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The Equitable Subordination
of Claims in Bankruptcy

Asa S. Herzog* and Joel B. Zweibel**

The authors of this article address themselves to the problems raised by the use by bankruptcy courts of their equity powers to subordinate claims. They discuss the distinctions between subordination and disallowance, the interplay between state and federal law, res adjudicata, and the classes of cases in which equitable subordination occurs. They conclude that, while much confusion exists in this area, the equitable principles involved are generally sound and that applying them is often in the best interest of debtor, creditor, and public.

I. Jurisdiction

Equality of distribution is the theme of the Bankruptcy Act.1 Section 65a2 provides that “dividends of an equal per centum shall be declared and paid on all claims except such as have priority.” Except for section 64a3 which sets up certain classes of debts having priority in advance of payment of dividends to creditors, there is nothing in the act which specifically authorizes departure from the principle of equality declared by section 65a. Subordination of one or more claims or of one or more classes of claims, therefore, is not ordinarily a statutory function of the bankruptcy court in administering bankrupt estates.4 Yet, it is obvious that certain claims possess an intrinsic ethical superiority to others; this ethical superiority presents a compelling reason for overriding the principle of equality declared by section 65a.

Since the power of a court of equity to superintend the administration of justice is universally recognized, the bankruptcy courts simply drew upon their powers as courts of equity to correct the abuses, fraud and inequity which would otherwise flow from a strict and unswerving application of the equal distribution principle of section 65a. Furthermore, the Bankruptcy Act directly confers equitable jurisdiction upon the bankruptcy courts. Section 2a invests the courts of bankruptcy with “such jurisdiction at law and equity as will enable them to exercise original jurisdiction in

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Consequently the courts have held that for many purposes courts of bankruptcy are essentially courts of equity and their proceedings inherently proceedings in equity; in exercising the jurisdiction conferred upon them, they apply the principles and rules of equity jurisprudence.

These equitable powers have been exercised in passing on a wide range of problems arising out of the administration of bankrupt estates to the end that fraud will not prevail, that substance will not give way to form and that technical considerations will not prevent substantial justice from being done. Thus, without direct authority in the act, the courts have enjoined a creditor, after adjudication and discharge, from prosecuting a claim in the state courts; have protected an estate against fraudulent assessment; have compelled execution of a deed to make bankrupt's equitable title a complete legal title; have recovered dividends paid pursuant to an order later reversed; and have permitted claims to be proved after expiration of the six months period in order to prevent injustice.

In the field of claims, equitable powers are even more directly conferred. Section 2a(2) empowers the courts to allow and disallow claims and to reconsider claims allowed or disallowed, and section 57k provides that "claims which have been allowed, may be reconsidered for cause and reallocated or rejected in whole or in part according to the equities of the case...." Thus "equity" twice crops up in connection with claims: the court is invested with jurisdiction in equity to allow, disallow and reconsider claims (section 2a(2)) and upon reconsideration may reject allowed claims according to the equities of the case (section 57k). And, if a claim previously allowed may later be rejected in whole or part according to the equities of the case, then logic dictates that disallowance or subordination in the light of equitable considerations may originally be made.

6. Local Loan Co. v. Hunt, 292 U.S. 234 (1934). As early as 1900, immediately after enactment of the present Bankruptcy Act, the Supreme Court, in Bardes v. Hawarden Bank, 178 U.S. 524 (1900), held that the proceedings in bankruptcy are generally in the nature of proceedings in equity. Accord, In re Rockford, 124 Fed. 182 (8th Cir. 1903); In re Siegel-Hillman Dry Goods Co., 111 Fed. 980 (D.C. Mo. 1901).
7. Larson v. First State Bank, 21 F.2d 936 (8th Cir. 1927); Pepper v. Litton, 308 U.S. 295 (1939).
12. In re Lilyknit Silk Underwear Co., 73 F.2d 52 (2d Cir. 1934).
13. Burton Coal Co. v. Franklin Coal Co., 67 F.2d 796 (8th Cir. 1933); Williams v. Rice, 30 F.2d 814 (5th Cir. 1929); Larson v. First Nat'l Bank, 21 F.2d 936 (8th Cir. 1927).
15. Pepper v. Litton, supra note 7. A few isolated cases have looked to § 2a(7) of the act, Searle v. Mechanics Loan & Trust Co., 249 Fed. 942 (9th Cir. 1918); or have
Hence, equality of distribution is not an "inexorable rule" and while specifically empowered to inquire into the validity of any claim asserted against the estate and to disallow it if it be without lawful existence, or fictitious or sham, the power of the court is not narrowly limited to the bare legal question of validity. The test is not the existence or non-existence of the debt, rather, the courts will be guided by cardinal principles of equity jurisprudence to the end that injustice or unfairness is not done in the administration of the bankrupt estate. The Supreme Court has unequivocally stated that the power of the bankruptcy courts to subordinate claims or to adjudicate equities arising out of the relationship between creditors is complete.

However, it is well settled that the equitable power of the court to subordinate claims does not extend to any of the priority classes provided for in section 64; the court may not set up sub-classifications within a class in which there is no priority and fix an order of priority for the sub-classes on some equitable basis. The reason is that the court may not, by granting a priority which it deems equitable, set aside the clear congressional mandate that there is to be no priority among the priorities.

II. SUBORDINATION OR DISALLOWANCE?

Before launching into a discussion of the nature, cause and effect of equitable subordination, some mention should be made of the distinction between outright disallowance of a claim and the subordination thereof to the claims of others. There seems to be an inadvertent confusion of the concepts of disallowance of a claim and postponement or subordination of it. This has resulted in frequent obiter dicta that mere reasons of equity may require a creditor's claim to be either totally disregarded or subordinated. On other occasions courts, aware of the differentiation, have nevertheless held the question to be academic, saying since there is small chance of the other unsecured creditors receiving more than a small percentage of their claims, postponement instead of disallowance would be of no benefit to the

referred to the doctrines of estoppel, Bird & Sons Sales Corp. v. Tobin, 78 F.2d 371 (8th Cir. 1935), equitable lien, Searle v. Mechanics Loan & Trust Co., supra, or constructive trust, In re Dodge-Freedman Poultry Co., 148 F. Supp. 647 (D.N.H. 1956), aff'd, 244 F.2d 314. The leading decisions, however, find their support in the inherent equity powers of the bankruptcy court and in § 2a(2) and § 57k of the act.

18. In re Hicks & Son, Inc., 82 F.2d 277 (2d Cir. 1936).
20. Pepper v. Litton, supra note 7.
22. Luther v. United States, 225 F.2d 495 (10th Cir. 1955); In the Matter of Columbia Ribbon Co., 117 F.2d 999 (3d Cir. 1941).
claimant. From a practical point of view such approach may be quite reasonable, but it could result in grave injustice, if, for instance, additional assets are recovered to the estate sufficient to pay general creditors in full with a surplus over.

Disallowance of a claim negates its validity and existence and completely ousts the claimant from creditor status for all purposes. A claim should be rejected and disallowed, it seems to us, when it has no basis in fact or law, is non-existent or illegal. Equitable jurisdiction should not be exercised when there is a full, adequate and complete remedy at law. Subordination should be ordered when the claimant is undeniably a creditor, but for reasons of equity should be relegated to a rank inferior to that of general creditors.

The jurisdiction to disallow claims on legal grounds is derived directly from the act. Only in subordinating or postponing claims does the court exercise its inherent equitable powers. In all these cases the court proclaims itself a court of equity with the power to do equity—but relief in equity is remedial and not penal. Disallowance of a valid legal claim because of misconduct obnoxious to a court of equity is certainly penal in nature. If under the cardinal principles of equity a creditor is not entitled to share ratably with other creditors, then it seems clear that the proper remedial relief is postponement of payment to him until all others have been paid in full.

We think that one fairly accurate test is the direction of claimant’s harmful conduct: if directed at the bankrupt, then the claim should be disallowed either on the purely legal ground that the claim is invalid or because a valid defense exists; if directed at the creditors, or at both the bankrupt and creditors, to perpetrate a fraud on them, or to obtain an unfair advantage over them, then although the claim may be a valid one as against the bankrupt, the remedy is properly subordination. 25

24. McDonell v. Sampsell, 193 F.2d 954 (9th Cir. 1952) (subordination equated with disallowance); Columbia Gas & Elec. Corp. v. United States, 151 F.2d 461, 470 (6th Cir. 1945); Goldie v. Cox, 130 F.2d 695 (8th Cir. 1942).
25. See discussion under heading “Classification of Subordination Cases,” infra.
27. Sections 2a(2) and 37k.
29. Collier points out that the equities may in “extreme” cases be strong enough to warrant disallowance absolutely and entirely, but that in the cases characterized as “extreme” the disallowance negatives the very validity of the claim. 3 Collier, Bankruptcy 214 (14th ed. 1958). This would seem to mean that in such cases the conduct of the claimant was such as to give rise to a legal defense.
31. Goldie v. Cox, 130 F.2d 695 (8th Cir. 1942). It is true that where equity pierces the corporate veil in the alter ego situations, the stockholder’s claim may be
Besides the improbable, but not impossible, situation where a surplus may remain after payment to creditors in full, there are, it seems to us, other cogent reasons why the distinction should be observed, and why claims which ought to be subordinated should not be penalized with disallowance. For instance, the question of insolvency may well become an issue in suits to avoid preferences, or liens obtained by attachment, judgment, levy, etc., or fraudulent transfers, where the inclusion or exclusion of the subordinated claim as a debt could spell the difference between solvency and insolvency. A creditor whose claim is subordinated does not cease to be a creditor, and a subordinated debt does not reduce the overall indebtedness of the bankrupt; it remains a liability to be counted in determining whether the bankrupt is or was insolvent. Furthermore, there appears no valid reason why a subordinated claim cannot be voted. Subordination, as we have said, does not destroy the claimant's status as a creditor. The right of the creditor to have his claim allowed is in no wise dependent upon the order of payment as between the various creditors, and subordination simply adjusts equities among the creditors and regulates distribution. Section 1(11) of the act defines a “creditor” to include anyone who owns a debt, demand or claim provable in bankruptcy, and section 56a states that “creditors” shall pass upon matters submitted to them at their meetings. Thus it would seem clear that a creditor, whose claim has been subordinated, is not thereby disfranchised or otherwise deprived of his creditor rights except to share pari passu with the other creditors.

