ORIGINAL

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

U. S. BANKRUPTCY COURT
NORTHERN DISTRICT OF TEXAS
ENTERED
DEC - 6 2001
TAWANA C. MARSHALL, CLERK
By
Deputy

| | | |
|---|---|---|
| IN RE: | § | |
| | § | |
| SGS STUDIO, INC., | § | CASE NO. 00-33766-SAF-7 |
| DEBTOR. | § | |
| | § | |
| SGS STUDIO, INC., | § | |
| PLAINTIFF, | § | |
| | § | |
| VS. | § | ADVERSARY NO. 00-3351 |
| | § | |
| THE CIT GROUP/COMMERCIAL | § | |
| SERVICES, INC., | § | |
| DEFENDANT. | § | |

**MEMORANDUM OPINION AND ORDER**

In this adversary proceeding, Daniel Sherman, the Chapter 7 trustee of the bankruptcy estate of SGS Studio, Inc., the debtor, challenges the extent, validity, and priority of the lien of the CIT Group/Commercial Services, Inc. In addition, the trustee seeks to avoid allegedly preferential transfers to CIT pursuant to 11 U.S.C. §547 and to subordinate the claim of CIT pursuant to 11 U.S.C. §510(c). With the subordination cause of action, the trustee further alleges a claim of tortious interference with existing and future contracts. The complaint raises core matters over which this court has jurisdiction to enter a final order or judgment. 28 U.S.C. §§157(b)(2)(F) and 1334. The court

46

conducted a trial on August 20, 2001, September 19 and 21, 2001, and October 2, 2001. This memorandum opinion contains the court's findings of fact and conclusions of law. Bankruptcy Rule 7052.

SGS had been in the business of manufacturing and selling women's apparel. CIT provided factoring, loans, and other financial services to SGS. On June 7, 2000, SGS filed a petition for relief under Chapter 11 of the Bankruptcy Code. At that time, SGS owed CIT $2,826,821.00. CIT has reduced that debt to $1,659,312.50, with the application of the proceeds of receivables. Post-petition, pursuant to three orders entered July 26, 2000, July 31, 2000, and August 22, 2000, CIT advanced $1,034,894.54 to SGS. The court granted CIT a lien on the property of the bankruptcy estate for the post-petition advances. 11 U.S.C. §364(c). CIT collected post-petition proceeds of $1,290,477.00. After repayment of the post-petition advances, the bankruptcy estate has approximately $255,583, in cash, CIT holds about $195,900 of that amount, while the trustee holds the remainder. On September 11, 2000, the court granted a motion to convert the case from Chapter 11 to Chapter 7 of the Bankruptcy Code. The United States Trustee appointed Daniel Sherman as the Chapter 7 trustee. Sherman asserts that the $255,583 should be available for payment of administrative expenses and distribution to the general unsecured creditors. CIT asserts a pre-petition

lien on the cash, making it cash collateral, which should be applied to CIT's pre-petition advance balance.

**Liens**

CIT asserts a perfected first priority security interest in all of SGS's pre-petition receivables, accounts, instruments, chattel paper, contract rights, general intangibles, as well as certain inventory. CIT contends that the cash it holds derives post-petition from that pre-petition collateral. The trustee asserts that CIT did not perfect its liens and that CIT's security interest does not reach pre-petition inventory.

On June 15, 1987, SGS and Barclays American/Commercial, Inc., entered a Factoring Agreement. Under the Factoring Agreement, Barclays purchased accounts from SGS. The trustee does not challenge CIT's ownership of those accounts and the cash collected from those accounts.

In addition, under that agreement, SGS sold and assigned accounts receivables to Barclays, later assigned to CIT. SGS granted a security interest to Barclays in all of its receivables, all proceeds from its receivables, and in all returned merchandise. Factoring Agreement, par. 3. On June 24, 1987, Barclays American/Commercial, Inc., filed a UCC-1 financing statement with the Texas Secretary of State for its lien on SGS's accounts and receivables.

On December 7, 1989, Barclays filed an amendment to the financial statement changing SGS's address. On May 1, 1990, Barclays American/Commercial, Inc., filed an amendment changing the secured party's name to Barclays Commercial Corporation. On April 13, 1992, Barclays Commercial Corporation filed a continuation of the financing statement. On January 21, 1997, CIT filed a statement with the Texas Secretary of State reporting Barclays Commercial Corporation's total assignment of "All Collateral" to The CIT Group/Commercial Services, Inc. On January 21, 1997, CIT filed a continuation of the financing statement. On February 20, 1998, CIT filed an amendment to the financing statement, adding a new security interest in inventory, discussed below, as well as changes to SGS's and CIT's addresses.

CIT is the successor in interest to numerous entities encompassing, but not limited to, Barclays American/Commercial, Inc., Barclays Commercial Corporation, and the CIT Group/BCC, Inc. Accordingly, CIT has had an uninterrupted perfected security interest in SGS's accounts and receivables since June 24, 1987, and the proceeds therefrom, until the bankruptcy petition.

