UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 91-3871
Summary Calendar

IN THE MATTER OF: SOUTHERN STANDARD FITTINGS CO., INC.,

Debtor.

IRWIN H. DAVLIN and
NATIONAL ASSET BANK, N.A.,

Appellants,

versus

SOUTHERN STANDARD FITTINGS CO., INC.,

FIDELCOR BUSINESS CREDIT CORPORATION,

Appellee.

Appeal from the United States District Court for the
Eastern District of Louisiana
(91-CV-1497)

(February 5, 1993)

Before GARWOOD, HIGGINBOTHAM, and BARKSDALE, Circuit Judges.*

GARWOOD, Circuit Judge:

Plaintiff-appellant Irwin H. Davlin (Davlin) commenced this

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* Local Rule 47.5 provides: "The publication of opinions that have no precedential value and merely decide particular cases on the basis of well-settled principles of law imposes needless expense on the public and burdens on the legal profession." Pursuant to that Rule, the Court has determined that this opinion should not be published.

adversary proceeding in the bankruptcy case of debtor Southern Standard Fittings Company, Inc. (Southern) asking that the claim of defendant-appellee Fidelcor Business Credit Corporation (Fidelcor) be equitably subordinated. Davlin brings this appeal from the district court's decision affirming the bankruptcy court's denial of the requested equitable subordination. We affirm.

Facts and Proceedings Below

In March 1987, Standard Fittings Company (Standard), a manufacturer of high-pressure fittings and flanges, entered into a financing agreement with Fidelcor. Under the agreement, Fidelcor agreed to advance, on the security of Standard's accounts receivable, up to seventy-five percent of the net amount of those acceptable accounts, the determination of "acceptable" accounts being left to Fidelcor's sole discretion. Fidelcor also agreed to advance up to fifty percent of the aggregate principal amount of Standard's eligible and acceptable notes receivable, and up to forty percent of the value of Standard's eligible and acceptable raw and finished inventory. Again, acceptability was to be determined solely by Fidelcor, as was the value of the inventory. Fidelcor also acquired a security interest in Standard's inventory and notes receivable.

Payments on accounts receivable were to be received by Standard in trust for Fidelcor, and delivered to Fidelcor on the day of receipt. At Fidelcor's option, they could be delivered to a lock box. Standard agreed to endorse all notes receivable to Fidelcor and to instruct the makers of the notes to pay Fidelcor directly. Fidelcor reserved the right at any time during business

hours to inspect Standard's premises and to audit Standard's accounts, records, and correspondence. Standard appointed Fidelcor as its attorney-in-fact, enabling Fidelcor to receive and open correspondence addressed to Standard, to sign for Standard on any invoice or bill of lading relating to collateral, and to do all other things necessary to carry out the agreement.

Fidelcor made an initial $4,000,000 inventory advance. Under the agreement, the outstanding principal of this loan was required to be reduced by $83,333.33 each month, so as to be reduced by $1,000,000 at the end of the first year. Fidelcor also made an additional term loan of $1,800,000 that was also subject to a monthly amortization payment. From March 31, 1987 to April 29, 1988, Fidelcor was the sole source of operating capital for Standard (and, later, its successor, Southern).

On or about August 28, 1987, Davlin, the controlling owner of Standard, sold Standard's assets to a group of purchasers who formed the acquiring entity, Southern. On November 11, 1987, an agreement was reached whereby, *inter alia*: (1) Fidelcor agreed to fund Southern under the financing agreement previously entered into with Standard until February 15, 1988, and Southern assumed all obligations and indebtedness of Standard under that agreement; (2) Fidelcor agreed to refrain until February 15, 1988 from taking legal action based upon then-existing defaults under the agreement; (3) Davlin pledged a $3,000,000 letter of credit to Fidelcor as additional security for the loan; (4) Fidelcor received an additional security interest in certain real property; and (5) Fidelcor was allowed to send a field examiner to remain at

Southern's plant indefinitely to report on activities there.

Southern filed a voluntary petition under Chapter 11 of the Bankruptcy Code on January 25, 1988. Three days later, Fidelcor and Allied Bank of Texas (Allied) entered into a cash collateral agreement with Southern that was approved by the bankruptcy court.[1] Allied had until March 1987 been the principal source of financing for Standard's business operations. When Standard entered into its March 1987 agreement with Fidelcor, Standard had paid the balance owed to Allied, and Allied had remained a creditor of Davlin alone with a mortgage, which was second to Fidelcor's, on certain assets of Standard. The January 1988 cash collateral agreement essentially preserved the terms and conditions of the existing financing agreement, except that the accounts receivable advance rate was reduced to sixty-five percent.