If the distinction we make between disallowance and subordination is valid and if claims which ought to be merely subordinated should not be properly disallowed, but this is simply because the stockholder and the bankrupt corporation are deemed one, and of course a bankrupt cannot at the same time be its own creditor.

35. Goldstein v. Wolfson, 132 F.2d 624 (2d Cir. 1943).
36. In re Ultimite Corp., 207 F.2d 427 (2d Cir. 1953).
37. McKey v. Brims, 243 Fed. 370 (7th Cir. 1917).
38. In re Kansas City Journal-Post Co., 144 F.2d 791 (8th Cir. 1944).
40. The implication of Schwartz v. Mills, 192 F.2d 727 (2d Cir. 1951), is that if the corporation creditor were subordinated for equitable reasons, it would not be permitted to vote for a trustee. But this on the ground that if the corporate veil were pierced, claimant would fall within the disfranchising provisions of Bankruptcy Act § 44a, 30 Stat. 557 (1898), as amended, 11 U.S.C. § 72a (1958). But see In re Itemlab, Inc., CCH Bankr. L. Rep. ¶ 60232 (E.D.N.Y. 1961), where a creditor who obtained a subordination agreement from another creditor was held entitled to vote the claim of the subordinated debt for acceptance of an arrangement. The subordinated debt, said the court, was held as security for a loan, gave the holder complete control over the claim and created an equitable lien in his favor.
disallowed, then the legal form subordination should take seems obvious enough. Several methods suggest themselves but the one most logical seems to be to allow the claim and to provide in the order of allowance for postponing participation in distribution until all other general creditors have been paid in full.  

III. Federal or State Law

Section 6342 of the act prescribes what debts are provable, and while provability and allowability are essentially a federal question, a debt exists or does not exist by force of state law.  

If there was no valid claim under local law before bankruptcy, there is no claim for a bankruptcy court to recognize or reject. Nevertheless, it is well established that federal law and not state law is determinative of the relative priority of claims asserted against a bankrupt estate. This problem arose in Prudence v. Geist. There the Second Circuit, by a divided court, followed the New York rule that a guarantor of mortgage certificates who also has an interest in the mortgage cannot share in the collateral until certificate holders have been paid in full unless there is a clear reservation in the certificate to the contrary. The majority saw the New York rule as one of contract construction, while Judge Frank, dissenting, saw it as an equitable rule of administration in the distribution of the assets of an insolvent guarantor. The Supreme Court, agreeing with Judge Frank, held that the Bankruptcy Act prescribes its own criteria for distribution and federal, not local, law will be applied in determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim in bankruptcy requires its subordination to other claims.

While a debt founded upon a state court judgment is a provable claim under section 63a(1) of the act, the judgment does not necessarily foreclose the bankruptcy court from subordinating it to the claims of other creditors. Whether the bankruptcy court will look behind the judgment and determine whether the claim asserted is without lawful existence is quite another question which we need not consider here at length. Pepper v. Litton.

41. Boyum v. Johnson, 127 F.2d 491 (8th Cir. 1942). Collier suggests four alternate methods of treating the claim and comes to the conclusion that a simultaneous allowance and qualification thereof is to be preferred. 3 Collier, BANKRUPTCY 215-16 (14th ed. 1959).
44. Vanston Comm. v. Green, supra note 43.
46. 316 U.S. 89 (1941), reversing 122 F.2d 503 (1941).
47. 308 U.S. 295 (1939).
plainly says that the bankruptcy court has precisely that power. But *Heiser v. Woodruff* seemingly rejects *Pepper* in this respect and holds that the bankruptcy court may not re-examine the issues determined by the judgment itself. Be this as it may, the decisions are in accord that merger of the claim into the judgment does not prevent the bankruptcy court from subordinating a claim. The question of subordination turns not on the existence or non-existence of the debt, but involves simply the order of payment as affected by the violation of recognized principles of equity. Once it is recognized that the bankruptcy court has the paramount power to subordinate a valid debt on equitable principles, it follows that a judgment may not be interposed as a roadblock to an inquiry into whether or not equitable grounds to subordinate exist.

**IV. Res Judicata**

In this connection the doctrine of res judicata is frequently raised. But since the misconduct which moves the bankruptcy court to subordinate does not turn on the existence or non-existence of the debt, such misconduct is seldom involved in the previous litigation. Thus in *Pepper* the court held that as the judgment creditor was also a controlling stockholder, he was a fiduciary for the other creditors of the corporation and, as such, could not prove his claim in competition with other creditors. Nor is the judgment res judicata on the question of fraud or collusion in the procurement thereof. And this is especially true as to judgments obtained by default or *pro confesso* since the danger of fraud in such judgments is far greater than in adversary proceedings. Where a party has been prevented by fraud from raising a valid defense, the bankruptcy court may go behind the judgment and determine the *validity of the debt*. And as a corollary, the court may find that although the defense is legally insufficient to defeat the claim, yet it constitutes conduct which at least requires subordination of the claim to the end that fraud will not prevail.

Of course, where the trustee in bankruptcy has already litigated an issue in the state courts, the salutary doctrine of res judicata will prevail.

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48. 327 U.S. 726 (1946). It is interesting to note that Mr. Justice Douglas, who wrote the *Pepper* decision, dissented in *Heiser* (Mr. Justice Black concurring), and adopted the opinion of the court below (150 F.2d 689 (10th Cir. 1945)); there, following *Pepper*, it was held that the court could go behind the judgment and decide for itself the questions previously litigated and tried, including the merits of the cause of action.

49. *Heiser v. Woodruff*, *supra* note 48; *Pepper v. Litton*, *supra* note 47.


53. *Ibid*.


Thus, where the same defense of fraud had been twice litigated unsuccessfully by the bankrupt and his trustee in the same court where the judgment had been rendered, the fraud allegation could not be raised again in the bankruptcy court.56 But where the trustee moved in the state court to set aside the judgment on the technical ground that it had not been confessed in the manner required by state statute, he was not barred from collaterally attacking the judgment in the bankruptcy court.57 Furthermore, denial of the trustee's motion in the state court to set aside the judgment will not be deemed res judicata where his motion was denied without inquiring into the merits of his contention.58

V. CLASSIFICATION OF SUBORDINATION CASES

The situations involving subordination generally assume certain definite recurring patterns which make it possible to arrive at a fairly distinct classification. The cases will ordinarily fall into one or more of the following broad categories which will be discussed ad seriatim: First, consensual subordination, express or implied; second, the so-called “capital contribution” cases wherein purported loans to the bankrupt by stockholders, partners or joint-venturers are translated into capital contribution or other proprietary interest; third, cases where fraud by the claimant in one or more of its many facets requires subordination; fourth, illegality in the origin or enforcement of the claim; and fifth, the broad “equitable considerations” cases where claimant's relationship to the bankrupt either as dominant parent, controlling stockholder or other fiduciary position requires certain standards of conduct, in the absence of which subordination of the claim will result.

A. Consensual Subordination

Voluntary agreements to subordinate or postpone claims which become litigable in a bankruptcy forum are generally encountered in certain repetitive contexts.

It is not uncommon for creditors of a debtor in financial straits to agree to subordinate their claims to that of a prospective lender, in the hope that the debtor may be rehabilitated by the infusion of additional funds. The agreement commonly provides that in the event of liquidation of the debtor's assets, the lender will be paid first. In this manner the lender is compensated for the risk he assumes in advancing funds where more cautious money fears to tread.

Often the officers or stockholders of the debtor promise to forego the collection of any claims they have against the corporation until existing and

56. Ibid.
58. In re James A. Brady Foundry Co., 3 F.2d 437 (7th Cir. 1924).
future creditors are paid, in consideration for an extension of the time of payment of the latters’ claims.

However, not all agreements to subordinate arise out of pecuniary distress. Agreements to subordinate are sometimes built into the capital structure of a business entity, for example, where negotiable debentures are expressly subordinate in payment to other classes of claims.59

Agreements to subordinate are uniformly enforceable and the particular chapter of the Bankruptcy Act in which the agreement is invoked will not affect its enforcement.60 The terms of such agreements vary with the intent of the parties. Thus, the agreements may subordinate in favor of a specific creditor or group of creditors,61 or may elevate the status of all other creditors.62 “New money” may take priority in payment or it may be subordinate to the payment of other claims.64

The cases involving express agreements to subordinate present little difficulty. More provocative are the cases in which the precise language of the agreement does not call for subordination, but where from the nature of the promise made, interpreted in the light of accompanying facts and circumstances, an intent to subordinate may be inferred. For example, where money was advanced by the president of a corporation to “guarantee” the first payment under a composition agreement with the corporation’s creditors, the court held that it was intended that the president’s claim be subordinated to the claims of settlement creditors, though not subordinate to those of subsequent creditors.65

Subordination by implication was also invoked where a debtor and certain of its creditors agreed that the business be placed in the hands of a trustee and that the debtor provide sufficient funds to pay the expenses of the trustee and any new liabilities incurred in the operation of the business, and


61. Bird & Sons Sales Corp. v. Tobin, 78 F.2d 371 (6th Cir. 1935) (subordination to all future indebtedness); In re Dodge-Freedman Poultry Co., supra note 60 (one creditor subordinates to another); In re Handy-Andy Community Stores, Inc., 2 F. Supp. 97 (W.D. La. 1932) (all creditors subordinate to bank).

