

IN THE UNITED STATES BANKRUPTCY COURT FOR  
THE EASTERN DISTRICT OF TENNESSEE

IN RE )  
TENNOL ENERGY COMPANY ) NO. 88-02650  
Debtor ) Chapter 7  
)

M E M O R A N D U M

This case came to be heard upon a motion by several creditors ("movants") for leave to file an adversary proceeding against the United States Department of Energy ("DOE") and Banker's Trust Company ("BTC"). A proposed three-count complaint was tendered with the motion. The proposed complaint seeks to subordinate the claims of DOE and BTC pursuant to the provisions of § 510 of the Bankruptcy Code. DOE filed a response in opposition to the motion. Attached to DOE's response is the affidavit of the chapter 7 trustee and several exhibits. At the hearing on the creditors' motion, the parties argued their respective positions. No additional evidentiary material was offered at the hearing. Following the hearing, the parties submitted supplemental briefs. Accompanying the movants' brief was the affidavit of attorney Shelley Rucker who had filed an objection on behalf of two creditors to the trustee's original compromise which released all of the estate's causes of action against DOE and BTC.

I.

The record in this case reveals that on October 3, 1988, an involuntary petition under chapter 7 was filed against the debtor, Tennol Energy Company ("Tennol"), by certain petitioning creditors. Immediately thereafter, Thomas E. Ray was appointed interim trustee.

Tennol was organized as a partnership principally to design, construct, and operate an ethanol plant in Marion County, Tennessee. The plant was financed by a loan from BTC which was partially guaranteed by the DOE. Prior to the filing of the involuntary petition, Tennol had defaulted on the DOE-guaranteed loan. Because of the default, BTC had, prior to the chapter 7 filing, instituted foreclosure proceedings pursuant to its security and financing agreements. On the day the involuntary petition was filed, BTC filed a motion for relief from the automatic stay so that it could conclude its foreclosure. As a consequence, the trustee was faced immediately with the question of how the estate would respond to the motion and how the administration of the estate would proceed.

According to the trustee's affidavit, he began to evaluate potential claims of the estate immediately upon his appointment. Among the first of the potential claims he evaluated were the estate's potential claims against the DOE and BTC. The trustee states he specifically reviewed the question of whether DOE and BTC might have improperly exercised control over the debtor or its general partner in a manner which caused injury to the debtor, its general partner, or their creditors. The trustee further states that he concluded no claim existed against DOE or BTC which would warrant prosecution by the estate and that pursuing the potential claim against DOE and BTC would not be beneficial to the estate as a whole. Further, the trustee concluded that in exchange for a release from all of the estate's potential claims against them, DOE and BTC could be induced to release certain liens which would permit the estate to obtain cash needed by it to prosecute claims that appeared at the time to be more meritorious against other parties and to otherwise fund the estate's administration. The trustee also states he had reached the conclusion the DOE could become an important

source of information and assistance in developing the estate's potential claims against third parties if the potential for controversy between the estate and DOE were eliminated at an early stage in the proceeding.

As a result of these considerations, the trustee submitted for review by the court a proposed settlement with DOE and BTC which released all of the estate's claims against those entities. According to the trustee's affidavit, notice of the proposed settlement was provided to all creditors and, after hearing objections on the proposed settlement, the court approved the settlement by order of October 12, 1988, as amended by the order of December 2, 1988. The relevant portion of the October 12 order reads as follows:

After reasonable investigation by the Interim Trustee, all claims by the debtor, the estate, the interim trustee and/or any successor trustee against the Collateral Trustee, the Bank, DOE, Bankers Trust Company (as Servicer [the "Servicer"] pursuant to the Servicing Agreement, dated as of August 22, 1984, among the Servicer, DOE and the debtor) or any director, officer, agent or employee of the Collateral Trustee, the Bank, the Servicer of DOE, for any and all causes of action or claims, including, without limitation, action or claims arising out of any purported or alleged preferences, fraudulent transfers, or actions arising by tort or contract, shall be deemed compromised and settled with full pre-judice with said compromise and settlement being binding upon any subsequently appointed trustee.

Agreed Order, entered October 12, 1988.

The relevant portion of the December 2, 1988, order reads as follows:

The Trustee and creditors do not waive any right they may have to review and object to any claim filed."

This compromise and settlement will not in any way affect the claims or rights of any third party against the Bank, the Collateral Trustee, or the DOE.