After the filing of the bankruptcy petition, Fidelcor received directly all payments made to Southern for accounts receivable. It also controlled Southern's billings to the extent of directly receiving sales invoices and bills of lading, and mailing these documents to customers with instructions to make payment directly to Fidelcor. In addition, Fidelcor exercised some influence over Southern's disbursements by regularly inquiring as to which bills needed to be paid at certain times, and then structuring its advances so that enough was advanced to cover only payment of those

[1] Under section 363(c)(2) of the Bankruptcy Code, a trustee may not use cash collateral without authorization of the bankruptcy court or the consent of the entity holding a security interest in the collateral.

necessary bills.[2] Fidelcor placed limits on the accounts of customers who had long business relationships with Southern. Fidelcor also, to the detriment of Southern's business relationships, directly contacted account debtors about payment.

Funding from Fidelcor for raw material purchases virtually ceased after the bankruptcy petition. This halt in funding hindered Southern's sales and prevented it from reducing its backlog of sales orders. The funding cutbacks also necessitated the layoff of employees by Southern, a step that was urged by Fidelcor on two occasions. For several reasons, the amount of funding provided by Fidelcor after bankruptcy was consistently less than Southern calculated should be available under the agreement. Davlin alleges that one cause was Fidelcor's inconsistent and arbitrary determinations of eligible and ineligible accounts.[3] He further claims that Fidelcor withheld funds paid on an ineligible account, a departure from its pre-bankruptcy practice and an action not authorized by the loan agreement. In addition, he contends that Fidelcor computed the value of eligible inventory (forty percent of which was the ceiling on inventory advances) in a manner

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[2] According to the bankruptcy court's findings, in only one instance was it clear that Fidelcor paid or directed payment of a specific bill. This occurred after the closing of Southern's facilities on May 8, 1988, when Fidelcor, after consultation with the bankruptcy court, made payments for guard service, utilities, and property insurance.

[3] Prior to Southern's bankruptcy, Fidelcor apparently followed a practice of deeming all receivables less than ninety days old eligible. After bankruptcy, it allegedly (1) declared receivables less than ninety days old ineligible if the account debtor also had other debts more than ninety days old, and (2) placed arbitrary maximum limits on the amount of receivables in certain accounts that it would consider eligible.

that resulted in a steady reduction of available funds and a liquidation of Southern's debt as it sold inventory.[4] The bankruptcy court found that Fidelcor encouraged the liquidation of finished goods as scrap or at greatly reduced prices. Finally, Davlin argues that when Fidelcor's calculation of forty percent of the value of eligible inventory was less than the amount of the inventory then outstanding, Fidelcor should not have reduced the funds available under other parts of the loan agreement to make up for this shortfall.

Over the first nine months of the loan agreement, *i.e.*, through December 1987, the total principal reduction on Fidelcor's loan had been $749,000. During the first four months after Southern filed its bankruptcy petition, the total principal reduction was $1,877,000. Fidelcor also received approximately $3,900,000 from Southern's pre- and post-petition accounts receivable during that four-month period. Fidelcor terminated funding for Southern at the end of April 1988.

On April 8, 1988, Davlin commenced an adversary proceeding in Southern's bankruptcy to equitably subordinate Fidelcor's claim under section 510(c) of the Bankruptcy Code (11 U.S.C. § 510(c)). Southern was added as a plaintiff in December 1988, and a trial on the issue of liability was held on January 26 and March 6 and 7,

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[4] Fidelcor evidently made a ten percent accounting debit for cost of sale on each sale from inventory, so that each sale reduced the eligible inventory account by fifty percent of the value of the item sold, but only forty percent of the value of the replacement item was subsequently added back in. Davlin argues that as a consequence sales of inventory automatically and continually reduced the amount Southern was able to borrow.