62. Bank of America Nat’l Trust & Sav. Ass’n v. Erickson, 117 F.2d 798 (9th Cir. 1941) (officers of debtor subordinate to all indebtedness, present and prospective).

63. Johns v. United Bank & Trust Co., 15 F.2d 300 (9th Cir. 1928); Searle v. Mechanics’ Loan & Trust Co., 249 Fed. 945 (9th Cir. 1918).

64. In re George C. Bruns Co., 256 Fed. 540 (7th Cir. 1919).

65. In re George C. Bruns Co., supra note 64. See also Prudence Realization Corp. v. Geist, 316 U.S. 89 (1942), where federal equity law was held to require the subordination of a solvent surety of an insolvent’s obligation to the creditors whose claims the surety had undertaken to assure.
the creditors signing the agreement agreed not to press their claims while
the agreement was in effect. In a subsequent bankruptcy proceeding it was
held that the creditors' promise to refrain from proceeding on their respec-
tive debts was a plain expression of intent to subordinate to the claims of
subsequent creditors.66

However, due to the serious consequences of an order of subordination,67
the courts should be chary of finding a subordination by implication where
the proof is not clear and convincing that the parties, by their words and
conduct, intended to effect a consensual subordination.

Although it is sometimes startling to find that one not a party to an
agreement to subordinate may secure the benefits of the agreement, some
courts have reached just such a result without further elucidation.68 In
keeping with the general contractual framework, these holdings might be
sustained on a third-party beneficiary doctrine or on the rationale of a
continuing offer to subordinate being accepted by prospective creditors as
they extend credit. We think, however, that only where subsequent
creditors rely on a subordination agreement should a court of equity employ
the principle of estoppel to subordinate.69

The doctrine of estoppel plays an important role in this area. In one
case,70 an agreement to subordinate to a new lender was to become effective
only upon execution by ninety per cent of creditors in amount. The doctrine
was invoked to estop creditors from complaining of lack of due execution of
the agreement where they had permitted the lender to advance funds under
the agreement knowing that such action was based on the mistaken assump-
tion that the requisite ninety per cent had been secured.

In another case,71 a principal stockholder of a debtor was estopped by
the spirit of his subordination agreement from waiving his claim in the
debtor's chapter XI proceeding and thereby preventing the other party to

67. See discussion under heading "Subordination or Disallowance," supra.
68. Bank of America Nat'l Trust & Sav. Ass'n v. Erickson, 117 F.2d 796 (9th Cir.
1941); In re Geo. P. Schinzel & Son, Inc., 116 F.2d 289 (S.D.N.Y. 1926). In re Salem
Co-op. Window Glass Co., 40 F.2d 298 (D. Wyo. 1930) arrived at the unique result that
stockholders who were parties to a decision to have the corporation deduct on its books
$300 of the amount which should be earned as wages by each of the stockholders (the
corporation being a co-operative glass manufacturing concern) were not bound as
between themselves to refrain from asserting their $300 claims against the corporate
estate; but, though dictum, it was said that such an agreement would be binding as
to bona fide general creditors of the corporation though they were not parties to the
agreement. No reasons were given to support the dictum, although the situation
seemed to warrant the use of estoppel theory.
69. Bird & Sons Sales Corp. v. Tobin, 78 F.2d 371, 373 (8th Cir. 1935) pointed in
that direction by emphasizing that subsequent creditors relying upon subordination
were preferred.
70. Searle v. Mechanics' Loan & Trust Co., 249 Fed. 942 (9th Cir. 1918). See
also Litzke v. Gregory, 1 F.2d 112, 114 (8th Cir. 1924).
the agreement from obtaining the benefits of the subordination agreement.

An agreement to subordinate having been found, the question has arisen as to whether the bankruptcy court can postpone payment of dividends merely upon the basis of the promise to subordinate, or whether there must exist, in addition, a specific assignment of the claim or dividends to be subordinated. One early case\textsuperscript{72} held that a signed covenant that a certain bank be paid in full before the claimant should receive anything on its account was not an assignment of the claim or dividends to accrue thereon and that in the absence of a specific order or transfer of a portion of the fund, subordination could not be granted.

This excessively formalistic view should be distasteful to a court of equity. In fact, recent cases have not made such demands. Indeed, it has been held that, although an agreement to subordinate does not convey a present title to the claim subordinated, a court of equity can enforce an agreement to subordinate when the necessary conditions arise.\textsuperscript{73}

It has been held that a statutory priority may be relinquished by express agreement.\textsuperscript{74} Such a view is questionable, however, in the light of the line of authority that the doctrine of equitable subordination is inapplicable to the statutory priorities.\textsuperscript{75}

In any event, the principles surrounding agreements to subordinate are sufficiently settled to alert creditor interests to exactions which are within their grasp before a debtor plummets into bankruptcy. The only caveat would be that the agreement should be quite specific and show clearly that the purpose is to subordinate certain specified claims to other particularized claims in the event of the occurrence of certain conditions including any proceeding under the Bankruptcy Act.

**B. Debt or Proprietary Interest: The Capital Contribution Cases**

The so-called “capital contribution” cases have invariably been treated as a sub-classification within the general sphere of equitable subordination of claims. In these cases an alleged debt is transformed by the bankruptcy court into what it deems to be the essential nature of the transaction, to wit, a capital contribution or other proprietary interest.

Several courts relying on Pepper v. Litton\textsuperscript{76} have failed to see that these cases actually turn upon the existence or non-existence of a debt, and not upon the question of whether the court will subordinate the claim.\textsuperscript{77}

\textsuperscript{73} In re Handy-Andy Community Stores, Inc., 2 F. Supp. 97 (W.D. La. 1932).
\textsuperscript{74} In re Caledonia Coal Co., 254 Fed. 742, 746 (E.D. Mich. 1918).
\textsuperscript{75} In re Aktiebolaget Kreuger & Toll, 96 F.2d 768, 770 (2d Cir. 1938). That is not to say that a priority creditor cannot assign his claim.
\textsuperscript{76} 308 U.S. 295, 310 (1939).
\textsuperscript{77} Goldie v. Cox, 130 F.2d 695, 709 (8th Cir. 1942) (view of dissent); Boyum v. Johnson, 127 F.2d 491, 494 (8th Cir. 1942).
Actually, however, our perspective will be sharpened if we focus upon the sole question involved here, that is, whether the claim is, as a matter of substantial economic and legal reality, an indebtedness or whether it is a proprietary interest. Once the judicial investigation has determined that the claim is not in fact a debt but is a proprietary interest, subordination follows as a matter of course for the essential nature of a capital interest is a fund contributed to meet the obligations of a business and which is to be repaid only after all other obligations have been satisfied.

Inasmuch as the focal issue is the true nature of the transaction, in order to effect subordination it is not necessary to prove the existence of fraud or other inequitable conduct. Nevertheless, where the advance of capital funds is deliberately cloaked as a formal debt, it is indeed a common bedfellow with subordinating influences such as fraud, illegality or other variants of misconduct.

Undercapitalization is an important factor contributing to the insolvency of business corporations. When bankruptcy ensues, it is not atypical to find the dominant stockholders appearing with proofs of claim in hand for advances made by them to the corporation. Although the judicial determination of a loan or proprietary interest will depend upon the unique facts of each case, certain general principles can be abstracted from the cases. The appropriate standards to be employed in determining whether advances are in reality contributions to capital, and therefore not bona fide debts on the part of the business, have been stated more distinctly in tax cases.

Although the purpose of the inquiry in such cases differs from the purpose of the inquiry in bankruptcy, the basic question is still one of capital or loan, and the applicable standards should not differ measurably. The tax courts have said that what counts is the substance of the advance. If the funds have been advanced with reasonable expectations of repayment, they are loans; if as a matter of substantial economic reality they are risked upon the success of the venture, the funds are actually capital.

The factors relevant to the determination of capital or loan include: the original

78. Several courts have properly sighted upon the basic question of loan or proprietary interest, e.g., International Tel. & Tel. Corp. v. Holton, 247 F.2d 178, 182 (4th Cir. 1957); Goldstein v. Wolfson, 132 F.2d 624, 626 (2d Cir. 1943) (subordination results from a showing that the claim is not in fact based upon a loan).


80. Costello v. Fazio, 256 F.2d 903, 910 (9th Cir. 1958).


82. The problem before the tax court is to determine (1) whether returns upon advances to a corporation are deductible as interest on loans, or are dividends and therefore non-deductible in the computation of net income; and (2) whether, upon the failure of a business, advances to it will be fully deductible as bad debts or only partially deductible as a capital loss.

83. Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957).
debt-equity ratio, the lack of reasonable expectation of repayment, whether outside investors would make such advances, and the motives determining the form of the advance.

Unfortunately, some bankruptcy courts have utilized the vague criterion of Pepper v. Litton (i.e., the “rules of fair play and good conscience”) to determine the narrow question of whether the advance is in fact loan or proprietary interest. A few opinions, however, have attempted to sketch applicable principles. Thus, it has been said that it is not sufficient to find that the capitalization was inadequate, but that it must have been “purely nominal.” We believe that this test is too restrictive and that the court should make a factual determination as to whether the corporation has been provided with separate assets adequate to give it at least a reasonable business chance to carry out its asserted functions. There is, of course, no requirement in law or equity that stockholders must initially provide for unforeseen losses not ordinarily contemplated in the particular business. Capital in this context refers not to working capital, but to the amount of the stockholder’s investment, the paid-in capital.