Order, entered December 2, 1988.

In his affidavit, the trustee states his purpose in entering into the settlement agreement memorialized by the October 12 order as amended was to eliminate all potential controversies, whether then contemplated or not, between DOE and the estate in order to secure DOE's assistance in prosecuting the

estate's potential claims against other parties. The trustee further states it is his understanding that the claims set forth in the creditors' three-count complaint for equitable subordination are among the claims covered by paragraph 6 of the October 12 order as amended.

The affidavit of Shelley Rucker, the attorney who filed an objection to the original compromise order of October 12 states that the language, "[t]he Trustee and creditors do not waive any right they may have to review and object to any claim filed," was included by her in the modified order of December 2 and was included by her to:

"reserve the right to object to any attempt by the United States Department of Energy and Bankers Trust Company to participate in any settlement obtained by the Trustee as a result of litigation against or negotiations with [her] . . . clients [Lummus Credit, Inc. and Lummus Operating Associates, Inc.] or Combustion Engineering, Inc. in addition to being able to review security documents and the claimed amounts. It was my intent to specifically reserve the right to object to any such claim made against the debtor's estate by the United States Department of Energy or Bankers Trust Company.

. . . It is my understanding that the rights of the Trustee and any creditor to object to the participation in the debtor's estate by the United States Department of Energy or Bankers Trust Company were preserved by the December 2 Order.

Affidavit of Shelley D. Rucker, dated February 27, 1992.

The trustee eventually focused most of his attention toward developing the estate's claims against Combustion Engineering, Inc., Lummus Crest, Inc., Harbert International, Inc., and Southland Power Constructors, Inc. ("CE defendants"). He states in his affidavit that during the winter of 1988-1989, he learned from counsel for certain of the CE defendants that the defendants would argue the estate would be foreclosed from recovery of any sums that might be paid to the DOE by reason of the decision in *Matter of Barton & Ludwig*, 37 B.R. 377 (Bankr. N.D. Ga. 1984) ("*Barton & Ludwig* theory").

In the *Barton & Ludwig* case, a trustee sought to recover from a general partner of a debtor partnership the deficiency in the partnership bankruptcy

estate pursuant to the provisions of 11 U.S.C.A. § 723(a) (West & Supp. 1991). First National Bank of Atlanta, the debtor partnership's largest creditor, had a deficiency claim of approximately \$1,175,000 against the debtor partnership estate. Prior to the filing of the bankruptcy case, however, the bank and the general partner had entered into a settlement agreement wherein the bank gave up any deficiency claim it had against the general partner. Acknowledging the general rule that a general partner of a partnership is liable for any deficiency of the partnership estate, the court nevertheless held it would be unfair to allow the trustee to recover the deficiency attributed to the bank's claim from the general partner in light of the settlement agreement which precluded the bank from recovering such a deficiency.

One of the theories the trustee asserted against the CE defendants was that the defendants through their prepetition actions became general partners of Tennol and were therefore liable for the deficiency of the partnership estate under § 723(a). A large part of the deficiency consisted of the claims of DOE and BTC. Because of the nonrecourse language contained in the loan documents upon which the DOE and BTC claims were based, the CE defendants took the position that the *Barton & Ludwig* rationale precluded the trustee from recovering deficiencies from them that were based upon DOE and BTC claims.

The trustee states in his affidavit that during the summer of 1989 he approached DOE to ask it to assist the estate by providing the funding necessary to prosecute estate's claims against the CE defendants. In seeking to dissuade DOE from providing the requested funding, counsel for certain of the CE defendants argued to DOE that it would be unable to participate in any recovery by the estate because its claims against the estate would be subordinated by virtue of the *Barton & Ludwig* theory. DOE solicited the trustee's response to this argument. The trustee's counsel responded to DOE stating that it was the trustee's belief that the CE defendants' position was not well taken and that it would be an improvident expenditure of estate funds were the estate to seek to subordinate DOE's claims on the basis of the *Barton & Ludwig* theory. Counts

I and III of the proposed complaint seek subordination under the *Barton & Ludwig* theory.