1989. On September 28, 1989, the bankruptcy court entered findings of fact and conclusions of law. Noting that Fidelcor's conduct closely matched that of the creditor in a case before the court in 1986-87 in which it had ordered equitable subordination, *see Matter of Clark Pipe and Supply Co., Inc.*, 87 B.R. 21 (E.D. La. 1988), and relying on this Court's recent decision affirming that order, 870 F.2d 1022 (5th Cir. 1989) (*Clark Pipe I*), the bankruptcy court concluded that Fidelcor had exercised effective control over Southern and utilized that control in a manner inequitable to other creditors. The court concluded that Fidelcor kept the company operating solely in order to liquidate inventory and increase accounts receivable, and that it effectively shut off payments to other creditors. The bankruptcy court ordered that Fidelcor's claim be subordinated to those of unsecured creditors to the extent of the harm caused by its inequitable actions, and directed that a second trial be held to determine the extent of subordination.

Fidelcor appealed to the district court. While the appeal was pending, this Court withdrew its previous opinion in the *Clark Pipe* case and issued a decision holding that the degree of control exercised by the lender in that case did not rise to the level warranting equitable subordination. 893 F.2d 693 (5th Cir. 1990) (*Clark Pipe II*). The district court then remanded this case to the bankruptcy court for reconsideration in light of *Clark Pipe II*. On August 28, 1990, the bankruptcy court issued a decision slightly modifying its factual findings and reversing its conclusion. It dismissed the equitable-subordination complaint, holding that, given the broad powers allowed Fidelcor by the loan agreement,

under *Clark Pipe II* Fidelcor did not exercise improper control or act inequitably.

On September 7, 1990, the Trustee and creditor First Interstate Bank of Texas, N.A. (First Interstate), successor to Allied, filed a motion for a new trial, arguing that the *Clark Pipe II* decision established the relevance of evidence that the plaintiffs had not introduced at trial. The bankruptcy court heard oral argument on the motion on October 16, and denied it on January 25, 1991. Davlin brings this appeal from the district court's affirmance of the bankruptcy court's judgment.[5]

Discussion

This Court has identified three conditions that must be present for equitable subordination to be appropriate: (1) the claimant must have engaged in some type of inequitable conduct; (2) the misconduct must have injured the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination must not be inconsistent with the provisions of the Bankruptcy Code. *Matter of Missionary Baptist Foundation of America, Inc.*, 712 F.2d 206, 212 (5th Cir. 1983). Three general categories of conduct have been deemed sufficient to meet the first condition: (1) fraud, illegality, or breach of fiduciary duties; (2) undercapitalization; and (3) the claimant's use of the debtor as a mere instrumentality or *alter ego*. *Matter of Fabricators, Inc.*, 926 F.2d 1458, 1467 (5th Cir. 1991); *Missionary Baptist*, 712

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[5] This appeal was initially brought by National Asset Bank, successor to First Interstate, and by Davlin. National Asset Bank, however, has dismissed its appeal.

F.2d at 212. Whether a creditor's conduct was so egregious as to justify equitable subordination is a legal question reviewable *de novo*. *Clark Pipe II*, 893 F.2d at 699 n.5. However, satisfaction of the three conditions merely *permits* a bankruptcy court to equitably subordinate a claim--it does not compel that remedy. *Fabricators*, 926 F.2d at 1464 n.9. The bankruptcy court's factual findings will not be set aside unless clearly erroneous. Bankruptcy Rule 8013; *Matter of Jordan*, 927 F.2d 221, 223-24 (5th Cir. 1991).

In *Clark Pipe II*, we clarified the effect of a loan agreement giving the lender broad discretion in its level of funding on the determination of whether the lender's reduction in funding constitutes inequitable conduct. The facts there were closely analogous to those of the present case. Associates lent money to Clark Pipe secured by an assignment of accounts receivable and an inventory mortgage. Associates based the amount of its advances on a percentage of the eligible accounts receivable, although the agreement allowed Associates to reduce the advance rate in its discretion. In early 1982, as Clark Pipe's business condition became desperate, Associates reduced its advance rate so that Clark Pipe had only enough money to pay the vendors and creditors essential to keeping its doors open. Clark Pipe sold inventory, the proceeds of which were used to pay off past advances from Associates. Clark Pipe then declared bankruptcy in May 1982.

