Warren was "to establish a source of market grain for its business."<sup>74</sup> It noted Warren

---

Cargill. See also *Stansifer v. Chrysler Motors Corp.*, 487 F.2d 59 (9th Cir. 1973) (characterizing a relationship as buyer-seller despite evidence of substantial control of one party by the other; the court focused on the "acting on behalf of" element of the agency relationship, noting that the acting party set its own price on the goods involved).

69. Plaintiff's brief addressed the argument quoted from Appellant's Brief in note 68, *supra*, in the following terms: "Cargill's argument is without basis. The transactions 'in question' were all directly or indirectly potentially beneficial to Cargill. Every cent of net income obtained by Warren from *any* transaction was beneficial to Cargill in that it reduced Warren's debt to Cargill by so much." Respondents' Brief at 30-31, *Cargill* (No. 50744).

70. The assumption made in traditional agency law is that it is not morally justifiable to impose a loss on someone who has a deep pocket and has any connection, no matter how thin, with the acting party. This point is made effectively in the related context of respondeat superior tort liability by Williams, *Vicarious Liability and the Master's Indemnity*, 20 MOD. L. REV. 220, 232 (1957):

What other theory is there? Well, there is the purely cynical theory that the master is liable because he has a purse worth opening. The master is frequently rich, and he is usually insured - two arguments that might be used by any burglar, if he ever troubled to justify his thefts.

71. 309 N.W.2d at 291.

72. Recall the language in the *Krivo* case: "Although National Distillers' position as a major creditor undoubtedly vested it with the capacity to exert great pressure and influence, we agree with the District Court that such a power is inherent in any creditor-debtor relationship . . ." *Krivo*, 483 F.2d at 1114; see *supra* text accompanying note 52.

73. 309 N.W.2d at 293.

74. *Id.*

sold "almost all of its market grain to Cargill."<sup>75</sup> The court concluded that, "[o]n the whole, there was a unique fabric in the relationship between Cargill and Warren which varies from that found in normal debtor-creditor situations."<sup>76</sup>

The "unique fabric" argument involves the trade creditor distinction noted earlier.<sup>77</sup> A trade creditor benefits not only from receiving interest on a loan but also from reinforcing and to some extent controlling the trade relationship between it and its debtor.

The connection between the trade creditor and its debtor and the benefit (to both parties, presumably) is greater than that of the ordinary commercial lender. But does that alone justify characterizing the trade creditor relationship as one of agency? To do so would be to characterize the relationship as a fiduciary relationship where one party is acting on behalf of the other under circumstances where the facts do not fairly support that characterization.<sup>78</sup> Other cases have addressed the liability of the controlling trade creditor. The *Krivo* case<sup>79</sup> involved a creditor that sold goods to its debtor.<sup>80</sup> Yet the

---

75. *Id.* at 292. The court at this point cited to and quoted extensively from *Butler v. Bunge Corp.*, 329 F. Supp. 47 (N.D. Miss. 1971) as authority in support of its decision that the relationship between Cargill and Warren was one of agency, not buyer and seller. The *Butler* case also involved a suit against a large grain exporter (Bunge) for payment of the debts of a grain elevator which it financed. Bunge was held liable for the debts. One major distinction between the two cases, however, is that Bunge first built the grain elevator on its own land, and then entered into an operating agreement with one Bayles to run the facility. Bayles sold grain to Bunge at prices fixed by Bunge and could sell grain to others only after receiving Bunge's permission. Bunge was involved in determining the price Bayles paid farmers for the grain. These facts destroy the inference that Bayles was running a business of his own. The court stated it is "clear that Bunge did not consider Bayles an independent operator who was free to become Bunge's competitor in buying grain from the farmers in the region, but rather he was effectively given authority to buy grain for Bunge." *Id.* at 61. The court in *Butler* did not cite to Section 14 O. Perhaps counsel saw no need to raise it in a case where the "on behalf of" element was so easily satisfied.

76. *Id.* at 293. The court did not further develop this point, but apparently it is referring to the convenience to Cargill of having a steady supply of grain in that part of Minnesota. This is a benefit similar to that enjoyed by the buyer in a requirements contract. Is the court saying that whenever a requirements contract buyer lends money to its seller, this converts their buyer-seller relationship into one of agency, at least if the loan is substantial and some checks on proper accounting are required as part of the loan?

77. *See supra* note 15.

78. *See* Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 147 (1989):

The lender-borrower relationship . . . is not analogous to the principal-agent relationship. In a loan agreement, there is no comparable delegation whereby one party agrees to act on behalf of the other; thus, no agency relationship is created. The relationship is more accurately described as being at arms-length, where both parties act for themselves rather than as agents for each other.