On occasion the undercapitalization has been bold and immediately apparent. For example, in one case where a partnership was incorporated, two partners who became the officers, directors and controlling stockholders of the corporation converted their partnership capital contributions of $56,620 into loans, leaving the successor corporation with a gross undercapitalization of $6,000, the court construed the purported loan to be in fact capital contributions. In another case, the bankrupt was organized with an entirely inadequate capital of $1,500; the corporate predecessor had substituted for capital stock an indebtedness to itself of $565,000, thus rendering the bankrupt insolvent, in the bankruptcy sense, from its birth. An extensive inquiry into the amount of capital necessary to

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84. See Isidor Dobkin, 15 T.C. 31 (1950) where the ratio of debt to capital stock investment was 35 to 1; in conjunction with other factors, the advance was deemed capital.
86. Costello v. Fazio, 256 F.2d 903, 910 (9th Cir. 1958); Coldie v. Cox, 130 F.2d 695, 709 (8th Cir. 1942) (view of dissent).
87. Discussed under heading “The Instrumentality and Alter Ego Cases,” supra.
88. Brown v. Freedman, 125 F.2d 151, 156 (1st Cir. 1942).
90. Id. at 307.
91. Pepper v. Litton, 308 U.S. 295, 310 (1939); Costello v. Fazio, 256 F.2d 903, 906 (9th Cir. 1958).
92. Costello v. Fazio, supra note 91. See also Boyum v. Johnson, 127 F.2d 491 (8th Cir. 1942), where due to the amounts, duration and need for cash advances, it was held that the sole stockholder had embarked on a course of permanent financing.
93. International Tel. & Tel. Corp. v. Helton, 247 F.2d 178 (4th Cir. 1957). There are, of course, cases in which the determination is exceedingly close and where the referee’s findings of fact, after hearing the witnesses, takes on added significance. In re Madelaine, Inc., 164 F.2d 419 (2d Cir. 1947).
generate a reasonable volume of business may not be necessary where
the facts indicate that for no apparent reason ostensible loans were not
repaid, no interest was paid, and the loans were not intended to be repaid
in the ordinary course of business.94

A good indication of the essential nature of an advance, although cir-
cumstantial, is the cause of the eventual insolvency. If the financial diff-
culties which occasion the "loans" result from the initial insufficiency of
capital, the loans are more susceptible to being regarded as contributions to
capital.95 On the other hand, if bankruptcy is attributable to causes other
than that the entire life of the company from its inception was an insolvent
operation, the loan is more likely to be sustained as such.96

No distinction should be made between contributions of money and
contributions of property.97 Property may be leased or loaned or it may
be part of the original capitalization, and identical principles should apply
in ascertaining the essential economic nature of the property transfer.

Another factor is time. The longer a corporation functions on its initial
capital before controlling stockholders make advances, the greater the
likelihood that the advances will be held bona fide loans.98

The situation of partners presenting a claim against their partnership is
comparable to that of stockholders claiming against their corporation.99
No claim may be proved for what was meant to be a capital contribution.100
Where, however, the advance represents an ordinary and bona fide debt,
there is no reason why a partner should be precluded by his mere capacity
as a partner from sharing in the assets according to the criteria established
by section 5 of the Bankruptcy Act.101

Although restricted in number, the so-called "joint-venture" cases are,

94. L. & M. Realty Corp. v. Leo, 249 F.2d 688 (4th Cir. 1957).
95. SEC v. Liberty Baking Corp., 240 F.2d 511, 514 (2d Cir.), cert. denied, 353
U.S. 930 (1957).
96. In re L. M. Alleman Hardware Co., 181 Fed. 810, 813 (3d Cir. 1910); In the
Matter of Lumber Inc., 124 F. Supp. 302, 306 (D. Ore. 1954) (the downfall was not
due to an inadequate initial capital, but to heavy losses in receivables and the president's
speculative commitments).
97. Gleick, Subordination of Claims in Bankruptcy Under the Equitable Power of
the Bankruptcy Court, 16 Bus. Law. 619 (1961), suggests a different result when
property rather than money is contributed, citing Brown v. Freedman, 125 F.2d 151 (1st
Cir. 1942). In that case, however, the court found that the paid-in capital was not
purely nominal and the decision did not hinge on whether the contribution was in the
nature of property or money.
98. See Arnold v. Phillips, 117 F.2d 497 (5th Cir.), cert. denied, 313 U.S. 583
(1941), where advances prior to the launching of an enterprise and advances in its
first year were held permanent investments, while loans thereafter were due to
adversity not linked to insufficient capitalization.
99. 3 Coller, Bankruptcy 1801 (14th ed. 1960).
100. In re W. J. Floyd & Co., 156 Fed. 206 (E.D.N.C. 1907). See also Wallerstein
v. Ervin, 112 Fed. 154 (3d Cir. 1901), where a claim for advances by a corporate
member of a partnership was subordinated to firm creditors.
like the capital contribution cases, a source of confusion for the courts and
the commentators. This is due to a failure to analyze the reasons why a
court ought to subordinate certain claims by members of a joint venture.

As a matter of theory, a claim by a participant in a joint venture should
be first subjected to the test of debt or proprietary interest (by application
of the standards described herein). If the claim is based upon a proprietary
interest, subordination to the claims of bona fide creditors follows virtually
as a matter of natural law. For a proprietary interest, whether it be a
stock interest or a partnership stake, inevitably is subsequent in time of
payment to bona fide loans. Therefore, once the claim has been estab-
lished as an ownership interest in reality, akin in nature to a capital con-
tribution, it is not provable under the express terms of section 63 which
permits proof and allowance only of "debts of the bankrupt." If, however,
it appears that the claim is an out-and-out debt, then all of the conceivable
subordinating influences discussed in this article become relevant and con-
stitute a second test for the claim.

The primary test, i.e., loan or proprietary interest, should be applied in
the light of the traditional principle that a joint venture is a species of
the genus partnership. The question of whether an individual is a partner
in, or a creditor of, the partnership is a matter which the cases have amply
discussed, and no useful purpose would be served by repeating it in this paper. The principles which have been forged to resolve this question lie midway between the two extreme positions into
which the relatively few bankruptcy cases have fallen.

The doctrine of subordination by classification as a joint venture interest
has developed in virtual isolation in the Ninth Circuit, and there only
with respect to a narrow question of the nature of interests in an oil and
gas lease. Nonetheless, these cases reveal a dichotomy of positions which
should be resolved.

In 1932 the Ninth Circuit was faced with a situation where the bankrupt,
as lessee of real property under an oil and gas lease, "sold" "royalty inter-
ests" in a specific well, issuing therefor "assignments" which by their terms
described the relationship as one of vendor and vendee. The court in
subordinating the claims held that the assignees were not creditors but
were co-adventurers, hazardizing their investment upon the continued opera-
tion and success of the venture. This holding presumably was based

102. A proprietary interest, of whatever genre, assumes the risk of last repayment
in the event of liquidation, in return for the profit potential.
(joint venture is a partnership of limited duration and purposes, the subject of a single
self-contained enterprise).
105. UNIFORM PARTNERSHIP ACT § 7.
106. In re Lathrap, 61 F.2d 37 (9th Cir. 1932).
107. Id. at 43.
upon the facts that the assignees constantly referred to themselves as "investors"; the assignment did not purport to transfer a part of the corpus of the oil (the royalty being measured by the gross proceeds); under California law the owner as lessee of the surface of land had no present title to the oil in place; and the California Corporation Securities Act defined a certificate of interest in an oil lease as a security, thereby analogizing the interest to a preferred stock interest in a corporation. Thus, the nature of the interest, without any consideration of the degree of participation in management or control of the venture, was sufficient to establish a proprietary interest.

This rule lasted but six years. In 1938 the Ninth Circuit was presented with the situation of an advance to a debtor corporation in consideration of an offer by a stockholder of his "net profits" in the development or sale of the oil lease. On these facts, the court could find no joint-venture, but merely a debtor-creditor relation due to the absence of proof that the lender had any voice in the management of the venture or that he participated in the work.

It would seem, however, that the true rule partakes of both stands. A partnership or other proprietary interest may be based solely upon a contribution of capital, without any right to or desire for a management interest. On the other hand, active participation in management may be one of a series of cumulative indicia of a proprietary interest.

C. Fraud

Fraud by a creditor in the creation or assertion of a claim will result in disallowance or subordination of the claim. In this connection fraud is a term of broad import. There is no requirement, for example, that the

108. In re Pomoc Oil Co., 100 F.2d 210 (9th Cir. 1938).

109. Theriot v. Plane, 126 F.2d 1015 (9th Cir. 1942), has also been cited for the proposition that the mere fact that a claim arose out of a joint venture does not of itself justify subordination where the claimant exercised no measure of control. Gleick, Subordination of Claims in Bankruptcy Under the Equitable Power of the Bankruptcy Court, 16 Bus. Law. 619 (1961). Despite an inappropriate reference to "joint adventurer" doctrine, Theriot should be read merely as stating that a loan by a stockholder-general manager of a corporation engaged in the development of an oil and gas lease will not be subordinated in the absence of facts showing a breach of fiduciary duty. But see Consolidated Royalties, Inc. v. Ashton, 132 F.2d 228 (9th Cir. 1942), where the lack of participation in the conduct or management of the business precluded a finding of co-adventure. In effect, however, the court twisted its way to the same result as in Lathrop, on the theory that the assignment sub judice was a transfer of a specific percentage of the oil produced. This placed the claimants, by an alternate route, in the position of "owners."