**Inventory**

On December 16, 1993, the parties entered a Security Agreement Supplement Inventory. In that agreement, Barclays obtained a lien on inventory "limited, however[,] to Inventory

imported under letters of credit issued by Barclays Bank PLC." On December 29, 1993, Barclays Commercial Corporation and SGS executed and filed a UCC-1 Financing Statement with the Texas Secretary of State regarding the Security Agreement Supplement Inventory. The trustee contends that CIT's lien only extends to inventory imported pursuant to the letters of credit. John Smith, SGS's president, testified that the trustee's argument accords with industry practice not to provide blanket liens on all inventory.

However, by an agreement dated February 11, 1998, entitled Letter of Credit Agreement, the parties expanded the definition of inventory pledged to CIT as security. The agreement provides:

> C. As security for the prompt payment in full of all your [SGS] present and future indebtedness or obligations whether under the factoring or financing agreement between us, any other agreement between us or otherwise, as well as to secure payment in full of all Obligations referred to herein, you hereby pledge and grant us a continuing general lien upon and security interest in the following "Collateral", whether now or hereafter acquired by you, wherever located, whether in transit or not: all presently owned and hereafter acquired: (a) warehouse receipts, bills of lading, shipping documents, documents of title, chattel paper and instruments, all whether negotiable or not; (b) merchandise, inventory and goods which relate to any of the foregoing or which are purchased from suppliers located outside the United States or its territories or which relate to letters of credit opened through or with our assistance . . .; and (c) cash and non-cash proceeds of any and all of the foregoing, of whatever sort and however arising.

On February 20, 1998, CIT filed with the Texas Secretary of State an amendment to the financing statement adding this definition of

inventory subject to its security interest.

On February 20, 1998, CIT also amended its financing statement to indicate the "total assignment" from Barclays Commercial Corporation to The CIT Group/Commercial Services, Inc.

As of the petition date, SGS's inventory consisted of fabric that was primarily located in Guatemala. The inventory could not be released for shipment to the United States until SGS paid manufacturing and other costs in Guatemala. The merchandise manufactured from the inventory would be shipped to the United States subject to or covered by warehouse receipts, bills of lading, shipping documents, documents of title, chattel paper, and instruments. Therefore, the inventory held in Guatemala at the petition date constituted collateral as defined in the Letter of Credit Agreement. Consequently, CIT held a security interest in that inventory at the petition date.

The SGS inventory at the petition date had been obtained after the Letter of Credit Agreement and the filing of the financing statement amendment covering that agreement. The court, therefore, does not address the reach of CIT's lien on inventory acquired prior to that amended agreement.

The trustee alternatively contends that, at the petition date, the inventory had no value, resulting in no secured claim for SGS. Under the Bankruptcy Code, a secured claim under non-bankruptcy law may be restructured into a secured and unsecured

claim for bankruptcy purposes based on the value of the collateral. 11 U.S.C. §506(a). At the petition date, without payment of the Guatemalan expenses, the inventory would not have been shipped to the United States. Instead, the inventory would have been liquidated in Guatemala to pay the Guatemalan creditors. The inventory in Guatemala, if not released for shipment to the United States, had virtually no value to SGS or CIT. But, post-petition, with the use of CIT's cash collateral and post-petition financing under 11 U.S.C. §364: (1) the Guatemalan creditors were paid; (2) the goods were shipped to the United States; (3) the goods were sold; and (4) the proceeds were generated post-petition. Because CIT advanced the funds to pay the Guatemalan creditors, the inventory obtained its American market value. That value produced the proceeds at issue. 11 U.S.C. §552(b). The cash proceeds from the pre-petition collateral are less than CIT's pre-petition debt balance. Consequently, the trustee may not use §506(a) to strip the lien from the inventory.

Had SGS filed a petition for relief under Chapter 7 on June 7, 2000, the inventory in Guatemala would have had no value, thereby resulting in an increased unsecured claim for CIT under §506(a). If SGS had successfully reorganized under Chapter 11, then it may have been able to invoke §506 in the plan of reorganization process. However, neither alternative occurred.

Instead, CIT advanced funds post-petition which resulted in its pre-petition inventory collateral being converted to cash collateral, that was subject to CIT's lien. Therefore, the equities favor recognizing the lien. 11 U.S.C. §552(b).

**Ledger Debt**

From time to time, CIT advanced funds to a CIT client who provided goods to SGS. Under a guaranty agreement, CIT occasionally guaranteed the SGS debt to a vendor who was not a CIT client. SGS was liable to CIT for the advances made by CIT to CIT clients who provided goods to SGS, which SGS did not pay. SGS also assumed liability for the advances made by CIT on guaranteed SGS debt. At trial, the parties referred to the SGS obligations to CIT under both categories as ledger debt.