DOE subsequently agreed to fund the estate's prosecution of the claims against the CE defendants. As a result, a settlement was eventually reached between the trustee and the CE defendants of approximately \$5 million. An evidentiary hearing was held on the trustee's motion for approval of the compromise. At the conclusion of the hearing, the court entered a lengthy memorandum granting the trustee's motion. According to the court's findings, the settlement arrived at by the trustee was based primarily upon the trustee's cause of action seeking a return of equity wrongfully returned to the CE defendants and was not based upon the cause of action which attempted to recover a deficiency claim under § 723 (a). The court stated "[b]ecause the defendants possess a substantial legal defense [the *Barton & Ludwig* theory] to the trustee's attempt to recover that portion of the deficiency attributed to the DOE and Bankers Trust claims the court does not find it unreasonable that the trustee has arrived at a settlement figure based primarily upon an evaluation of a recovery under his theory relating to a wrongful return of capital." *In re Tennol Energy Company*, No. 88-02650 p. 23 (Bankr. E.D. Tenn. April 19, 1991).

The trustee concludes his affidavit by stating that nothing he has learned in the course of prosecuting the CE claims or in performing any of his other duties as trustee over the past three and one-half years has caused him to change his view that the claims extinguished by the October 12 order as amended are not viable.

## II.

Generally speaking, the trustee, as representative of the estate, is the proper party to assert equitable subordination. *First Bank Billings v. Feterl Mfg. Co. (In re Parker Montana Co.)*, 47 B.R. 419, 421 (D. Mont. 1985); *Acme Eng'g Co. v. Bayside Enters. (In re Medomak Canning)*, 101 B.R. 399, 401-02 (Bankr. D. Me. 1989); *International Union v. Ludwig Honold Mfg. Co. (In re Ludwig Honold*

*Mfg. Co.*), 30 B.R. 790, 792 (Bankr. E.D. Pa. 1983); In *Societa Internazionale Turismo v. Barr (In re Lockwood)*, 14 B.R. 374, 381 (Bankr. E.D.N.Y. 1981).

Unless the trustee fails or refuses to bring an equitable subordination claim against a creditor, and the court then grants a general creditor leave to prosecute the claim, a general creditor does not have standing to bring an equitable subordination action. *Acme Eng'g Co. v. Bayside Enters. (In re Medomak Canning)*, 101 B.R. at 401-02. It was the movants' recognition of this rule that prompted them to seek this court's permission to file their adversary complaint alleging claims of equitable subordination.

The record does not indicate the trustee improperly refused to assert an equitable subordination claim against DOE and BTC. The trustee's affidavit makes clear that at the beginning of the case the trustee developed his strategy for administering the es-tate and for pursuing certain claims against third parties that appeared to have the most merit. Part of this strategy included making peace with DOE and BTC so that the trustee could obtain moneys for the estate through release of certain liens by these secured creditors; also, the trustee was in need of DOE's cooperation in developing his claims against the CE defendants. Indeed, as it later turned out, that cooperation led to DOE's financing the trustee's lawsuit against the CE defendants.

The trustee has declined to assert equitable subordination claims against the DOE and BTC for primarily two reasons: it is the trustee's belief the claims are not viable and it is the trust-ee's belief he compromised any claims for equitable subordination through the October 12 order as amended. Also, in soliciting fi-nancing from DOE, the trustee through his counsel assured DOE that the trustee did not intend to seek subordination of DOE's claim.

The issue for determination is whether the court should now allow certain general creditors of the estate to assert an equitable subordination action against DOE and BTC on behalf of the es-tate.

Before turning to the effect of the order of October 12 as amended, the court will first address the theory of equitable sub-ordination that is predicated upon the *Barton & Ludwig* theory. The movants have not contested the amount of the DOE or BTC claim in this case, nor have they contested the fact that DOE and BTC hold claims against the bankruptcy estate. They seek to subordinate these claims under the theory that because DOE and BTC could not have recovered against the CE defendants directly--since they held nonrecourse claims against the estate--they should not be allowed to receive a pro rata dividend with other unsecured cred-itors.

As previously noted, the trustee's settlement was primarily based upon his return-of-capital theory and not his § 723(a) theory. Hence, even if the movants' *Barton & Ludwig* theory of equitable subordination were valid with respect to a recovery stemming from a § 723(a) action, the record in this case would not support a finding that the settlement was predicated upon the § 723(a) action. Secondly, the court is not aware of any authority that would allow subordination of a valid claim against the estate just because the estate assets were recovered in an action by the estate which the creditor could not have maintained directly. In short, the court agrees with the trustee's position that the mov-ant's *Barton & Ludwig* theory of equitable subordination is not viable.