110. For example, an extensive body of law has flourished around the limited partnership.

111. The reasons which may impel a court to choose to subordinate or disallow are discussed under the heading "Subordination or Disallowance," supra.

112. 3 Collier, Bankruptcy § 63.06, at 1793 (14th ed. 1960).
factual pattern fit into the classic common law concept of fraud.113

Furthermore, the fraudulent conduct cases are frequently interwoven with other subordinating influences discussed in this paper.114 This, together with the kaleidoscopic variations in fraudulent conduct, prevents refinement of the cases into precise categories. It is possible, therefore, to sketch only a few of the more repetitive patterns of fraudulent conduct which result in subordination.

One rather large group of cases involves a fraudulent misrepresentation of credit status. In this area certain definite principles have been formulated, conforming this objection closely to the typical cause of action for fraud and deceit. For example, where one creditor knowingly makes false statements as to the bankrupt's financial condition, that creditor's claim is postponed only to the claims of other creditors who are shown to have been deceived by the misrepresentation and suffered thereby.115 The misrepresentation must be intentional or at least made with negligence so wanton as to amount to willfulness.116 However, where the claimant is also in a fiduciary relationship to the bankrupt, less will be required to move the court to subordinate.117

The misuse of a judgment claim to the detriment of other creditors will lead to subordination. The flagrant misuse by the dominant stockholder in Pepper v. Litton118 of his salary claim for the patent purpose of avoiding payment of a valid debt of the corporation is a prime example of this mode of misbehavior. Similarly, where a creditor, in collusion with the debtor, uses his claim for the purpose and with the effect of defrauding other creditors, the tainted claim will be postponed.

113. Some of the classic badges of fraud are dealt with by specific sections of the Bankruptcy Act, i.e., § 67d and § 70e, in which total disallowance is the statutory remedy.
114. In re Wenatchee-Stratford Orchard Co., 205 Fed. 964 (W.D. Wash. 1913) (breach of fiduciary duty merges with fraudulent conduct on the part of the president of a corporation). See also Carter v. Bogden, 13 F.2d 90 (6th Cir. 1926), which, although dealt with on fraud lines, had elements of the undercapitalization cases.
115. L & M Realty Corp. v. Leo, 249 F.2d 688 (4th Cir. 1957), reversing 151 F. Supp. 531 (1957) (for prior history of this case see Leo v. L & M Realty Corp., 238 F.2d 89, reversing 131 F. Supp. 557, cert. denied, 350 U.S. 969 (1956)); In re Bowman Hardware & Elec. Co., 67 F.2d 792 (7th Cir. 1933); In re Star Car & Foundry Co., 2 F.2d 53 (4th Cir. 1924); Wallace v. Ohio Valley Bank, 2 F.2d 53 (4th Cir. 1924); Spencer v. Lowe, 198 Fed. 961, 964 (8th Cir. 1912); In re Ewald & Brainard, 135 Fed. 168 (N.D. Iowa 1906).
116. In re Madelaine, Inc., 164 F.2d 419, 420 (2d Cir. 1947) (mere financial bragging did not constitute fraudulent misrepresentation); First Nat'l Bank v. Young's Estate, 41 F.2d 8, 10 (6th Cir. 1930) (no showing that gratuitous declaration of intention to pay bankrupt's indebtedness made in bad faith); Crowder v. Allen-West Comm'n Co., 213 Fed. 176, 184 (8th Cir. 1914) (creditor of an insolvent debtor stands in no fiduciary or contractual relationship to other creditors and he therefore owes them no duty to inform them of the debtor's financial condition or indebtedness to him).
117. Goldie v. Cox, 130 F.2d 695, 699 (9th Cir. 1942).
118. 308 U.S. 295 (1939).
Concealment, as well as overt misrepresentation, will cause a claim to be subordinated provided there is a duty to reveal. Consequently, where stockholders of an insolvent corporation obtained from its creditors an extension of time of payment on a promise to pay into the corporation a certain sum for the continuation of the business, without giving any intimation to the creditors that they would be secured for such advance, the court encountered little difficulty in finding that the creditors would not have consented to the extension had they been fully informed, and that a blatant fraud had been perpetrated.

To summarize, although general principles cannot be abstracted to cover every manifestation of fraudulent conduct, there are sufficient warning flags to place potential claimants in bankruptcy on notice that their course of conduct may result in the downgrading of their claims.

D. Illegality

Although illegality is a defense which might be used in any ordinary litigation, it may also constitute a species of inequitable conduct which, under certain circumstances, will invite a bankruptcy court to disallow entirely or to subordinate a claim. Claims based on contracts or other transactions which under applicable state law are invalid or illegal are no more enforceable in the bankruptcy court than they would be in ordinary litigation, being neither provable nor allowable.

Nevertheless, it can not be said without qualification that illegality ipso facto renders a claim void and unprovable. The illegality, whether in the origination, acquisition, or performance of the claim, must bear more than an incidental relation to the claim.

The foregoing principal was enunciated in the leading case of Columbia Gas & Electric Corp. v. United States. There it was found that claimant had engaged in a conspiracy to restrain and monopolize trade and commerce and that its claims against the debtors were acquired pursuant to and in accomplishment of the aims and purposes of that conspiracy. Claimant's basic argument, in opposition to a prayer for subordination, was that the wrong involved (i.e., restraint of trade and monopoly) was a wrong to the public generally, not to the creditors, and that the bankruptcy court could not impose penalties for such conduct other than those specified in anti-trust statutes. The court of appeals agreed that the trustee must prove, in addition to inequitable conduct, that the debtors, their stockholders

119. Litzke v. Gregory, 1 F.2d 112 (8th Cir. 1924).
120. 3 COLLIER, BANKRUPTCY 1778 (14th ed. 1960).
121. 3 COLLIER, BANKRUPTCY 1807 (14th ed. 1960). It is outside the scope of this paper to consider the manifold examples of illegal conduct. Only a few instances of such conduct which resulted in subordination will be discussed here.
122. 151 F.2d 461 (6th Cir. 1945).
or creditors were injured thereby; it held, however, that subordination to all creditors was proper in this instance since the inevitable result of the illegal conduct was to irrevocably impair the interests of creditors of every class. Thus, it was not the illegality involved as such, but equitable considerations which led to subordination.

Nevertheless, a transaction entered into in good faith and perfectly proper in law may result in subordination merely because the intervention of insolvency renders performance of the agreement illegal. For instance, it is generally improper for a corporation to purchase its own shares of stock except out of surplus. The fact that such surplus existed when the contract of purchase was executed will not prevent subordination where insolvency intervenes before consummation of the transaction.

E. Fiduciary Relationship

A large number of subordination cases involve claims asserted against a bankrupt corporation by an officer, director, or controlling stockholder. While not ipso facto precluded from entering into contracts with or loaning money to his corporation, an officer, director, or controlling stockholder, long held to be a fiduciary, must face a court of equity with clean hands. Consequently, the bankruptcy court will regard such a transaction, if not with distrust, then certainly with a large measure of watchful care in order to be satisfied that the transaction was entered into in good faith and with a view to benefit the corporation as well as other creditors and not solely with a view to his own benefit. As early as 1875 the Supreme Court pointed out that directors' dealings may be set aside on "slight

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123. Id. at 467. The requirement of proof of injury proximately caused by the inequitable conduct is a common theme in the other categories of subordinating influences.

124. In West 52nd Theatre Co. v. Tyler, 178 F.2d 128, 129 (2d Cir. 1949), the court cited Columbia Gas, supra note 122, for the proposition that mere illegality in the purchase of a claim does not require subordination of the claim absent the elements of fraud upon and actual injury to the debtor. However, in Tyler, the Second Circuit could not find those additional elements on the facts before it.

125. Robinson v. Wangemann, 75 F.2d 737 (5th Cir. 1935); Keith v. Kilmer, 261 Fed. 733 (1st Cir. 1919), decree amended, 269 Fed. 298, cert. denied, 252 U.S. 578 (1920). In our view, disallowance rather than subordination should result since the illegality would be a complete defense under typical state law to an attempt to enforce the contract.

126. Stuart v. Larson, 298 Fed. 223, 225 (8th Cir. 1924). Such persons are frequently most interested in resuscitating the business and should not be bound to preside over its demise when in a position to furnish assistance.


128. Richardson v. Green, 133 U.S. 30 (1890); Brown v. Freedman, 125 F.2d 151, 158 (1st Cir. 1942) (searching scrutiny); In re Burnsides Lodge Inc., 7 F. Supp. 785, 787 (D. Minn. 1934) (rigid scrutiny and careful examination).
grounds" under a doctrine founded upon "the soundest morality."\textsuperscript{129}

However, it seems inequitable to us to impose an unbearable burden upon fiduciaries. Such expressions as that the bona fides of their claims must be demonstrated "beyond cavil,"\textsuperscript{130} or that a mere challenge is sufficient to place the burden upon the fiduciary,\textsuperscript{131} do not seem reasonable. The claim of the fiduciary should not be denied the same prima facie value as any other claim and should stand, absent proof by the objectant that there has been a breach of the fiduciary obligation. Furthermore, it should appear that the misconduct relates to the claim either in its origin or in its acquisition.\textsuperscript{132} It is only at that juncture, it seems to us, that the burden of going forward should be upon the fiduciary, and his claim subjected to microscopic analysis.

The variations of the situations which may arise in connection with a fiduciary's relationship with the corporation are infinite indeed. A fertile area of litigation in this field relates to officers' salary claims. These are subject to the same scrutiny as all other transactions between a fiduciary and the corporation, and it is well settled that such claims do not differ from claims of any nature which are rendered void or voidable because the vote of the claimant helped to bring them into being.\textsuperscript{133}

In the case of the "one-man" or "family corporation," claims based upon purported loans of money or property have been subordinated on the "capital contribution" theory, or because the corporation and the stockholder are found to be one under the alter ego theory.\textsuperscript{134} In the succeeding section entitled "The Instrumentality and Alter Ego Cases," we shall discuss further the controlling equitable considerations applied by the courts when fiduciaries are involved.