79. *Krivo Indus. Supply Co. v. National Distillers & Chem. Co.*, 483 F.2d

court in *Krivo* did not treat the trade creditor relationship as a circumstance creating a special standard of liability for the creditor.<sup>81</sup>

Another case of importance to the trade creditor issue is *Buck v. Nash-Finch Company*,<sup>82</sup> which involved a suit by unsecured creditors of a retailer (Boedeker) against a grocery wholesaler (Nash-Finch) that made secured loans to Boedeker. Nash-Finch exercised a considerable amount of control over Boedeker. The plaintiffs invoked Section 14 O, claiming that as a consequence of its control Nash-Finch was the undisclosed principal of Boedeker and thus liable for merchandise sold to him.

As the court noted, Nash-Finch had a dual interest in Boedeker. It had loaned Boedeker \$50 thousand and was "interested in preserving and protecting its security." Also, it wanted to develop "a flourishing retail outlet for its wholesale wares."<sup>83</sup> Nash-Finch insisted as a condition of the loan that Boedeker's accounting be done by a Nash-Finch employee. The employee made up the payroll, compiled a weekly operating report from records of sales and deposits, and prepared a financial statement at five week intervals. Nash-Finch later required its employee also countersign all checks issued by Boedeker.

Despite these precautions, it became apparent the volume of business was not sufficient to carry Boedeker's operation, including the Nash-Finch loans. Nash-Finch recommended Boedeker hire an experienced store manager in an attempt to better the situation. After some initial resistance, Boedeker apparently agreed to this and Nash-Finch produced one Estel Parshall.<sup>84</sup> Boedeker asked Hanson, the Nash-Finch representative, what would happen if he did not like Parshall or found him incapable. "Hanson answered, 'I had to get along with Estel or else.'"<sup>85</sup>

---

1098 (5th Cir. 1973), *modified and reh'g denied*, 490 F.2d 916 (5th Cir. 1974); see *supra* text accompanying note 38.

80. It is a matter of interest that the creditor in *Krivo* exercised far more control than was exercised by the creditor in *Cargill*. See *supra* text following note 40.

81. The *Krivo* case was decided on the instrumentality theory, not under Section 14 O. It is true, nevertheless, that the court did not treat the trade creditor relationship as a matter of special significance in a case where it had the opportunity to do so.

82. 78 S.D. 334, 102 N.W.2d 84 (1960).

83. *Id.* at 346, 102 N.W.2d at 90. Like *Cargill* and *Krivo*, therefore, this suit involves a trade creditor.

84. The relationship between Nash-Finch and Parshall is left vague in the opinion. Apparently the initial plan was to put him on the Nash-Finch payroll, then instead it was decided to put him on Boedeker's payroll with Nash-Finch subsidizing part of his salary. *Id.* at 338, 102 N.W.2d at 86.

85. *Id.* Boedeker testified he understood Hanson to mean that he had to get along with Parshall or Nash-Finch would foreclose on its mortgages on the property. *Id.*



Parshall took charge of the produce department, assisted with advertising and promotions, raised the salaries of several store employees, fired Boedeker's stepson (after consulting with a higher Nash-Finch official) when he caught him in an act of dishonesty, counted the cash and made most of the deposits, required everyone, including Boedeker, to go through the check-out lanes in withdrawing merchandise from the store, and changed the locks and prevented off-hours access to anyone but Boedeker and himself. Boedeker continued to buy most of the inventory for the store.

The facts make it clear Nash-Finch exercised a great deal of control. The trial court gave judgment to the plaintiffs, holding Nash-Finch was Boedeker's undisclosed principal. The South Dakota Supreme Court cited to and quoted from Section 14 O in apparent approval of the principle of law there articulated. It acknowledged that Nash-Finch assumed control over certain phases of the business and that Nash-Finch had a dual interest in doing so. Yet it reversed the trial court judgment on the ground that its central finding of agency was against the clear preponderance of the evidence.

The claims being litigated were for debts incurred in the purchase of inventory for the store. The court focused its inquiry on control over such purchases. It found that Parshall did not exercise control over that part of the business,<sup>86</sup> nor did any other Nash-Finch representative. The only hint of criticism by Nash-Finch of Boedeker's conduct as a buyer of inventory related to his buying from wholesalers other than Nash-Finch. But Nash-Finch was unwilling to extend Boedeker further credit to finance additional purchases from it. Apparently other wholesalers were willing to sell to Boedeker on credit.