Although Associates had effectively directed Clark Pipe's liquidation, and the testimony of Associates' loan officer corroborated that he had structured the loans so that there would

be only enough for Clark Pipe to turn inventory into receivables, we rejected equitable subordination because Associates' power over Clark Pipe's affairs was conferred by the loan agreement, and Associates had not acted inconsistently with the agreement. *Id.* at 701. We stated:

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

We distinguished *In re American Lumber Co.*, 5 B.R. 470 (D. Minn. 1980), by noting that, unlike the debtor in that case, Associates had not owned any stock in Clark Pipe, had not made management decisions such as deciding which creditors to prefer or which bills to pay, had not placed any of its employees as officers or directors of Clark Pipe, had never influenced the removal of any Clark Pipe personnel, and had not directed Clark Pipe not to pay vendors. *Clark Pipe II*, 793 F.2d at 702. We further noted that Associates did not mislead creditors to continue supplying Clark Pipe, and, most important, Associates did not coerce Clark Pipe into executing new security agreements in its favor after Clark Pipe became insolvent. *Id.* "Associates' control over Clark's finances, admittedly powerful and ultimately severe, was based

solely on the exercise of powers found in the loan agreement." *Id.*

The lesson that emerges from *Clark Pipe II* is that, absent a situation in which the debtor ceases to have independent existence, the exercise of control over a debtor's affairs made possible by a lender's financial leverage will not support equitable subordination so long as the actual means employed are those contemplated by a freely negotiated loan agreement. In other words, absent fraud, illegality, or breach of fiduciary duty, contractually designated remedies will not be disallowed simply because they have the practical effect of dictating an insolvent debtor's business decisions, even though the creditor resorts to the remedies realizing and intending that this consequence will follow.

Viewing Davlin's contentions in this light, we conclude that they must fail. They are almost entirely challenges to Fidelcor's exercise of powers conferred by the loan agreement (*e.g.*, "Fidelcor used its discretion to limit availability of funds to determine which creditors would be paid and to require the termination of several employees."). Davlin's challenges to Fidelcor's calculations of the eligible inventory loan amounts and to its determinations of eligible accounts receivable address matters reserved under the agreement to Fidelcor's sole discretion. The bankruptcy court found that there was no ultimately persuasive evidence that, given Fidelcor's discretion under the agreement, its funding during the relevant time period was inconsistent with the loan formula, and Davlin has not shown any convincing reason for us to disturb that finding. Moreover, as in *Clark Pipe II*, Fidelcor

does not appear to have actually usurped management of Southern, but rather at most exercised a type of veto over Southern's management decisions by making funding choices permitted under the agreement. There are no allegations that Fidelcor made misrepresentations to other creditors.

In some respects Fidelcor's involvement in Southern's business was more extensive than Associates' involvement in Clark Pipe's; whereas Associates apparently relied *entirely* on restrictions in funding to effect desired results on Clark Pipe's operations, Fidelcor also became involved to the extent of billing customers directly and placing limits on the accounts of certain customers. However, as the bankruptcy court found, these actions too were either directly authorized or implicitly allowed by Fidelcor's broad protections under the loan agreement. Paragraph 14 of the agreement empowered Fidelcor, without notice to or consent from Southern, to alter the terms of Southern's business arrangements with its customers by compromising or extending the time for payment on accounts receivable, or by accepting the return of goods represented by accounts receivable. Paragraph 15 appointed Fidelcor Southern's attorney-in-fact, with the authority to receive correspondence and send notices to account debtors. Moreover, under the loan agreement *all* accounts receivable were collateral, not merely the accounts deemed "eligible" for purposes of Fidelcor's funding formula.

Davlin next argues that Southern's situation is distinguishable from Clark Pipe's in that Fidelcor's injurious conduct occurred *after* Southern had filed for bankruptcy

protection. He relies on the *Clark Pipe II* court's observation that the loan agreement did not give Associates total control over the debtor because "[a]t all material times Clark had the power to act autonomously and, if it chose, to disregard the advice of Associates; for example, Clark was free to shut its doors at any time it chose to do so and to file for bankruptcy." *Clark Pipe II*, 893 F.2d at 702. Davlin argues that, already being in bankruptcy, Southern (and Southern's other creditors) had no means of protection from Fidelcor's self-serving acts other than to seek equitable subordination. We see no reason, however, why the coercive power wielded by a lender would be greater over a borrower under the jurisdiction of the bankruptcy court than over one fighting to stave off bankruptcy; indeed, the contrary supposition seems more plausible. We therefore find no basis for distinguishing *Clark Pipe II* on this ground.[6]