\textbf{F. The Instrumentality and Alter Ego Cases}

Perhaps the most unsettled area in the field of equitable subordination of claims involves the debt due from a bankrupt corporation to its parent or affiliated corporation, or to its controlling stockholder or stockholders. This remains so despite a number of Supreme Court and court of appeals cases which were thought to be decisive. The problem is not as to the validity or extent of the claimed indebtedness, nor again as to the jurisdiction of the court in the exercise of its broad equitable powers to subordinate the claim of one creditor to others in the same class. The nub of the problem

\textsuperscript{129} Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1875).
\textsuperscript{130} 3 COLLIER, BANKRUPTCY § 63.06, at 1789 (14th ed. 1956).
\textsuperscript{131} Pepper v. Litton, 308 U.S. 295, 306 (1939).
\textsuperscript{132} In re Kansas City Journal-Post Co., 144 F.2d 791, 803 (8th Cir. 1944).
\textsuperscript{133} Goldie v. Cox, 130 F.2d 695, 717 (8th Cir. 1942); In re McCarthy Portable Elevator Co., 201 Fed. 923 (3d Cir. 1913); In re Wenatchee-Stratford Orchard Co., 205 Fed. 964 (W.D. Wash. 1913).
\textsuperscript{134} See discussions under the heading "Debt or Proprietary Interest," \textit{supra}, and under the heading "The Instrumentality and Alter Ego Cases," \textit{infra}. 
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is—what facts justify the exercise of these powers to subordinate?

To subordinate in these cases, the courts found it necessary to circumvent the legal concept of the separate corporate existence. They apparently reasoned that if the parent and subsidiary were ruled to be one and the same on the theory of principal and agent, or ownership of subsidiary by the parent, or by treating the corporate entity as an unreality, then the claimant stood at once as proprietor and creditor, and the general creditors must be preferred in the distribution of the assets. Thus arose the “instrumentality rule,” said to be first declared in In re Watertown Paper Co.

There, without citation of authorities, and by way of obiter dicta, the Second Circuit stated that there were two exceptions to the separate corporate entity rule: (1) when necessary to circumvent a fraud and (2) where a corporation is so organized and controlled, and its affairs are so conducted, as to make it merely an instrumentality or adjunct of another corporation. The language of this second exception was quoted by the same court in Gay v. Hudson River Electric Power Co., was adopted in Hunter v. Baker Motor Vehicle Co., and cited in Joseph R. Foard Co. v. Maryland and Pittsburg & Buffalo Co. v. Duncan.

The pure instrumentality rule was short-lived. In Gay v. Hudson River Electric Power Co., the same judge who wrote the opinion in Watertown Paper pointed out that the subsidiary involved was but an adjunct of the parent, and yet decided the case on entirely other grounds. This, said the Sixth Circuit Court of Appeals (which had itself followed Watertown Paper but two years previously), leads to the in-

136. 165 Fed. 252 (2d Cir. 1909).
137. Id. at 256.
138. 187 Fed. 12, 14, 15 (2d Cir. 1911).
139. 225 Fed. 1006, 1015 (N.D.N.Y. 1915).
140. 210 Fed. 827 (4th Cir. 1914).
141. 232 Fed. 584, 587 (6th Cir. 1916).
142. That is not to say that the memory does not linger on. For many years, until Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939), the instrumentality rule kept popping up. In re Kentucky Wagon Mfg. Co., 3 F. Supp. 958 (W.D. Ky. 1932), indulging in semantics, adopted the principal and agent theory to subordinate a claim; the court said that the test is whether one corporation controls another, and where it does the debts due the parent-principal from the subsidiary-agent must be postponed to the debts of other creditors! Affirming, the circuit court said that the determinative question is whether the relation of principal and agent existed, i.e., whether the subsidiary was an instrumentality of, or an adjunct of the parent. 71 F.2d 802 (1934). We distinguish the instrumentality cases from the alter ego cases discussed infra under this heading, in that, in the former, the corporate form may be strictly observed, while in the latter, to all intents and purposes, the corporate form and separate entity are wholly ignored.
143. 187 Fed. 12 (2d Cir. 1911).
ference that the Second Circuit hesitated to apply the doctrine, although seemingly applicable, a hesitancy which makes the Gay case more valuable because manifested by the court which first announced the doctrine. The Sixth Circuit thereupon drowned the pure instrumentality rule in a sea of verbiage, concluding that adjunct, as used in this connection, must be redefined as involving the idea of "sinister purpose or wrongful results." The instrumentality rule announced by the Second Circuit was unacceptable, said the Sixth Circuit, unless qualified to mean an agency or instrumentality in the sense of a means to effect a wrong, or through which a wrong is done.

This modification of the pure instrumentality rule was supported by respectable authority. The instrumentality rule at this point in its development was transmuted into what properly may be called the "instrumentality plus" rule: to justify application of the instrumentality rule, there must be present, in addition to the element of control through stock ownership and common directorates and officers, elements of fraud and wrongdoing on the part of the parent to the detriment of the subsidiary and third persons in their relation with the subsidiary.

Referring to this instrumentality rule, the Supreme Court in the landmark case of Taylor v. Standard Gas & Electric Co. said that it was not, properly speaking, a rule, but a convenient way of designating the application in particular circumstances of the broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when to do so would work fraud or injustice.

Thus far we have endeavored to trace the development of the pure instrumentality rule, from the concept that the finding of an agency or adjunct by itself was sufficient to pierce the corporate veil, to its modification to "instrumentality plus" (the plus factor being "sinister purpose," "wrongful results," "elements of fraud," or "wrong or injury"). Put succinctly, domination and control plus fraud will result in disregard of the corporate entity and call into play the equitable doctrine of subordination. This rule offers no real problem in application, for the courts from time immemorial have dealt with fraud and deceit, and the badges of fraud are easily recognized.

But modification of the "pure instrumentality" rule did not stop with

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146. The court said that it used agency, adjunct, branch, instrumentality, dummy, buffer and tool, all to mean very much the same thing (as indeed they do). 250 Fed. at 673.
147. Forbush Co. v. Bartley, 78 F.2d 805 (10th Cir. 1935); Commerce Trust Co. v. Woodbury, 77 F.2d 478, 487 (8th Cir. 1935); Duffy v. Treide, 75 F.2d 17 (4th Cir. 1935); Finn v. George T. Mickle Lumber Co., 41 F.2d 676 (9th Cir. 1930); Majestic Co. v. Orpheum Circuit, Inc., 21 F.2d 720 (8th Cir. 1927); New York Trust Co. v. Carpenter, 250 Fed. 669 (6th Cir. 1918); Peckett v. Wood, 234 Fed. 833 (3d Cir. 1916).
the equation of domination and control plus fraud equals subordination. Taylor said that the corporate entity would "not be regarded when to do so would work fraud or injustice." That last word "injustice," used in the disjunctive, is the clue to the entire "Deep Rock" doctrine developed and announced in the Taylor decision. That decision stated a new equation to the effect that control plus mismanagement equals subordination. It re-opened the door through which Pepper v. Litton\textsuperscript{149} leaped some nine months later, coming up with its "rules of fair play" concept, which had been announced sixty-four years earlier in Twin-Lick Oil Co. v. Marbury.\textsuperscript{150}

An analysis of the lower court opinion\textsuperscript{151} in Taylor is both instructive and enlightening. The Tenth Circuit Court of Appeals was confronted with the following situation: a complicated, intertwined corporate structure with interlocking officers and directors; complete domination and management by the parent, Standard; huge loans by it to its subsidiary, Deep Rock, which, while undercapitalized and in dire need of cash working capital, had to pay preferred dividends in large amounts. The opinion discussed the instrumentality rule in great detail, saying that it had not yet been defined "with a degree of certainty so that it can be applied as a precise yardstick in the admeasurement of legal rights"; the court also pointed out that there was "respectable authority" for the proposition that to justify the application of the rule there must be present elements of fraud or wrongdoing. The court ended by approving a compromise which recognized the parent's claim against the subsidiary. The concurring judge declined to express any opinion as to whether Deep Rock was an instrumentality of Standard, but agreed that the claim should be recognized since he found no evidence of fraud from the record. The dissenting opinion adhered to the already discredited "strict" instrumentality rule.\textsuperscript{152}

In reversing\textsuperscript{153} the Supreme Court did not by any means adopt the minority opinion in the Court below.\textsuperscript{154} The minority judge, however, was definitely on the right track when he said:

\begin{quote}
\text{"Such transactions were not effected for the benefit of Deep Rock; that the interest
\end{quote}

\textsuperscript{149} 308 U.S. 295 (1939).
\textsuperscript{150} 91 U.S. 587 (1875).
\textsuperscript{151} 96 F.2d 693 (10th Cir. 1938).
\textsuperscript{152} The dissent stated that where the subsidiary is so dominated and controlled "that it becomes the mere agency or instrumentality of the parent corporation, courts disregard the fact that they are separate corporate beings and treat the subsidiary as the agent or instrumentality of the parent." \textit{Id.} at 708. Furthermore, "a parent corporation may not assume the position of creditor and assert a claim in bankruptcy against its subsidiary which has been dominated and controlled as a mere adjunct, department, or instrumentality, since the assertion of a claim in such circumstances amounts to the presentation of a claim against itself in fraud of bona fide creditors." \textit{Ibid.}

\textsuperscript{153} 306 U.S. 307 (1939).
\textsuperscript{154} "We agree with the conclusion of the dissenting judge, but for different reasons." 306 U.S. at 314.
of Standard was the dominant motive; that Standard was substantially enriched through them and they constituted unjust infringement upon the rights of Deep Rock; and that the allowance of the claim in any sum amounts to Standard asserting a claim against itself in legal fraud of others having interest in Deep Rock.155

The Supreme Court found that Deep Rock was precipitated into bankruptcy not only because of the enormous sums it owed to Standard, but also because of abuses in management due to the paramount interests of interlocking officers and directors in the preservation of Standard's position. In order to remain in undisturbed possession and to prevent the preferred stockholders from having a vote and voice in management, Standard caused Deep Rock to pay preferred dividends in large amounts which, whatever their legality, would not have been paid out by a company on the precipice of bankruptcy and in dire need of cash working capital. Such payment of dividends, said the court, was only one of the ways in which Standard's management and control operated to the detriment of Deep Rock's financial condition and ability to function.