[T]he clear preponderance of the evidence is against the finding of an implied mutual agreement that Boedeker would act under the control and supervision of Nash-Finch Company in his purchases of merchandise. [W]e deem the manifestation of such a mutual agreement essential to the existence of the relation upon which the asserted liability of Nash-Finch must rest.<sup>87</sup>

This approach is different from that of the *Cargill* court. The *Cargill* court was satisfied with evidence of substantial control whether or not it related specifically to the activity that resulted in the claims at issue.<sup>88</sup> The control Nash-Finch exercised consisted in part of

---

86. The court stated that "[o]ther than the ordering he did as head of the produce department, there is no evidence that he participated in any manner in stocking the store or in issuing checks in payment for stock." *Id.* at 347, 102 N.W.2d at 91.

87. *Id.* at 348, 102 N.W.2d at 91.

88. The court expressed no interest in whether control was exercised over the activity of purchasing grain from farmers. *See Cargill*, 309 N.W.2d at 291. None

initiating transactions (Parshall apparently ordered produce for the business), yet the court did not find Nash-Finch liable under Section 14 O because those transactions were not directly related to the suits being brought.<sup>89</sup>

Little doubt exists that the control Nash-Finch exercised would have resulted in liability under Section 14 O in the eyes of the court that decided the *Cargill* case. The control Cargill exercised consisted solely of requiring financial statements and audits of Warren's books and requiring Cargill's consent before undertaking significant expenditures of capital, incurring indebtedness, declaring dividends, or selling or buying stock.<sup>90</sup> None of this related to the purchase of grain by Warren from farmers. Yet the *Cargill* court upheld a jury verdict of liability. The *Cargill* and *Buck* cases seem clearly inconsistent, with the *Buck* case standing for a narrow reading of Section 14 O.<sup>91</sup>

As mentioned above, in a separate part of its opinion the *Cargill* court took note of the trade creditor relationship between Warren and Cargill.<sup>92</sup> The *Buck* court was aware that the relationship between Nash-Finch and Boedeker was one of trade creditor and debtor,<sup>93</sup> yet it accorded that fact no particular legal significance, similar to the reaction of the *Krivo* court.

On another matter, the court in the *Buck* case at the end of its opinion stated "in the other cases which have come to our attention

of the requirements or suggestions made by Cargill to Warren related to that activity. *Id.* at 289 n.4. This point is less clear with regard to *Plymouth Rock Fuel Corp. v. Leucadia, Inc.*, 100 A.D.2d 842, 474 N.Y.S.2d 79 (1984) (*see supra* note 65), where the defendant creditor's approval was required for expenditures. Nevertheless, the court's opinion in *Plymouth Rock* paid no attention to the relationship between the control and the nature of the activity involved in the suit. *See id.* ("[D]ue to the degree of control exercised by Talcott over Silverman's operation, Silverman became Talcott's agent for the purpose of ordering fuel.")

89. *Buck v. Nash-Finch Co.*, 78 S.D. 334, 348, 102 N.W.2d 84, 91 (1960).

90. It is true there was in addition an endless stream of suggestions from Cargill to Warren; however, they received only a cold shoulder from Warren. *See supra* text following note 62.

91. It should be emphasized that the *Buck* court treats Section 14 O as controlling authority. The court states as follows:

As the above quoted authorities indicate, if the premise that Nash-Finch Company manifested an intention to assume complete control of the business, and Boedeker consented to act therein under the complete control and direction of that company is warranted under this record, it would follow as a matter of law that Nash-Finch became liable as indicated by counsel even though it did not actually intend to bring about such a consequence. Such, as we understand it, is the teaching of . . . § 14 O . . . .

78 S.D. at 348, 102 N.W.2d at 90.

92. *See supra* text accompanying note 76.

93. The court stated Nash-Finch wanted to develop "a flourishing retail outlet for its wholesale wares." *See supra* text accompanying note 83.

the courts have not hesitated in holding evidence of broad measures of control by a creditor insufficient to sustain a finding that the debtor was authorized to contract on behalf of the creditor as an undisclosed principal."<sup>94</sup> This observation, which was not further developed,<sup>95</sup> appears to shift the focus of analysis to a topic not previously addressed in the opinion, the "on behalf of" element in an agency relationship. To the extent this analysis is a basis for the decision, the case can be read as questioning a literal reading of Section 14 O which, as noted previously, does not address the "on behalf of" element.

*The distinct situation of total control*

The opinion in *Cargill* noted that in the last few days of business Cargill completely took over the grain elevator and ran its operations. Assuming hypothetically that several of the eighty-six claims made by plaintiffs stemmed from that period of time, would a stronger case for liability on those particular claims exist? The argument in favor of liability would be that under that circumstance it was clear Cargill had taken over the management and was engaged in initiating transactions because it was the party effectively in charge of the business during that period of time. Thus the principle of Section 14 O would be applicable under even its narrowest reading.