Next, the court will comment upon the allegations set forth in count II of the proposed complaint. The second count of the movants' proposed complaint seeks equitable subordination based upon allegations that DOE and BTC impermissibly assumed control over Tennol by forcing it to enter into a modification of the "EPC Agreement" which made substantial concessions on the performance guarantees required of Lummus under the terms of the original "EPC Agreement." The complaint does not state how DOE and BTC assumed control of the debtor. The trustee states in his affidavit that even after three and one-half years' involvement in the case, he remains of the opinion that the equitable

subordination claims against DOE and BTC, including claims based upon alleged improper control over Tennol, are not viable.

When a creditor takes control of the debtor, it assumes the duties of management, including the fiduciary duty to deal fairly with the debtor. *In re Beverages Int'l*, 50 B.R. 273, 282 (Bankr. D. Mass. 1985). Absent a fiduciary duty to the debtor, however, any creditor that does not seek to maximize or protect its investment or claims in the debtor might violate the fiduciary responsibility owed to its own shareholders and creditors. See *Cosoff v. Rodman (In re W.T. Grant Co.)*, 699 F.2d 599, 610 (2d Cir.), cert. denied, 464 U.S. 822 (1983). Thus, taking control is not itself impermissible. Rather, by taking control the creditor becomes liable as a fiduciary and any liability results from a breach of the fiduciary duty that a finding of control imposes. Note, *Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control,"* 65 TEX. L. REV. 801 (1987).

The ability to control the management of a debtor through the control of its finances is a narrowly construed avenue for finding that a fiduciary relationship exists between the creditor and the debtor. After all, in any large commercial relationship between a creditor and debtor, the creditor exerts influence over business decisions. Hence, control of management must be substantial before a court imposes a fiduciary obligation upon the creditor. The mere ability to influence management decisions of a debtor does not create a fiduciary duty. See *Harris Trust & Savings Bank v. Keig (In re Prima Co.)*, 98 F.2d 952, 965 (7th Cir. 1938) ("[n]o doubt the debtor, because of its inability to meet its maturing obligations, acquiesced in [the bank's] recommendations, but this we think is not sufficient to constitute domination of its will"), cert. denied, 305 U.S. 658 (1939); *Zimmerman v. Central Penn. Nat'l Bank (In re Ludwig Honold Mfg. Co.)*, 46 B.R. 125, 129 (Bankr. E.D. Pa. 1985) ("[a]lthough the bank offered the debtor suggestions on the operation of its business, we construe this advice to have been simply spawned by prudence; the debtor was under no obligation to accept it"); *Bank of New Richmond v. Production Credit Ass'n (In*

re Osborne), 42 B.R. 988, 997 (Bankr. W.D. Wis. 1984) (stating that, although a creditor's security interests in most of the debtor's assets gave the creditor considerable power, there was no basis for a finding of control); see also Note, *Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control"*, 65 TEX. L. REV. 801 (1987).

As previously mentioned, the trustee in his affidavit states that his investigation and three and one-half years' involvement in this case failed to reveal a viable equitable subordination claim against the proposed defendants of the nature being considered here, namely a claim predicated upon the exercise of control over the debtor and a breach of a fiduciary duty. The movants have failed to submit any material, other than conclusory allegations in their proposed complaint, which demonstrates that the trustee's assessment of the claim is incorrect. Considering the trustee's affidavit, and further considering that the factual allegations asserted in the proposed complaint do not set forth a factual basis for concluding that either of the proposed defendants owed a fiduciary duty to the debtor or its creditors, the court is not persuaded that the movants should be granted leave to prosecute equitable subordination claims against DOE or BTC on behalf of the debtor's estate.

In addition, the court agrees with the position of DOE and the trustee that any equitable subordination claims belonging to the estate against DOE and BTC were compromised by the order of October 12 as amended. The order of October 12 clearly provided that "all claims by the debtor, the estate, the interim trustee and/or any successor trustee against . . . DOE, Bankers Trust Company (as Servicer [the "Servicer"] pursuant to the Servicing Agreement, dated as of August 22, 1984, among the Servicer, DOE and the debtor) . . . for any and all causes of action or claims . . . shall be deemed compromised and settled with full prejudice with said compromise and settlement being binding upon any subsequently appointed trustee." The language in the October 12 order is not ambiguous; all causes of actions or claims by the estate against DOE and BTC were to be compromised. After objections were filed to the October 12 order, an order

amending the October 12 order was entered December 2, 1988. The movants argue the December 2 order reserves equitable subordination claims for the estate. The language of the December 2 order relied upon by the movants reads "[t]he trustee and creditors do not waive any right they may have to review and object to any claim filed," and "[t]his compromise and settlement will not in any way affect the claims or rights of any third party against the Bank, the Collateral Trustee, or the DOE."