The facts in Taylor paint a classic picture of domination and control of an instrumentality or agency and if the pure instrumentality rule had had any validity the Supreme Court could have made that rule the basis of its decision without further ado. What made its ruling a “doctrine” distinguishable from the so-called instrumentality rule was the “plus” factor.

The Court later said in Pepper v. Litton157 that the subordination in Taylor was based on the equities of the case—the history of spoilation, mismanagement and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of the public investors. Again, eight years later in Comstock v. Group of Institutional Investors,158 the Court said that in Taylor it had reformulated for application to reorganization cases a wholesome equity doctrine that a claim by a parent against a subsidiary should be at least subordinated when the parent wholly dominates and controls the subsidiary and in the transactions creating the debt breaches its fiduciary duty and acts both to its own benefit and to the detriment of the debtor.

Comstock in effect delivered the coup de grace to the instrumentality rule when it said that it is not the mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use by the parent of the opportunity afforded by the domination to advantage itself to the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong.

155. 96 F.2d at 710. (Emphasis added.)
156. The charter of Deep Rock conferred voting power on preferred stockholders only in case the company should be in default of dividends on the preferred stock for a period of more than six months. 306 U.S. at 320 n.1.
158. 335 U.S. 211 (1948).
Taylor, in enunciating the Deep Rock doctrine, dispelled the uncertainty surrounding the application of the instrumentality rule. In order to justify disregard of the fiction of separate corporate entity—to pierce the corporate veil—there must appear more than domination and control. So much is now clearly established law. In Taylor the “plus factor” was a history of spoilation, mismanagement and faithless stewardship, which clearly tainted the transactions with fraud. But Taylor also said, without further elucidation, that the necessary additional factor could be “injustice” and therein lies the rub, for this enters the realm of the higher abstractions. It was into this world of abstractions that Pepper vaulted. Dealing with as blatant and glaring a fraudulent attempt to cheat a creditor as is conceivable, Pepper could have disposed of the case on its fraud aspect alone. Nevertheless, it proceeded to discuss at some length the violation of moral obligations which should move the court to exercise its equitable powers. Consequently the decision is a parade of the highly abstract terms “equities of the case,” “unfairness,” “arms-length bargain,” “fair play,” “good conscience,” and “unconscionable,” all of which, by dictionary definition, are synonymous with “justice” and “injustice.” It is, of course, impossible to extract from Pepper a basic rule or set of rules which can be followed with any consistency or uniformity. Who, for example, can recite the “rules of fair play” referred to by Justice Douglas? In dealing with these abstractions, what may be “fair play” to one judge is “unconscionable” to another. Thus, the dissenting opinion of Mr. Justice Murphy in the Comstock case, concurred in by Justices Black, Douglas and Rutledge, disagreed not so much with the principles expressed by the majority, but with the interpretation to be placed upon the facts disclosed: the majority saw no violation of the rules of fair play; the minority did.

The plain truth is that Pepper said not too little, but too much. It is impossible to criticize anything said by Justice Douglas; everything he expressed is in accord with the cardinal principles of equity jurisprudence. But it seems to us that the opinion should have been content with restating the broad principles enunciated in Taylor, leaving it to the lower courts to apply them to the facts peculiar to each case. It is utterly impossible to delineate, as Pepper sought to do, the multitudinous combination of facts which are only limited by the ingenuity of man bent on self-aggrandizement at the expense of another.

Were all the rules of Pepper reduced to one general formula, it could be stated as follows: officers or directors or a controlling stockholder or group of stockholders are fiduciaries whose dealings with the company are subject to rigorous scrutiny; in passing upon their claims the bankruptcy court, sitting as a court of equity, will sift the circumstances of their transactions with the corporation to see whether they are inherently fair and carry the earmarks of an arm’s length bargain; where they do not, they will be dis-
allowed, or at least subordinated.\textsuperscript{159}

The third of the "big three" Supreme Court decisions in this area, \textit{Comstock v. Group of Institutional Investors},\textsuperscript{160} not only modifies the \textit{Pepper} case, but also clearly illustrates how nebulous are the border lines drawn by the abstractions in \textit{Pepper}. In \textit{Comstock}, the majority said that the parent so dominated the subsidiary that under the rule of the \textit{Taylor} case it could not enrich itself by breach of its trust, if any such breach were found to exist. The case hinged largely on contemporary advances by parent to subsidiary for capital improvements and the payment of dividends which for the most part went to the parent. The court below\textsuperscript{161} made explicit findings that the effect of control was beneficial and advantageous to the subsidiary and that all dividends were paid either out of earned surplus or out of net income after payment of all prior charges against income. The majority opinion in the Supreme Court held that while contemporaneous borrowing and payment of dividends is not in itself illegal, it would come under the ban of the \textit{Taylor} decision if carried out in breach of good faith to the advantage of the parent and to the detriment of the subsidiary. In view of the findings of good faith, fair dealing and freedom from fraud or overreaching, allowance of the claim was held not to be an error of law.

The minority\textsuperscript{162} wrote that the equities which form the Deep Rock doctrine relate not only to matters of bad faith, but are also concerned with the essential fairness and propriety of transactions from an objective point of view (citing \textit{Pepper}). Inequity, they said, may be present where there is the utmost good faith. Since Justice Douglas, who concurred in this dissent, wrote the opinion in \textit{Pepper}, we can assume that he intended there to exclude good faith in the test of fairness and impropriety. If that be so, then \textit{Comstock} must be considered to modify \textit{Pepper} to that extent.

It is interesting to note that while five Justices found that the claim of the parent was the outgrowth of complicated but legitimate good faith business transactions, neither in design nor effect producing injury to the subsidiary's investors, four justices disagreed, finding a breach of fiduciary obligations and mismanagement clearly within the ban of the Deep Rock doctrine. This difference of opinion again demonstrates that in dealing with abstractions the result will be as varied as the outlook of the judges who must apply them to a given set of facts.

The wide-spread disagreement in this sphere is illustrated by a trio of cases in the Second Circuit. \textit{In re V. Loewer's Gambrinus Brewery Co.}\textsuperscript{163} was decided in March 1948, three months before \textit{Comstock} was handed down. Judge Frank, citing \textit{Taylor} and \textit{Pepper}, said that the test does not

\textsuperscript{159} Goldie v. Cox, 130 F.2d 695 (8th Cir. 1942).
\textsuperscript{160} 335 U.S. 211 (1948).
\textsuperscript{161} 163 F.2d 350 (8th Cir. 1947).
\textsuperscript{162} 335 U.S. at 231 (Justices Murphy, Black, Douglas and Rutledge).
\textsuperscript{163} 167 F.2d 318 (2d Cir. 1948).
equitable subordination will “work injustice,” will not “be fair and equitable to other creditors,” will result “in violation of rules of fair play and good conscience.”

He then turned about and proceeded to decide the case on the basis of the “pure instrumentality” rule, holding that the potential injustice to creditors was so great as to require subordination. For, he said, “in such circumstances, unfairness can easily occur and yet be so easily concealed that no scrutiny by the bankruptcy court, however rigid, could correct it.”

“As a matter of public policy,” wrote Judge Frank, “the stockholders will not be heard to deny unfairness.” This astonishing proposition was flatly contradicted four months later by Comstock which said: “It is not the mere existence of an opportunity to do wrong which brings the [Deep Rock] rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong.”

In Gambrinus, Judge Learned Hand, concurring165 with Judge Frank, likewise conceded that the Deep Rock rule had repudiated “adjunct,” “agency,” or “instrumentality” as a test. He then proceeded to expound his own views as to why it is unfair to permit the controlling parent-creditor to share in any case in the assets with the insolvent subsidiary’s creditors. The third judge, Judge Swan, merely concurred in the result.