The argument against liability would be that Cargill nevertheless was not running the business on its own behalf. Similar to a receiver, Cargill instead was simply attempting to close operations down in

---

94. 78 S.D. at 348-49, 102 N.W.2d at 91-92.

95. The court cites the following cases in support of the statement quoted in the text: *Commercial Credit Co. v. L.A. Benson Co.*, 170 Md. 270, 280, 184 A. 236, 240 (1936) (lender had representatives placed in borrower's manufacturing plant to oversee expenditures and purchases; lender held not liable because there was no evidence that debtor had agreed to act as agent of lender. "This conduct cannot be construed to create the relation of principal and agent, especially so when such construction would do violence to the actual intentions of the parties . . ."); *Wasilowski v. Park Bridge Corp.*, 156 F.2d 612, 614 (2d Cir. 1946) (lender-factor took control over expenditures involved in performance of debtor's contract with the federal government after debtor had used part of advances previously made for purposes other than those called for in the loan contract. "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."); and *Waldie v. Steers Sand & Gravel Corp.*, 151 F.2d 129, 132 (2d Cir. 1945) (L. Hand, J.) ("Plainly, the only purpose [of the lender-surety in installing an engineer to supervise a project] was to protect the loans, and it would impute to the parties an improbable intent to hold that, as an incident, the surety meant to make itself generally liable under the contract. Indeed, that is just what it meant not to do.").

an orderly manner. It was not the owner of the business. So long as it used due care and was honest in its dealings, there is no fair basis for holding it liable for transactions engaged in even during those closing days.<sup>96</sup> Moreover, the imposition of liability would run counter to long-standing agency principles which are exemplified by an early case, *Cox v. Hickman*.<sup>97</sup>

It is difficult to imagine creditors more completely in control of their debtor's business than those involved in the *Cox* case. Although the plaintiff sought to hold the controlling creditors liable as partners, not as undisclosed principals, the control issue addressed in Section 14 O and the liability being asserted—that of personal responsibility for the debts of the business—are the same.<sup>98</sup>

The Smiths, who carried on a business as ironmasters and corn merchants under the name B. Smith and Son, "became embarrassed in their circumstances,"<sup>99</sup> resulting in a meeting of their creditors. It was agreed at the meeting that the Smiths would assign all of the property of the business to a committee of five of their creditors in trust on behalf of all the creditors. The trust was to carry on the business in the name "The Stanton Iron Company" and to pay the net income among the creditors of the Smiths. A majority in value of the creditors had the power to make rules for the conduct of the business or to order discontinuance of it. The agreement provided that the net income "was always to be deemed the property of the two Smiths."<sup>100</sup> The property was to be reconveyed to the Smiths once the debts were paid.

The Stanton Iron Company apparently fared no better than B. Smith and Son. Plaintiff supplied goods to the company, was not paid, and sued all the creditors. The basis of his claim was that, by having a right to take profits, defendant creditors were partners of the business and thus were liable for its debts. Prior English authority appeared to establish exactly that proposition in the case of *Waugh v. Carver*.<sup>101</sup> The court in the *Cox* case qualified the *Waugh* case,

---

96. See *Midland Bean Co. v. Farmers State Bank of Brush*, 37 Colo. App. 452, 552 P.2d 317 (1976). In this case a bank that was a secured creditor of a grain elevator took over the assets of the elevator upon default and liquidated the business. It was sued by an unsecured creditor who claimed the bank was liable for all debts as a principal when it took over the assets of the elevator. The court rejected the claim and held the bank had pursued its rights as a secured creditor in a lawful manner. The analysis of the court was summary on this point, but the case can be cited in support of the argument made above.

97. 11 Eng. Rep. 431 (1860).

98. The following language from the *Cox* case is relevant to this point: "The liability of one liable for the acts of his co-partner is in truth the liability of a principal for the acts of his agent." *Id.* at 446.

99. *Id.* at 432.