The trustee contends that the ledger debt was not secured. The 1987 Factoring Agreement provides, at paragraph 11,

> Our [SGS] Reserve Account may be debited from time to time for any obligation owed by us [SGS] to you [CIT] from whatever source, including any amounts owing by us to you for merchandise purchased from any other concern factored by you. You may treat all indebtedness owed by us to you as an entire single indebtedness for which we shall remain liable for full payment without demand and you may, at your option, apply any funds, receivables, credits or property of ours coming into your possession to any particular portion of the indebtedness.

Without labeling that description ledger debt, SGS agreed that its obligations to CIT included any amounts SGS owed for merchandise purchased from a CIT client.

SGS granted a security interest to CIT in its receivables, proceeds therefrom, and returned merchandise, "[t]o secure all of our present and future obligations and indebtedness to you [CIT]." Factoring Agreement, par. 3. Therefore, the debt for merchandise purchased from CIT clients is included in the security agreement.

By letter agreement dated July 27, 1994, the parties expressly agreed that SGS would be liable to CIT for any payment CIT made on account of guarantees issued to SGS vendors. The parties defined those obligations as "Ledger Debt Obligations." The agreement provides:

> 1. Any and all indebtedness, payments, claims, losses, damages, obligations, costs, charges, fees, expenses or liabilities which we may incur as a result of our issuance of the Guaranty or in connection therewith, whether direct or indirect, absolute or contingent, due or to become due (herein collectively "Ledger Debt Obligations") shall be incurred solely as an accommodation to you [SGS] and for your [SGS's] account.
> 2. You hereby unconditionally agree to indemnify us and hold us harmless from and against any and all Ledger Debt Obligations.
> 3. We shall have the right to charge the account maintained in your name on our books pursuant to the Agreement with the amount of any and all Ledger Debt Obligations.

The trustee first contends that SGS entered that agreement with The CIT Group/Commercial Services, Inc., but the CIT Group/BCC, Inc., executed the agreement. However, from July 27, 1994, to the petition date both SGS and CIT acknowledged, by

their conduct, that SGS was liable for the guaranteed debt.

The trustee next contends that only the guaranteed obligations covered in the 1994 agreement can be included in ledger debt charged by CIT. Gary Vessecchia, CIT's vice president, testified, however, that CIT required the 1994 agreement to establish SGS's liability for the guaranty obligations. The 1994 letter is unambiguous. SGS agreed to assume liability for the guaranty obligations, labeled as ledger debt. SGS was already liable, under the Factoring Agreement, to CIT for debt to CIT clients. Therefore, the 1994 letter neither eliminates nor lessens SGS's obligations under the Factoring Agreement for CIT clients. Under the Factoring Agreement, as found above, SGS granted CIT a security interest for "all of our present and future obligations and indebtedness."

Accordingly, the court concludes that what the parties at trial referred to as ledger debt is part of CIT's secured claim. That includes SGS's liability for funds advanced by CIT to CIT client vendors for SGS, as well as SGS's liability for funds advanced by CIT to non-CIT client vendors under the guaranty.

**Perfection Issues**

The facts found above establish CIT's perfection of its security interest. The trustee has raised several challenges to CIT's filings. CIT's continuation statement filed in 1997 complies with Tex. Bus. & Com. Code §9.403(c). According to the

statute, the continuation statement does not have to describe the collateral. Rather, it has to refer, by number, to the original financing statement and indicate that the original financing statement is still effective. CIT's filing satisfies that requirement.

CIT's assignment filed in 1997 complies with Tex. Bus. & Com. Code §9.405(b). The original financing statement describes the types and items of collateral. CIT's 1997 assignment filing informs third persons that CIT took a total assignment of all collateral. The assignment references by number the original financing statement. Therefore, CIT's 1997 assignment conforms with the statutory requirements.

But, the trustee further contends that CIT added to the collateral, which requires an amended financing statement. The trustee asserts that the 1997 assignment is ineffective with regard to inventory. But, the 1997 assignment does not apply to a financing statement covering inventory. The trustee contends that to reach inventory a separate financing statement was needed. He is correct and CIT complied with that prerequisite. See the Inventory section above.

Moreover, the trustee contends that the filed 1997 assignment does not contain the signature of CIT. Tex. Bus. & Com. Code §9.405. The court first notes that CIT submitted a copy of the filed assignment showing a CIT signature, whereas the

trustee submitted a copy without the signature. This issue may, therefore, be resolved. But, if not, in the trustee's copy in the blank designated "Signature of secured party," the form has the typed words "The CIT Group/Commercial Services, Inc." The unsigned statement indicates an intention by CIT to authenticate the writing. See Tex. Bus. & Com. Code §1.201(39); In re Bufkin Bros., 757 F.2d 1573, 1576-78 (5th Cir. 1985) (applying Mississippi law)(noting that a financing statement that includes the creditor's typewritten corporate name, in lieu of a signature, substantially complies with the U.C.C.'s filing requirements).

The court, therefore, concludes that CIT held a perfected security interest in SGS's receivables and accounts, proceeds therefrom, and inventory on the petition date.