The reservation of third-party claims is not pertinent to the estate's claims or causes of action. Thus, the second phrase quoted above does not reserve a right in the estate to prosecute equitable subordination claims against BTC or DOE.

The real question is whether a reservation of a right by the trustee and creditors to review and object to any claim filed is a reservation of a right to bring an equitable subordination action against BTC and DOE.

An action for equitable subordination is not an objection to a claim. As Collier points out:

Subordination is an equitable remedy in which the order of payment rather than the existence of the debt is in issue. If recognized principles of equity have been violated by the claimant, the court has the power, under section 510(c) of the Code, to subordinate or postpone his claim.

3 COLLIER ON BANKRUPTCY para. 510.02, at 510-4 (15th ed. 1992).

The court in *In re Huckabee Auto Co.*, 33 B.R. 132 (Bankr. M.D. Ga. 1981) discussed the differences between disallowance of a claim and subordination of a claim as follows:

[t]he court notes that Section 510(c) deals exclusively with equitable subordination, and makes no mention of disallowance. Subordination and disallowance are two distinct theories within the bankruptcy process because the former addresses the question of priority and participation, while the latter results in complete exclusion from participation. Subordination is an appropriate remedy for the Court in the exercise of its equitable powers, but disallowance is not.

*Id.* at 139-40; see also *McChesney v. OWOC (In re Shelter Enters.)*, 98 B.R. 224, 229 (Bankr. W.D. Pa. 1989) ("[t]o reach the issue of subordination this Court must first review the validity and nature of the claim"), *modified on other grounds*, 99 B.R. 668 (Bankr. W.D. Pa. 1989).

Further, indication that objections to claims and subordination actions are different theories for relief is evidenced by both the Bankruptcy Rules and Bankruptcy Code. An objection to a claim is brought pursuant to the procedures set forth in Bankruptcy Rule 3007, whereas a subordination action must be brought as an adversary proceeding pursuant to Bankruptcy Rule 7001. An objection to a claim challenges whether a claim can participate at all in any estate distribution. It challenges the legal or factual basis of the claim itself. If no objection to a claim is made, the claim becomes an allowed claim under the Bankruptcy Code. 11 U.S.C.A. § 502(a) (West 1979 & Supp. 1991). A subordination action applies only to an allowed claim, i.e., a claim to which no objection has been filed, or a claim to which an objection has been overruled. 11 U.S.C.A. § 510(c) (West 1979).

The language in the December 2 order reserving the right to object to claims of the DOE and BTC preserves only objections, not independent causes of actions such as subordination claims. The affidavit submitted by Shelley Rucker states that the language re-serving objections was intended to reserve the right to object to any attempt by the DOE and BTC to participate in any settlement obtained by the trustee as a result of litigation or negotiations with her clients and Combustion Engineering. A denial of a right to participate in any such recovery would result from a sustained objection to the claims of DOE and BTC. The movants are not seeking to bar DOE and BTC from participating in any settlement; rather, they are seeking a ruling declaring that they should be paid ahead of DOE and BTC. Notably, Ms. Rucker's affidavit does not address whether she intended subordination actions of the type at issue here to be barred by the order; the trustee, on the other hand, states in his affidavit that the order of

October 12, as amended by the December 2 order, was intended to preclude actions of the type brought by the movants.

The plain language of the settlement orders, bolstered by the affidavit of the trustee stating that the orders were intended to bar subordination actions of the type at issue here, lead the court to conclude the movants' proposed action is barred by res judicata. The court finds unpersuasive those authorities cited by the movants in support of their argument that an objection to a claim encompasses a cause of action for subordination.

Accordingly, for all of the reasons stated, an order will enter denying the motion of certain creditors for leave to file an adversary action asserting claims for equitable subordination against the DOE and BTC.

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JOHN C. COOK  
United States Bankruptcy Judge