Finally, Davlin contends that the bankruptcy court erred in denying the motion for a new trial filed by the Trustee and First Interstate. He contends that both the original loan agreement between Standard and Fidelcor and the January 1988 cash collateral agreement were entered into when the company was struggling or insolvent and lacked sufficient bargaining power to engage in an arm's length transaction. He argues that evidence of the negotiation of the original loan agreement was not introduced at

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[6] In addition, abandoning the effort to distinguish *Clark Pipe II*, Davlin argues that the decision is contrary to the underlying policies of the Bankruptcy Code. This panel, however, is not at liberty to overrule or disregard a prior decision of this Court. *In re Humble Place Joint Venture*, 936 F.2d 814, 817 (5th Cir. 1991).

trial because under existing jurisprudence it was not pertinent, but that after *Clark Pipe II* it became an issue of importance to this case.

Even if an intervening change in the controlling law might in some instances furnish grounds for a new trial under Federal Rule of Civil Procedure 59(a),[7] Davlin has not shown himself entitled to relief under the circumstances of this case. First, he should have requested a new trial when the case was first remanded from the district court rather than waiting until the bankruptcy court had made a second disposition. Moreover, he has not demonstrated a "change" in the law that renders it unfair to hold him to his initial presentation of his case. *Clark Pipe II* did not create a new cause of action; it rejected the application of the equitable subordination doctrine to the facts before it. It is true that this Court grounded its *Clark Pipe II* decision on the fact that all of Associates' actions were taken pursuant to loan and security agreements "entered into at arm's length prior to Clark's insolvency." *Clark Pipe II*, 893 F.2d at 702. However, in doing so

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[7] The closest parallel that we have found in this Circuit's case law is *Del Rio Distributing, Inc. v. Adolph Coors Co.*, 589 F.2d 176 (5th Cir.), *cert. denied*, 100 S.Ct. 80 (1979). In that case, a distributor brought a Sherman Act suit against a brewer and waived any claim under the Texas antitrust laws. On the day he rested his case, the Supreme Court handed down a decision strengthening the standard of proof in Sherman Act cases by overruling its former *per se* approach to vertical territorial restrictions and replacing it with a rule-of-reason approach. The plaintiff's motion for a new trial to allow him to resurrect his state claims was denied. This Court affirmed the denial, noting that because the Supreme Court had granted *certiorari* on the case before trial, the plaintiff's contention of surprise was not compelling and he had failed to show manifest injustice. *Id.* at 178-79.

the Court was merely applying the established requirement that the creditor act inequitably. There was nothing prior to *Clark Pipe II* barring Davlin from showing that Fidelcor acted inequitably in procuring the loan agreement, suggesting that such a showing would not be relevant to equitable subordination, or indicating that evidence of disparity of bargaining position would not be useful in such a showing. Indeed, as noted above, the *American Lumber* court emphasized the creditor's coercive procurement of security agreements; if Davlin believed that Fidelcor's conduct in connection with the 1987 loan agreement warranted equitable subordination, there was ample basis under existing law for including it in his complaint.[8]

Conclusion

Because we find Davlin's contentions to be unavailing, the judgment of the district court is

AFFIRMED.[9]

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[8] Davlin suggests to this Court that because of the state of the law prior to *Clark Pipe II* he was prevented from introducing evidence at trial regarding the negotiation of the March 1987 loan agreement. Again, however, any barrier that existed was a consequence of his litigation strategy, not of the applicable law. Because Davlin challenged only conduct after January 1988, and sought to introduce evidence of the earlier events only as historical background rather than as evidence of coercion, his presentation of events prior to bankruptcy was limited on relevancy grounds, and his discussion of the negotiations preceding the March 1987 loan agreement was precluded by the parol evidence rule.

[9] Fidelcor asks that this Court impose damages on Davlin and National Asset Bank for prosecution of a frivolous appeal. *See* Fed. R. App. P. 38. As discussed *supra*, the distinction between *Clark Pipe II* and a case in which equitable subordination is warranted, such as *American Lumber*, turns on an aggregation of facts about the creditor's conduct and the circumstances of the parties' dealings. As also noted above, this case is not

factually identical to *Clark Pipe II*, and indeed is in some respects arguably an intermediate case between *Clark Pipe II* and *American Lumber*. Therefore, although we conclude that Davlin's appeal should be rejected, it was not so plainly lacking in merit as to warrant an award of damages. Fidelcor's request is denied.