**Termination**

The trustee contends that SGS terminated the Factoring Agreement. By certified letter dated July 16, 1999, SGS wrote to CIT stating:

> Pursuant to the terms of our factoring agreement with the CIT Group, I am hereby giving thirty days termination notice from the above date. After careful consideration, I feel both of our companies will benefit from a speedy transition to our new factor Capital Factors, who will be in touch soon with an imdenity [sic] agreement. I thank you and the CIT employees I have worked with in the past.

John Smith, president of SGS, signed the letter. But, Smith acknowledged and conceded that, even after the thirty days had

elapsed, SGS and CIT continued to perform pursuant to the Factoring Agreement. Although the parties negotiated various approaches to remedying SGS's business problems, CIT continued to purchase accounts and advance funds to SGS. CIT did not reduce the advance rate until May 2000. Even then, the parties continued to perform under the Factoring Agreement. CIT reduced the advance rate to 50% in June 2000 and declined to make further advances on June 6, 2000. SGS filed its bankruptcy petition on June 7, 2000.

With this behavior pattern, both parties waived the effects of the letter of July 16, 1999. Since SGS continued to sell accounts to CIT and continued to accept and use advances from CIT, SGS would be estopped from asserting that the letter was not waived. "An assertion of the termination of a contract may be nullified by the subsequent acceptance of benefits growing out of the contract." United States use of Smith v. Maryland Casualty Co., 146 F.2d 379, 381 (5th Cir. 1944). See also Pope v. Clendennen, 257 S.W. 335 (Tex. Civ. App. 1923); 17A Am. Jur. 2d Contracts §549 (noting that if there is ratification or waiver, then a party may lose the right to terminate a contract). The Bankruptcy Code does not provide the trustee with any authority to escape that estoppel.

**Post-Petition Letter**

SGS's Chapter 11 counsel wrote to CIT's counsel, by letter dated September 6, 2000, stating "You have agreed that any 'surplus' collected ($266,000) is not the property or proceeds to which CIT is entitled." CIT's counsel did not reply. The trustee asserts, as a result, that CIT has waived any secured claim to the funds that it and the trustee hold.

The court does not construe that correspondence to amount to a waiver of a secured claim. All papers filed by CIT in the underlying bankruptcy case and all positions taken by CIT in hearings before this court reflect that CIT has advanced its position as a secured creditor. SGS's counsel's letter to CIT's counsel neither amounts to a pleading followed by a default nor an admission. Moreover, the letter neither constitutes an agreement of the parties nor a settlement of record. Indeed, the letter acknowledges that SGS contests the extent, validity, and priority of CIT's lien in an adversary proceeding, thereby implying that the lien issues will be resolved in litigation.

**Preference**

The trustee contends that payments to CIT during the ninety days preceding the bankruptcy petition amount to avoidable preferences under 11 U.S.C. §547(b). The court has found that CIT was a secured creditor pre-petition. CIT's collateral included the debtor's inventory as it existed at the time of the

transfers during the ninety days preceding the bankruptcy petition. The ledger debt is included within CIT's secured claim. Applying all its collateral to the debt, CIT was under-secured at the petition date. Consequently, CIT did not receive more from the transfers than CIT would have received in a liquidation under Chapter 7. 11 U.S.C. §547(b)(5); In re El Paso Refinery, L.P., 171 F.3d 249, 254-55 (5th Cir. 1999). The transfers, therefore, may not be avoided under §547(b).

CIT is not an insider of the debtor. Additionally, CIT did not exercise control over the operation of the debtor's business. Rather, CIT was a lender and a buyer of accounts. In that role, like all lenders, CIT had certain control over SGS's finances. That does not change the debtor-creditor relationship. In re Clark Pipe and Supply Co., 893 F.2d 693, 700-02 (5th Cir. 1990).

The trustee contends that he may recover under §547(c)(5) even if he cannot prevail under §547(b). CIT asserts that it meets the defense of §547(c)(5). Section 547(c)(5) does not create a separate basis for a preference. Section 547(c)(5) is a defense to recovery. But, the court notes under §547(c)(5), a trustee may recover a transfer if CIT improved its position over the ninety day preference period to the prejudice of unsecured creditors. CIT had a security interest in both inventory and accounts receivable. Recovery of collateral does not prejudice unsecured creditors. Clark Pipe, 893 F.2d at 696 n.3. Because

the trustee did not meet his burden of proof under §547(b), the court does not consider the affirmative defenses of §547(c).

**Equitable Subordination**

The trustee maintains that CIT's conduct warrants subordinating its claim below the claims of the general unsecured creditors. The trustee contends: (1) that CIT compelled SGS to pay its ledger debt before paying suppliers not financed by CIT; (2) that CIT tortiously interfered with SGS's contracts with J.C. Penney Co.; and (3) that CIT effectively forced SGS out of business.

The Bankruptcy Code provides that "the court may - (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." 11 U.S.C. §510(c)(1). To equitably subordinate a claim under §510(c)(1), the trustee must establish: (1) that the claimant engaged in inequitable conduct; (2) that the conduct resulted in harm to the creditors and conferred an unfair advantage on the claimant; and (3) that the subordination would not be inconsistent with the Bankruptcy Code. Matter of Fabricators, Inc., 926 F.2d 1458, 1464-65 (5th Cir. 1991); In re Mobile Steel Co., 563 F.2d 692, 699-702 (5th Cir. 1977).