Several years after Gambrinus, in Schwartz v. Mills,166 Judge Clark wrote that Gambrinus was “not stated as an absolute rule of law, to be applied notwithstanding the injustice it might cause.”167 Subordination, he said, did not follow automatically upon the showing of identity between officers and stockholders of parent and subsidiary. “We have traditionally stressed the elements of fraud and actual injury to the debtor interests . . . . Petitioner here has given no hint even of fraudulent conveyance, manufactured claim or mismanagement . . . .” But Judge Frank, the decision in Comstock to the contrary notwithstanding, dissented and held to his original views expressed in Gambrinus; that is, where there was identity of stockholders, then, without proof of any kind of fraud or unfairness whatsoever, the claim of the creditor corporation had to be subordinated to those of all other creditors.168

In 1955, Judge Frank finally conceded that in view of Comstock, the

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164. 335 U.S. at 229.
165. 167 F.2d at 319.
166. 192 F.2d 727 (2d Cir. 1951).
167. Id. at 729. With this decision, Gambrinus began to totter. The repudiation was made complete in Gannet Co. v. Larry, 221 F.2d 269 (2d Cir. 1955), and in 1957 Judge Hand bowed to Comstock, saying: “Whatever the effect of previous decisions . . . [Comstock] declared that some abuse of the stockholder’s control must appear before his debt loses its parity.” Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (dissenting opinion).
168. 192 F.2d at 731.
strict rule of *Gambrinus* could not stand; in subordinating the parent's claim he applied the Deep Rock doctrine as modified by *Pepper* and expounded in *Comstock*. In *Gannet Co. v. Larry*, the parent Gannet was in the publishing business. Fearing that the war situation would result in a newsprint shortage, it acquired the stock of the bankrupt, a paper manufacturer, to whom it made large advances for the purpose, among other things, of converting the bankrupt's plant machinery to the production of newsprint. Fears of a shortage proved unfounded, and the subsidiary, now producing newsprint, operated at a loss which led to bankruptcy. There was no proof of fraud or illegality, nor was it claimed that the parent acted in bad faith. The parent's claim was subordinated because the losses of the subsidiary were suffered in the attempt to turn it into a source of newsprint, of no interest to other creditors unless financially profitable, but of distinct interest to the parent, whether or not financially profitable, because of the possible newsprint shortage. It was therefore held to be "unfair" to allow the parent's claim on a parity with other creditors notwithstanding the absence of fraud or illegality.

Gannet's claim that the mistakes in management were business errors made in good faith were brushed aside. It is safe to assume that if Gannet were in a completely unrelated line of business and had launched its subsidiary on a new venture solely to improve the subsidiary's financial condition (and, of course, to reap the profits as sole stockholder), it would not have suffered subordination of its claim when the experiment ended in disaster.

Gannet did not establish a new doctrine. In 1890 the Supreme Court said in *Richardson v. Green* that courts of equity would regard with a "large measure of watchful care" all transactions by officers, directors and stockholders with their corporation and "unless satisfied by the proof that the transaction was entered into in good faith, with a view to the benefit of the company as well as its creditors, and not solely with a view to his own benefit, they [courts of equity] refuse to lend their aid to its enforcement." The italicized words have an almost uncanny applicability to the facts in *Gannet*.

*Gannet* was followed by the Fourth Circuit in *International Tel. & Tel. Corp. v. Holton*, where it was held that when a subsidiary is controlled by the parent for its own purposes, and without regard to the interest of the subsidiary, the claim of the parent should be subordinated and this without proof of fraud or illegality. This is a fair enough statement of the rule in *Gannet*. But, for reasons we cannot fathom, the Fourth Circuit cited with approval *New York Trust Co. v. Island Oil & Transport Corp.*, 247 F.2d 178 (4th Cir. 1957).

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169. 21 F.2d 269 (2d Cir. 1955).
170. 133 U.S. 30, 43 (1890). (Emphasis added.)
171. 247 F.2d 178 (4th Cir. 1957).
172. 56 F.2d 580 (2d Cir. 1932).
which stands for the pure instrumentality rule; on the other hand, the court ignored the Taylor case, decided a year earlier, which repudiated the pure instrumentality rule. Compounding this serious oversight, the same court also cited with approval the Gambrinus and Watertown Paper cases despite their repudiation by the court of their origin.

We think that Gannet has reached the outermost periphery of the principles announced in Taylor-Pepper-Comstock. Gannet presented nothing more than an honest mistake in judgment—the fear of a newsprint shortage was common to all involved in its use at that time. The mistake, however, was made in an effort not to improve the financial condition of the subsidiary, but to protect itself when, as and if the shortage occurred. Were the courts to go one step beyond the Gannet principle, the circle would be completed and we would be back to the pure instrumentality rule.

Before leaving this area, we should like to note that there may be some doubt as to whether the rules enumerated in the Taylor, Pepper, Comstock and Gannet cases (and the myriad others following, interpreting and explaining these decisions) have any bearing on the alter ego concept. Where the relationship goes beyond the instrumentality, adjunct, department, or principal and agent situation—where the corporation is so completely assimilated that it is truly the alter ego of the parent or of the dominant stockholder (as is frequently the case in the "one man" or "family corporation")—will the corporation be treated as if it had no existence? Will the corporate entity be disregarded without a "plus" factor? Pepper said that disallowance or subordination is a result reached where on the facts "the bankrupt has been used merely as a corporate pocket of the dominant stockholder, who, with disregard of the substance or form of corporate management, has treated its affairs as his own."\(^73\) We think that the tenor of the cases we have discussed is to abrogate the rule of the earlier cases dealing with alter ego situations; the modern tendency is to respect the corporate entity unless the notion of legal entity is used to justify wrong, protect fraud, or defend crime,\(^74\) or unless there is a "violation of the rules of fair play and good conscience by the claimant." Pepper said that one cannot use the corporate device to avail himself of privileges normally permitted outsiders in a race of creditors; cannot use his inside information for his own preferment; cannot do indirectly through the corporation what he could not do directly. The effect of Pepper clearly is to require in the alter ego cases some abuse or breach of the rules of fair play constituting a wrong which equity will remedy.

\(^\ast\) When, however, the parties themselves choose to ignore the corporate entity to the extent that it has no separate existence,\(^75\) then the courts well

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175. For example, where a single bank account is maintained, no corporate books
may, as the parties by their own conduct have already elected to do, disregard a pseudo-corporate entity.\textsuperscript{176} In such a case, the “plus factor” is easily discernible: having treated the corporation as its own enterprise, the dominant stockholder violates the rules of fair play and good conscience in attempting to assume the dual role of proprietor and creditor, whichever at the moment suits his purpose.

To recapitulate: mere control or domination of a corporation is not proscribed by law and is in itself insufficient to justify piercing the corporate veil and subordinating claims. The fiction of a separate legal entity will be respected unless to the elements of domination and control are added certain factors which will motivate the bankruptcy court, sitting as a court of equity, to disregard the fiction. These “plus” factors may be fraud, plain and simple, or a history of spoilation, mismanagement and faithless stewardship which is tantamount to fraud; they may be simply the violation of rules of fair play and good conscience which amounts to a breach of the fiduciary standards of conduct owed to the corporation, a use of the powers of an “insider” for personal advantage to the detriment of creditors—all of which constitutes a “wrong” which equity will undo or intervene to prevent.

There is nothing inherently wrong about a parent corporation or controlling stockholder, officer, or director becoming a creditor of the corporation, either through loans or advances of the character of loans; all such transactions, however, will be subject to rigid scrutiny and claims arising therefrom will be enforced only where good faith and fairness is found, only if the transactions carry the earmarks of an arm’s length bargain, and only when fraud or overreaching are wanting.

In examining the transaction, a basic question is whether it was for the benefit of the corporation or whether it was essentially for the benefit of the controlling parent corporation, or the controlling stockholder or stockholders, officers and directors. If the former, the claim will be allowed to share pari passu with other creditors; if the latter, it will be subordinated to the claims of the other creditors.

\textsuperscript{176} Centmont Corp. v. Marsch, 68 F.2d 460 (1st Cir. 1933) (subsidiary organized to accomplish a specific object of the parent and the separate corporate entity largely ignored); Page v. Arkansas Natural Gas Corp., 53 F.2d 27 (8th Cir. 1931) (assets of two syndicates intermingled, accounts confused, corporate affairs completely scrambled, and situation indicated implied merger); Edward Finch Co. v. Robie, 12 F.2d 360 (8th Cir. 1926) (sole stockholder disregarded corporate entity in every respect); \textit{In re} Muncie Pulp Co., 130 Fed. 546 (2d Cir. 1905) (subsidiary held to be a creature of parent having no independent business existence).
It seems to us that there has been much unwarranted confusion in connection with the subordination of claims in bankruptcy. The equitable powers of the bankruptcy court in dealing with claims have not been seriously challenged; certainly not in recent years. In subordinating ethically inferior claims, no new fundamental principles have evolved, nor have they been necessary in order to cope with the problem. All that was required was the extension of cardinal principles of equitable jurisprudence, long employed to thwart fraud and inequity, into a new field.

Analysis of the decisions relating to subordination disclose a number of reasons for the confused state of affairs in this area. Primarily, there has been an abundance of dicta which succeeding cases, without much thought, have relied upon and transformed into a body of case law. There also have been a number of cases which have relied upon decisions already repudiated by the courts of their origin; these same cases have ignored Supreme Court decisions directly in point.

The psychological factor has compounded the confusion: some judges have found it difficult to follow Supreme Court decisions which conflicted with their own strong personal convictions. Judge Frank's reluctance to retreat from his decision in the Gambrinus case and Judge Learned Hand's concurring opinion in that case are illustrative. Finally, as we have pointed out (and it bears repetition), in dealing with the abstract terms "justice," "fair play," and "good conscience," the outcome has often depended upon the particular bench—again a matter of the personal philosophy of the judge. This surely must explain the many opinions by divided courts in this field.

Perhaps, because of the psychological factors involved, and because the cases are decided by judges of widely divergent personal views in an area where there is room for honest difference of opinion in interpreting the facts, a certain amount of conflict is inevitable. Nevertheless, as a result of the Taylor, Pepper, Comstock and other leading cases, the direction is clear. The basic and overriding consideration of equity is the prevention of fraud and injustice when the remedy at law is inadequate. Where the facts indicate that allowance of a claim on equal terms with others would constitute an injustice, subordination is the remedy afforded by equity. And, where man's ingenuity creates new situations without precise factual precedent, equity has the capacity to adapt itself. In so doing, equity will be found equal to the task, extending old principles, if necessary, to accomplish its purpose.

177. Pepper v. Litton, 308 U.S. 295 (1939), so often cited, is a prime example.