100. *Id.*

101. 126 Eng. Rep. 525 (1793). The *Waugh* court held "he who takes a moiety

however, stating that, "the real ground of liability is, that the trade has been carried on by persons acting on [the profit-taker's] behalf. When that is the case, he is liable to the trade obligations, and entitled to its profits, or to a share of them."<sup>102</sup>

The court found the arrangement between the Smiths and their creditors did not cause the creditors to stand "in the relation of principal."<sup>103</sup> The debtor

is still the person solely interested in the profits, save only that he has mortgaged them to his creditors. He receives the benefit of the profits as they accrue, though he has precluded himself from applying them to any other purpose than the discharge of his debts. The trade is not carried on by or on account of the creditors.<sup>104</sup>

The court addressed the matter of control briefly in the following passage: "The trade did not become a trade carried on for them [the creditors] as principals . . . because they might have prescribed terms on which alone it should be continued."<sup>105</sup> The control exercised in the *Cox* case involved taking over the management, including the power to initiate transactions, and thus fell within the test posited by the comment to Section 14 O. The owners apparently were passive during the time the creditors attempted to salvage the business.

Not only is the control in *Cox* completely dominant because the creditors ran the business with apparently no interference from its owners, but also the controlling creditors shared profits in the business.<sup>106</sup> Yet, applying an "on behalf of" test, the court refused to hold the creditors liable as principals. The *Cox* case constitutes a sharp contrast to the doctrine set forth in Section 14 O.<sup>107</sup>

---

of all the profits indefinitely, shall, by operation of law, be made liable to losses, if losses arise, upon the principle that by taking a part of the profits, he takes from the creditors a part of that fund which is the proper security to them for the payment of their debts." *Id.* at 532. This reasoning is criticized in J. STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP 55 (7th ed. 1881) ("Creditors neither can nor do rely on profits for payment. Profits do not exist until creditors are paid. . . . In fact, what a creditor does rely on as a fund of payment are the gross returns, not the net profits.").

102. *Cox*, 11 Eng. Rep. at 447. As in the tradition of English appeals cases, the *Cox* decision is accompanied by multiple opinions. The quotations are taken from the opinion of Lord Cranworth, who wrote on the prevailing side. The opinion by Cranworth is the one that is most frequently quoted and usually regarded as most clearly expressing the reasoning of the majority.

103. *Id.*

104. *Id.*

105. *Id.*

106. They shared profits in the form of payment for their claims. *See supra* text accompanying notes 99-100.

107. It may be necessary to qualify the statement in the text because of the second paragraph of comment a to Section 14 O, where the situation involved in the *Cox* case appears to be addressed. (*See supra* text immediately prior to note 14,

As to the merits of the case, there was no evidence of fraud or negligence by the controlling creditors. They did not own the business. Applying the principle articulated by Judge Learned Hand,<sup>108</sup> the profits were not theirs, so neither should be the losses. True, they did share in the profits, but not in an ownership capacity. To use some of the language developed after the *Waugh* case, profits were not paid "as profits" to the creditors, but rather were paid in repayment of a debt.<sup>109</sup>

### *A new standard*

The situation of total control as evidenced by the *Cox* case is different from that addressed earlier in this article. In the total control case, the creditor has taken over the business. The debtor is passive, no longer playing a decision-making role in the day to day operation of the business. This is so extraordinary that it does not seem unfair to place an additional burden on a creditor in such a position.

The creation of an inference of negligence for losses incurred during a time of such extraordinary control may be a fair way to address this situation.<sup>110</sup> It would shift the burden to the creditor to

---

quoting comment a.) The Restatement invokes the "on behalf of" element in this paragraph and thus can be read as supporting the *Cox* case, although this reading conflicts with the tenor of the rest of the comment and the text of Section 14 O itself. A different reading of the paragraph would interpret it as addressing only the relationship between the assignee and the creditors, which in the *Cox* case was the trust relationship created by the committee of five creditors who ran the business on behalf of the remaining group of creditors. That relationship is a fiduciary relationship, of course. Such interpretation of the second paragraph would narrow its significance considerably.

108. See *supra* note 1 and accompanying text.

109. See STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP 50, 51 (7th ed. 1881).

110. An alternative way to proceed would be to impose a fiduciary duty on the totally controlling creditor. But that approach seems to pose more questions than it answers. To whom would the fiduciary duty be owed? To the other creditors? To the owners of the business? In some respects these interests may conflict. How would the creditor as an involuntary fiduciary decide which interest to prefer? And the imposition of a fiduciary relationship under these circumstances seems strange. Ordinarily a fiduciary duty is created by consent and with an understanding that one party is agreeing to act on behalf of another. See RESTATEMENT (SECOND) OF AGENCY § 13 comment a (1958), defining a fiduciary as "a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking." In the totally controlling creditor situation the creditor has placed itself in that position solely in order to look out for its own interests, not to protect the interests of others. Yet judicial authority does exist for the imposition of fiduciary duties on a controlling creditor under certain circumstances. See *Anaconda-Ericsson, Inc. v. Hessen* (In re *Teltronics Serv., Inc.*), 29 Bankr. 139, 171 (Bankr. E.D.N.Y. 1983) ("[Authority seems to suggest that] a non-

introduce evidence of its honesty and due care.<sup>111</sup> It is true that ordinarily a creditor will assume total control only under fiscally drastic circumstances. Nevertheless, the combination of the failure of the business and the dominant control of the creditor is such that it seems appropriate to provide an incentive for the creditor to explain exactly what it did, what choices it faced, and why it acted in the way it did.