Inequitable conduct usually involves: (1) fraud, illegality or breach of fiduciary duties; (2) undercapitalization; or (3) a claimant's use of the debtor as a mere instrumentality or alter

ego. In re Herby's Foods, 2 F.3d 128, 131 (5th Cir. 1993); Clark Pipe, 893 F.2d at 699. The inequitable conduct may occur when a fiduciary of the debtor misuses his position to the disadvantage of other creditors; when a third party controls the debtor to the disadvantage of other creditors; or when a third party actually defrauds other creditors. Matter of United States Abatement Corp., 39 F.3d 556, 561 (5th Cir. 1994).

CIT merely acted as SGS's lender. A lender has no fiduciary obligation to either its borrower or other creditors of its borrower in the collection of its claim. Clark Pipe, 893 F.2d at 702. Therefore, CIT was not a fiduciary of SGS. F.D.I.C. v. Coleman, 795 S.W.2d 706, 708-09 (Tex. 1990).

Nevertheless, the trustee contends that CIT overstepped the bounds of reasonable commercial practices. The trustee argues that CIT compelled SGS to pay ledger debt ahead of non-CIT financed creditors. The trustee further asserts that CIT forced those payments without providing SGS with regular statements of the outstanding ledger debt.

John Smith, SGS's president, testified that he decided who to pay and when. But, Smith testified that in January or February 2000, Gary Vessecchia, CIT's vice president and client credit manager, instructed Smith to pay CIT clients and CIT-guaranteed trade debts before paying non-CIT financed vendors. Smith understood that CIT felt uncomfortable with its exposure

and needed to improve its position. However, Smith did not understand that SGS had a contractual obligation to pay CIT clients or CIT ledger or guaranty debt first. But, Smith testified that he complied with Vessecchia's direction.

Smith testified that his compliance with CIT's directive resulted in non-CIT trade debt being paid late, thereby forcing tighter credit terms from the non-CIT trade. Smith also testified that from January 2000 to May 19, 2000, for fabric purchased, CIT or its clients received 80% of their debt while non-CIT trade vendors only received 30% of their debt. As a result, unsecured non-CIT vendor debt grew disproportionately to CIT ledger debt.

Vessecchia denied that he directed Smith to pay CIT's clients first. CIT had over-advanced SGS by mid-1999. SGS suffered significant losses in 1999. The losses continued into the first quarter of fiscal year 2000. CIT knew that SGS had to absorb a $600,000 loss in a J.C. Penney order from a Mexican product in 1999. Meanwhile, the ledger debt, which should have capped at $600,000, had grown substantially above that amount. CIT had to reduce its total exposure to SGS. Notwithstanding that pressure, Vessecchia denied that he directed Smith to pay CIT trade debts first.

But, Vessecchia conceded that CIT's statement of accounts to SGS does not report ledger debt. Vessecchia read the Factoring

Agreement as granting CIT the authority to charge ledger debt at any time. To charge for SGS's ledger debt, CIT would make internal adjustments to its books. However, CIT provided no statement to SGS regarding when and in what amounts it would charge ledger debt. CIT charged a substantial amount of the ledger debt to SGS's account on the eve of the bankruptcy petition.

Commercially reasonable practice between a lender and a borrower expects charging of debt upon written notice or statements to the borrower. However, failure to meet that expectation does not translate, standing alone, to inequitable conduct. Regardless of how CIT carried the debt on its books or when CIT actually charged the debt, SGS knew that it was liable to CIT for the ledger debt. Dan Hudgins, SGS's comptroller, and Vessecchia testified that it was customary industry practice for vendors to identify their factor or lender on invoices. Because each vendor included an identification of its factor or lender on its invoices to SGS, SGS knew which of its vendors were CIT clients. Hudgins testified that he thereby knew which vendor was a CIT client that would be subject to ledger debt. As a result, Hudgins and Smith knew whether SGS was incurring or reducing ledger debt. Similarly, Hudgins testified that SGS knew which vendor, not a CIT client, nevertheless had a CIT guaranty to its lender. Again, SGS knew whether it was incurring or reducing

guaranty debt. Therefore, CIT acted within its contractual rights under the Factoring Agreement. See Clark Pipe, 893 F.2d at 702.

As with the vendors' identification of their factors on invoices, it was customary industry practice for factors to include ledger debt arrangements in their lending portfolios. A borrower would logically pay its factor's clients first. A borrower would address its factor's clients first to maintain the best feasible relationship with its factor and thus enhance its ability to continue to finance its operations. Therefore, the court expects that reasonable commercial players in that industry would do likewise.