This approach retains the fault standard. The claims against the creditor would have to be framed in terms of dishonesty or negligence, not in terms of the strict liability of a principal for the debts of the business. This approach is fair because even at this stage of total control the business is not the creditor's. The creditor in most cases instead is engaged in attempting to bring things to an orderly close. Therefore, only the burden of going forward, not the burden of proof, should be imposed on the creditor.<sup>112</sup> If liability is established, losses should be confined to those proven to have been caused

---

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." (emphasis in original); Credit Mgrs. Ass'n of S. Cal. v. Superior Ct., 51 Cal. App. 3d 352, 361, 124 Cal. Rptr. 242, 248 (1975) (complaint alleged that creditor compelled debtor to hire its agent, a business consultant, giving the consultant complete management control, and that the consultant overruled the board of directors in operating the business. The court held that "[u]nder such circumstances, it is not unreasonable to hold [the consultant] to the same fiduciary obligations to the stockholders and creditors that the officers and directors would have had . . .").

111. This would not be an easy burden to meet. It would require the creditor to describe and explain in detail its actions while in control of the business. By assumption the business did fail while under the creditor's total control, however, which may support imposing such a burden on the creditor.

112. See MCCORMICK, LAW OF EVIDENCE 672-73 (1954):

As to every fact which is material to the establishment of an enforceable [sic] claim, one party or the other will have three distinct burdens. This trio consists of (1) the burden of pleading the fact, (2) the initial duty of producing evidence of the existence of the fact, and finally (3) the burden of persuading the jury or judge of the existence, or nonexistence of the fact. . . .

McCormick also points out that

[a]nother traditional doctrine often repeated by the courts is that where facts pleaded by one party lie peculiarly in the knowledge of the adversary, the latter has the burden of proving it. We have seen that this consideration of easier access by one party to the proof has been a governing consideration in the creation of certain presumptions, which regulate the burden of producing evidence. It is believed, moreover, that as a general doctrine, apart from specific presumptions, its effect is similarly limited to apportioning the burden of producing evidence without affecting the burden of persuasion.

*Id.* at 675.

by the conduct of the creditor. This is because liability is based on fault, not something akin to ownership as it would be under Section 14 O. Finally, the creditor should be able to invoke the business judgment rule in defense of its actions because it is in a similar position to a controlling officer.<sup>113</sup>

Analogous authority for this standard might be found in the well known case of *Ybarra v. Spangard*.<sup>114</sup> In *Ybarra*, the plaintiff suffered an injury during the course of an operation. He sued all the persons who had responsibilities relating to the operating room and the surgery, invoking the doctrine of *res ipsa loquitur*.<sup>115</sup> Not all of the defendants could be held to be at fault because many of them functioned independently of the others and at different times during the operation. But the court upheld this use of the doctrine, stating "[t]he control at one time or another, of one or more of the various agencies or instrumentalities which might have harmed the plaintiff was in the hands of every defendant or of his employees or temporary servants. This, we think, places upon them the burden of initial explanation."<sup>116</sup>

The liability being addressed in this article is not physical tort liability, of course, and it is not necessarily true that losses resulting from the financial collapse of a business are the result of blameworthy conduct. Also, the plaintiffs in the controlling creditor cases, who are almost always other creditors, are not the helpless victims that people in surgery represent. Nevertheless, the concept of placing the burden of initial explanation when things go wrong upon persons in total control applies with equal force to the situation presented by the totally controlling creditor.<sup>117</sup>

The burden of coming forward with evidence that one has acted honestly and with due care is substantial. In one sense, the creditor is being asked to establish a negative. In some respects it does not seem fair to place this burden on the wholly controlling creditor,

---

113. See CLARK, CORPORATE LAW 123-140 (1986), for a thoughtful discussion of the business judgment rule. Professor Clark considers at length the argument that the business judgment rule poses a standard of liability narrower than one of negligence, instead confining liability to gross negligence, fraud, or self-dealing. To the extent this is true, it seems fair to allow the controlling creditor to frame its defense in terms of such a standard.

114. 25 Cal. 2d 486, 154 P.2d 687 (1944).