With CIT needing to reduce its exposure to SGS and with the decline in SGS's business in 1999 and 2000, Vessecchia may have indeed reminded SGS of its obligations to CIT. He may have even done so vigorously and emphatically. But, SGS would have logically, prudently, and pragmatically paid CIT identified vendors' invoices first. The court finds no inequitable conduct in this apparent industry practice, although the court would expect timely statements of ledger debt from the factor to the client.

But, the trustee further contends that CIT allowed SGS to increase its ledger debt in 2000. As the ledger debt increased, CIT charged the debt to SGS's account. As the SGS account

increased, in May and June 2000, CIT reduced and ultimately eliminated advances to SGS. SGS needed the increased ledger debt to perform its outstanding orders. Smith testified that had CIT continued to advance funds on receivables, SGS would have completed outstanding orders, thereby generating receivables to service its debt to CIT. CIT recognized in 2000 that SGS needed credit approval for ledger debt. However, CIT had no obligation to continue to advance funds. Therefore, as SGS's obligation grew, CIT had the contractual right to terminate advances. Apart from voidable preferences and fraudulent conveyances, a creditor may use its bargaining position, including its ability to refuse to make further loans needed by the debtor, to improve the status of its existing claims. Clark Pipe, 893 F.2d at 702.

The trustee next argues that CIT tortiously interfered with SGS contracts with J.C. Penney and forced SGS out of business. For tortious interference with contracts, the court applies Texas law. To establish a cause of action for tortious interference with an existing contract, the trustee must establish: (1) the existence of a contract subject to interference; (2) the act of interference was willful and intentional; (3) the intentional act was a proximate cause of SGS's damage; and (4) actual damage or loss occurred. Stewart Glass & Mirror v. U.S. Auto Glass Discount, 200 F.3d 307, 316 (5th Cir. 2000). For tortious interference with prospective contracts, the trustee must

establish: (1) the reasonable probability that the parties would have entered into a contractual relationship; (2) an intentional and malicious act by CIT that prevented the relationship from occurring, with the purpose of harming SGS; (3) that CIT lacked privilege or justification to do the act; and (4) that actual harm or damage resulted from CIT's interference. Stewart Glass & Mirror, 200 F.3d at 316.

In the weeks before SGS filed its bankruptcy petition, its relationship with CIT deteriorated rapidly. CIT reduced its advance rate to SGS from 90% to 75% and then to 50% before refusing a further advance on the day before the bankruptcy. During the fall of 1999 and the first quarter of fiscal year 2000, SGS and CIT discussed several options including a new equity infusion, improved projected cash flows, and merger prospects. CIT did not oppose a merger or an acquisition or the infusion of new capital. Although Smith came close to a merger with another company, the transaction did not materialize.

Globex, a women's apparel business that did not directly compete with SGS, contacted Smith in May 2000. Smith and Globex's owner met in early June 2000. They subsequently entered into a confidentiality agreement. Smith and Charles Donner, then a CIT senior vice president, understood that Globex wanted to compete in some of SGS's markets.

SGS had a contract with J.C. Penney for the manufacture of

women's jumper outfits. John Smith had alerted J.C. Penney about SGS's financial problems, but he reported working on curing them. Patricia Smith, J.C. Penney's product manager in charge of the jumper program, testified that every supplier messes up sometimes. She was concerned with the timeliness of the jumper program deliveries.

Globex had previously been unsuccessful in obtaining dress business from J.C. Penney. Globex went to J.C. Penney to discuss SGS's business. Globex's owner met with Patricia Smith at J.C. Penney. Patricia Smith testified that she had been contacted by Globex in June 2000 about the SGS work. She had the impression that CIT had advanced a proposition to SGS for Globex involvement. She thought that if John Smith agreed to have Globex complete the SGS orders, then CIT would finance SGS. On June 5, 2000, Patricia Smith had the impression that Globex would complete the SGS project, while offering Belita Winstead, a designer at SGS, a long term contract. Patricia Smith was concerned with contract performance. In anticipation of the completion of the jumper program, she testified that J.C. Penney would negotiate for further business with SGS. But, the timing of the jumper program was crucial. Patricia Smith testified that CIT did not contact her regarding either the SGS contract or Globex.

Belita Winstead, a designer at SGS, testified that Globex

approached her for employment after discussions with John Smith about a possible merger. She had the impression that Globex was attempting to take over SGS's business.

Molly Jones, a vice president of Dorman & Company, a representative for fifteen textile mills worldwide, sold fabric to SGS for use in the J.C. Penney program. She had worked with J.C. Penney for 11 years, and had daily communications with SGS. Patricia Smith, of J.C. Penney, advised her that Globex would complete the outstanding SGS order. She had been "sick" to learn about the SGS situation, but expressed relief that the work would remain in Dallas with Globex. In the women's apparel industry, she testified that it would be quite unusual to change manufacturers in mid-stream.