115. *Id.* at 488-89, 154 P.2d at 688.

116. *Id.* at 492, 154 P.2d at 690. It is noted in MCCORMICK ON EVIDENCE 967 (3d ed. 1984) that the *Ybarra* case creates merely an inference of negligence, not a presumption, "permitting but not requiring, the jury to find negligence." The text states that this inference does not shift the burden of persuasion. A similar standard is appropriate for the totally controlling creditor, as noted above.

117. The liability proposed here is similar to the instrumentality doctrine as described by the court in the *Krivo* case. See *supra* text accompanying notes 41-42. The difference is in the willingness to infer negligence, subject to rebuttal.



who almost always has acquired that status by stepping into a desperate situation involving a floundering debtor.<sup>118</sup> This standard, however, is an improvement over that proposed by Section 14 O, which is indifferent to the defenses of honesty and due care. Furthermore, it should caution a creditor from yielding too easily to the temptation to take a business over completely and attempt to run it, which may be too great a departure from the normal behavior of a creditor.

### CONCLUSION

As noted above, there is judicial support for a broad reading of the proposition advanced in Section 14 O. A number of courts cite to, quote from, and express approval of its language. Not a single opinion has been found that expresses disapproval of Section 14 O or directly questions it in any way.<sup>119</sup> This also is true of all the law review articles discussing it and the cases applying it.<sup>120</sup> Furthermore, the Restatement of Agency is widely respected and justly regarded as a sound, highly professional work of careful, competent analysis.

---

118. The creditor would be able to present evidence of the conditions under which it took total control, of course. This presentation would include painting a picture of the extreme fiscal circumstances suffered by its debtor at that time. In the hands of a skillful attorney and in front of a fair trier of fact, this evidence should help to alleviate concerns about abuse of the proposed standard.

119. *But see* *Lubrizol Corp. v. Cardinal Constr. Co.*, 868 F.2d 767 (5th Cir. 1989). In this case a claim was made that the defendant, a creditor, had exercised excessive control over a corporate debtor. The trial court gave an instruction on the instrumentality theory but refused to give a separate instruction allowing liability to be based on Section 14 O. The jury found defendant not liable on the ground that its conduct, while controlling, was not wrongful. An appeal was taken from the refusal by the trial court to give the separate instruction on Section 14 O, which does not include wrongful conduct as an element. The appellate court in this apparent diversity case upheld the trial court, holding that Texas law (although there was no direct authority) does not recognize liability in the absence of wrongdoing by the controlling corporation. The court thus equated the "agency" and "instrumentality" theories. Section 14 O was not directly criticized in the opinion, but the result of the case would be to destroy any independent vitality for Section 14 O, at least in Texas, if the court's assumption with regard to Texas law is accurate.

120. *See* Tom, *Interpreting the Meaning of Lender Management Participation Under Section 101(20)(A) of CERCLA*, 98 YALE L.J. 925 (1989); Hass, *Insights into Lender Liability: An Argument for Treating Controlling Creditors as Controlling Shareholders*, 135 U. PA. L. REV. 1321 (1987); Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986); Lundgren, *Liability of a Creditor in a Control Relationship with its Debtor*, 67 MARQ. L. REV. 523 (1984); Kunkel, *The Fox Takes over the Chicken House: Creditor Interference with Farm Management*, 60 N.D.L. REV. 445 (1984); Douglas-Hamilton, *When are Creditors in Control of Debtor Companies?*, 26 PRAC. LAW. 61 (Oct. 1980); Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343 (1975).

All of this gives a critic of Section 14 O some pause. Yet it seems clearly wrong, whether read broadly or narrowly as interpreted in comment a. It departs without explanation from the foundations of agency law by treating the fact of control as exclusive and all-encompassing. With the exception of one paragraph at the end of comment a, which speaks to a narrow situation and seems almost an afterthought, it ignores the "on behalf of" element of the agency relationship. Yet the Restatement recognizes the existence of and necessity for the "on behalf of" element continually throughout its two volumes.

As noted earlier, the liability articulated in Section 14 O is that of an undisclosed principal. In exploring the rationale underlying Section 14 O it might prove useful to ask why the undisclosed principal is held liable for the losses incurred in the transaction it has initiated. The opinion of Justice Learned Hand in *Admiral Oriental Line v. United States*<sup>121</sup> made the following observation when discussing the rationale behind the rule that an agent has the right against his principal to recover expenditures necessarily incurred in the transaction of his principal's affairs: "The doctrine stands upon the fact that the venture is the principal's, and that, as the profits will be his, so should be the expenses."<sup>122</sup> Although *Admiral Oriental* was not an undisclosed principal case, the policy reflected in Judge Hand's words serves well to explain the reasoning underlying the liability of an undisclosed principal for the debts of his business.