Senior CIT vice president Charles Donner testified that CIT tried to work with John Smith for a "sew out," a winding down of SGS's business by completing then current projects. He and John Smith discussed a "sew out," but reached no agreement. Donner had the impression from John Smith that Smith was either interested in a sew out or had access to a new lender. In the May to June 2000 time frame Donner testified that CIT did advance the sew out approach, and also wanted SGS to retain a business consultant. John Smith raised the prospect of Globex involvement. John Smith told Donner that Globex went to J.C. Penney. After John Smith informed CIT about Globex's

involvement, Donner cleared talking to Globex with John Smith. On June 2, after John Smith called Donner to report the Globex approach to J.C. Penney, Donner called Globex. Donner met with Globex. But, Donner denied sending Globex to talk to J.C. Penney. On June 6, 2000, John Smith told CIT that SGS had no prospect of doing business with Globex, as Globex was trying to steal SGS's business. Donner testified that without a work out plan, CIT had no interest in making further advances to SGS.

John Smith said he was interested in a sew out if CIT would fund an orderly process. He testified that Donner instead wanted him to transfer his contracts to Globex. John Smith felt that Globex would not be good for his employees. John Smith felt that, as a prerequisite to obtaining more credit from CIT, he had to do business with Globex.

Vessecchia testified about the series of discussions between CIT and SGS to address SGS's business and its obligations to CIT. Vessecchia recalled that CIT suggested the sew out option. Vessecchia did not believe that Smith favored that approach, but nevertheless Smith prepared a sew out budget. CIT would not let its exposure to SGS get worse in May and June 2000. With no capital or merger on the horizon, CIT looked to a sew out as a better alternative than foreclosure. But, SGS ultimately neither agreed to nor implemented a sew out. Vessecchia denied ever directing Globex to contact J.C. Penney.

No one from Globex testified.

John Smith had guaranteed the SGS debt to CIT. After the conversion of the SGS case to a case under Chapter 7, Smith and CIT settled CIT's litigation to collect on Smith's guaranty. As part of that settlement, CIT required that Smith write a letter to SGS's counsel disavowing this litigation. By letter dated May 17, 2001, Smith wrote: "Please be advised that I, JOHN F. SMITH, no longer support the adversary proceeding brought in the name of SGS Studios, Inc., against The CIT Group/Commercial Services, Inc. ("CIT"), Adversary No. 00-3351 and I support the dismissal of the adversary proceeding against CIT with prejudice to the refiling of same."

The trustee moved to amend the complaint to add causes of action regarding that letter. The court denied the motion because of timeliness and the proximity to the trial, but without prejudice to the trustee commencing litigation within any applicable statute of limitations.

Nevertheless, the court must assess the impact of that letter on the credibility of the witnesses. At the time of the Smith/CIT settlement, CIT faced this instant law suit. Causes of action for tortious interference and equitable subordination are property of the bankruptcy estate. An act to exercise control over those causes of action could be a violation of the automatic stay sanctionable by contempt. Yet, with the litigation pending,

CIT required that Smith disavow this adversary proceeding. CIT and Smith assert that they sought global peace. Nevertheless, CIT, in effect, attempted to color the evidence at this trial. Without prejudice to any cause of action that may be filed, the letter undermines the credibility of CIT's witnesses' testimony.

Notwithstanding that credibility assessment, CIT had no contractual obligation to continue to advance credit to SGS. With the continued deterioration of SGS's business in May and June 2000, CIT had the contractual right to engage in discussions, even spirited discussions, with SGS concerning its financial future. CIT had the right to withhold financing if it concluded that the discussions were not fruitful. Clark Pipe, 893 F.2d at 702.

Applying these facts to the elements of tortious interference, SGS had a contract with J.C. Penney that was subject to interference. SGS had the prospect of future contracts with J.C. Penney. CIT's decision to decrease and ultimately eliminate advances does not amount to an interference with that contract. J.C. Penney did not terminate its contract with SGS. Even if CIT had played a role in Globex's approach to J.C. Penney, that activity did not cause SGS damage. SGS suffered damage when it could not obtain either continued financing from CIT or alternative financing. CIT's decision not to finance SGS after June 6, 2000, does not amount to tortious

interference with existing or future contracts. Even discounting CIT's witnesses' credibility because of the Smith letter, the trustee has not established that CIT conspired with Globex to take the J.C. Penney work from SGS. Globex approached J.C. Penney. Patricia Smith at J.C. Penney received her impressions through conversations with Globex and not with CIT. CIT's conversations with Globex followed those of John Smith. There is no evidence that CIT bears responsibility for the spin on discussions presented by Globex to J.C. Penney. But, in any event, CIT decided not to continue to finance SGS. That creditor's decision and SGS's inability to obtain financing elsewhere caused SGS's demise. Accordingly, the trustee has not met his burden of proof to establish a cause of action for tortious interference.

Turning to the trustee's other claims of inequitable conduct, in a sense, CIT forced SGS out of business. SGS could not obtain a capital infusion or a merger or acquisition partner. SGS and CIT did not agree to a sew out procedure. Smith initially contacted Globex but CIT had conversations with Globex thereafter. SGS backed away from Globex when SGS sensed that Globex was making a play for its business, with support from CIT, and without benefit to SGS and its employees. CIT allowed an increase in ledger debt in the months prior to bankruptcy, but that enabled SGS to obtain fabric for the jumper program. CIT

charged the ledger debt to SGS on the eve of bankruptcy without a prior statement or notice. But, SGS knew which suppliers were CIT clients or had CIT guarantees. CIT collected accounts but decreased and eventually eliminated new advances. However, SGS knew that CIT insisted that its exposure be reduced. SGS and CIT had been engaged in ongoing discussions regarding SGS's business. The court construes that discussion as increasingly acrimonious. This animosity may have caused CIT to insist on Smith's letter to the trustee, to try to shield that level of acrimony from the court.

But, when the dust settles, the court finds merely the deterioration of the secured lender/borrower relationship with the lender ultimately declining to advance new credit and pursuing its collateral. A decision not to advance new credit does not constitute inequitable conduct. In re CTS Truss, Inc., 868 F.2d 146, 148-49 (5th Cir. 1989). While distasteful to the debtor who could not otherwise obtain credit and who saw a once successful business fail, the court does not find inequitable conduct for purposes of equitable subordination.

CIT did not occupy a fiduciary relationship with SGS. The combination of ledger debt and factoring does not make CIT an insider of SGS. Instead, CIT merely acted as a factor and lender. Additionally, CIT held no equity position in SGS. CIT did not provide information about the debtor's finances or

performance to vendors. Moreover, CIT made no operational business or management decisions for SGS. Also, CIT did not place any of its people as officers or directors of SGS. Therefore, although CIT encouraged SGS to retain a consultant suggested by CIT and engaged in restructuring discussions with SGS, CIT played no role in SGS's decision to file a bankruptcy case.

CIT's actions did not improperly result in injuries to other creditors or confer an unfair advantage on CIT. CIT occupied a secured position. Vendors in the industry, who informed SGS of their factor or lender, should have reasonably expected SGS to service CIT clients or guarantees first. Indeed, the court infers from the description of the invoicing system that non-CIT vendors selling to manufacturers factored by their factor would expect to be paid first from those manufacturers. CIT's decision to scale back the advance rate and then to decline to advance, obviously, hurt SGS's suppliers. But, the decision was not based on misconduct but, rather, on the prudent decision of the lender. CIT's actions fell within its contractual rights. In short, the trustee has failed to establish the elements for equitable subordination.

The court also addresses the trustee's contention that the court should consider CIT's post-petition conduct, with regard to the post-petition loan and the Smith letter. The parties dispute

whether CIT offered SGS post-petition financing. See In re SGS Studio, Inc., 256 B.R. 581, 583 (Bankr. N.D. Tex. 2000). But, CIT had no obligation to offer or make a post-petition loan to SGS. SGS did not provide CIT with advance notice of its bankruptcy filing. SGS did not request debtor-in-possession financing from CIT. SGS obtained a loan commitment from another factoring company. That company required a lien priming CIT. See 11 U.S.C. §364(d). The court could not authorize that financial arrangement, absent CIT's consent, unless SGS could not obtain credit otherwise and could adequately protect CIT. At the hearing on July 7, 2000, to consider the financing, CIT offered interim funding. As a result, SGS could obtain financing without priming CIT. The court had to deny the motion unless the other factor waived the priming request, which it did not. Thus, as the hearing of July 7, 2000, evolved, CIT stepped forward to provide financing. That activity does not constitute a basis to subordinate CIT's secured claim.

The Smith letter is more problematical. The court has drawn adverse inferences from the letter concerning CIT witnesses' credibility in this trial. Even construing that testimony in an ill light, and assuming that CIT's actions were more heavy-handed than it would have the court believe, CIT basically pursued its contractual rights. This adversary proceeding does not involve whether CIT either attempted to interfere with the trustee's

liquidation of assets of the estate or attempted to interfere with the administration of justice in a United States Court. Those issues must await resolution, if pursued, in future litigation.

**Release of Funds**

CIT requests that the court direct the trustee to pay the funds that he holds to CIT, as well as authorizing CIT to apply the funds that it holds to its pre-petition debt. CIT has a pre-petition security interest in the funds it holds, which cannot be avoided or subordinated. CIT does not owe the estate on a judgment for a preference or for tortious interference with a contract. Accordingly, CIT may have a judgment applying the funds it holds to its pre-petition debt.

But, with regard to the funds held by the trustee, distribution is premature. The trustee has not filed a report with the court seeking approval of the distribution of funds. The trustee may have other causes of action involving CIT that must be resolved by litigation or settlement. CIT's interest in the funds is protected, as the trustee may not disburse the funds without order of this court.

**Order**

Based on the foregoing,

**IT IS ORDERED** that the complaint is **DISMISSED**.

**IT IS FURTHER ORDERED** that CIT may apply all funds it holds

to its pre-petition debt, but that the trustee shall not disburse the funds that he holds until further order of this court.

Counsel for CIT shall prepare a final judgment consistent with this memorandum opinion and order.

Signed this 5th day of December, 2001.

Steven A. Felsenthal
United States Bankruptcy Judge