This highlights one of the things that is mysterious about Section 14 O. It is indifferent whether the controlling party is entitled to profits of the controlled business in an ownership capacity.<sup>123</sup> Yet it is willing to hold the controlling party liable for the expenses of the business.

Section 14 O can be questioned on more than doctrinal grounds. It seems economically counterproductive as well.<sup>124</sup> As a practical matter, creditors will have an incentive to exercise control only over debtors who are in a financially troubled condition and to whom a substantial amount of money has been loaned. It is difficult to imagine many creditors wanting to devote the time, expense, and energy, not to mention the loss of good will of the debtor, to

---

121. 86 F.2d 201 (2d Cir. 1936).

122. *Id.* at 202.

123. In the words of *Admiral Oriental*, it is not true that "the venture is the principal's." *Id.* Instead, the venture is the debtor's in the Section 14 O setting.

124. See Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 151 (1989), observing that placing increased risks on lenders does not come cost free to borrowers. "If lenders cannot protect themselves by contract from debtor misbehavior, they will charge higher interest rates, to the detriment of borrowers as a class. The impact will be borne disproportionately by high-risk borrowers . . . ."

exercising intrusive, widespread control over debtors who are competently running a solvent business.

In general, the business world seems better off not discouraging creditors from exercising substantial control over financially troubled debtors. The efforts by Cargill to put a stop to the apparently continuous and excessive withdrawals of money from the Warren Seed Company for personal use by its executive officers and controlling shareholders surely were desirable from nearly everyone's perspective. The self-interest of a creditor in protecting its loans can redound to the benefit of other creditors, too, as well as to employees, noncontrolling shareholders, beneficiaries of pension plans, and so forth.<sup>125</sup>

Success is not guaranteed when a creditor exercises control, of course, as the eventual disintegration of the Warren Seed Company illustrates. But the case law on this point deals only with the failures. The successes do not inspire litigation nor do they receive publicity. And most of the real dangers posed by creditor control, involving incompetent or dishonest conduct by the creditor, are addressed by independent, long-recognized doctrines of the law.<sup>126</sup>

It is true that proving a creditor actually made things worse as a result of the negligent or dishonest exercise of control can be difficult. Also, the fear is genuine that a ham-handed creditor, well-intentioned but unsophisticated in the ways of a particular business, can have a destructive impact on the business. Certainly the debtor whose business fails may be the first to point the finger of blame to others, including his creditors. Also, there is no doubt that other creditors have a legitimate complaint if the controlling creditor deliberately uses its control to its advantage and to their disadvantage.<sup>127</sup>

---

125. See Tom, *Interpreting the Meaning of Lender Management Participation Under Section 101(20)(A) of CERCLA*, 98 YALE L.J. 925 (1989). Throughout her article the author describes the benefits which can be obtained through encouraging creditor monitoring and control of debtors who are financially troubled and pose potential environmental problems, in particular waste disposal problems. CERCLA exempts from liability a person who, "without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility." 42 U.S.C. § 9601(20)(A) (Supp. IV 1986). With the goal of encouraging creditor monitoring, the author urges that "participating in the management" be limited in its interpretation as it is in the instrumentality doctrine, to mean total domination. For two recent cases interpreting this phrase, see *United States v. Fleet Factors, Inc.*, 901 F.2d 1550 (11th Cir. 1990) (holding secured creditor liable on ground that it had the power to control debtor, even though no control was in fact exercised) and *Hill v. East Asiatic Co.*, 910 F.2d 668 (9th Cir. 1990) (expressly rejecting the approach of *Fleet Factors*).

126. See *supra* cases cited in notes 4-6.

127. The remedy for this conduct is subordination of the claims of the controlling creditor, not liability for the debts of the business subsequent to the exercise of control. The rules of agency are not helpful in this situation because

And perhaps the creditor who completely takes the business over, to the extent of excluding the owner from any decisions should, as noted earlier, bear a greater burden of explanation for whatever failures may have generated the lawsuit against it. Nevertheless, on balance, more good than harm would result from respecting the basic principles of agency law and rejecting the broad net of liability cast by Section 14 O.

---

there is no agency relationship. The doctrine of equitable subordination in the law of bankruptcy illustrates this approach. *See supra* note 3. *See also In re Clark Pipe and Supply Co.*, 870 F.2d 1022 (5th Cir. 1989). Liability of a controlling creditor should not go beyond this unless there is fraud or other personally tortious conduct in evidence which, again, is not agency liability.