Recent Court Decisions Affecting Lenders in Restructuring and Other Workout Matters

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In a continuing effort to alert our lender clients and other friends to developments in the bankruptcy, restructuring, workout and creditors' rights space, provided below is a summary of recent noteworthy court decisions.

Supreme Court Limits Priority-Skipping Structured Dismissals in Chapter 11

On March 22, 2017, the U.S. Supreme Court, in Czyzewski v. Jevic Holding Corp., issued a significant bankruptcy ruling that limits the manner in which a Chapter 11 case can be resolved through a "structured dismissal." Structured dismissals have developed as a controversial method of resolving a Chapter 11 case without resorting to the traditional methods of doing so – that is, confirming a Chapter 11 plan of reorganization or liquidation, converting the case to a Chapter 7 liquidation, or dismissing the case via a "plain vanilla" order that returns the parties to their pre-bankruptcy status. A structured dismissal is not defined in or prescribed by the U.S. Bankruptcy Code. Instead, it is essentially a settlement among key parties that is memorialized in the dismissal order. Typically, its terms include approving certain distributions to creditors (but perhaps not all creditors) and granting releases of claims among the settling parties and the bankruptcy estate. Structured dismissals often benefit the debtor's primary secured lender by releasing claims against the lender and its lien rights that could be brought by the debtor or a creditors' committee, perhaps in exchange for a carve-out or other "tip" to general unsecured creditors.

The Backstory

After Jevic Transportation, a trucking company, filed for Chapter 11, a group of former employees filed suit in bankruptcy court against Jevic and its private equity owner for violations of the New Jersey and Federal WARN Acts. That suit resulted in a judgment and claim against

Jevic's bankruptcy estate. Importantly, a portion of that claim was entitled to priority under the Bankruptcy Code over the claims of general unsecured creditors. In addition, the unsecured creditors' committee sued the owner and primary secured lender to avoid allegedly fraudulent transfers that occurred when the owner acquired Jevic in a leveraged buyout. Ultimately, a settlement was reached. Among other things, the settlement released the fraudulent conveyance claim; assigned the owner's lien (the owner held this lien as a "last out" participant in the credit facility) on the estate's remaining cash to a trust that would pay administrative claims and certain priority claims, and would pay general unsecured claims pro rata; and dismissed the Chapter 11 case. But while general unsecured creditors received a distribution, higher priority creditors were "skipped" – no payments would be made to the former employees who held the priority claim.

The Ruling

The Supreme Court overturned the Bankruptcy Court and lower appeals courts' decisions approving the structured dismissal, ruling that a bankruptcy court cannot approve a structured dismissal if it provides for distributions of estate value that deviate from ordinary priority rules without the affected creditors' consent. The Court also concluded that the priority rules do not allow for a "rare case" exception.

The Takeaways – and an Early Application of the Ruling

While Jevic's ban on non-consensual, priority-skipping structured dismissals is undoubtedly significant, the scope of the decision has important limits. First, it clearly did not invalidate structured dismissals entirely. Second, it suggests that structured dismissals that include priority skipping may be upheld if the impacted creditors consent (although it did not provide insight as to how consent might be obtained or what information might be required to obtain an informed consent). Third, it also suggests that common bankruptcy practices that violate priorities should survive scrutiny when they occur at an interim stage of the case, do not involve a final distribution of estate assets, and serve other bankruptcy justifications such as preserving or maximizing the debtor's going concern value or its chances of eventually confirming a plan. Examples of such practices include payment of pre-petition employee compensation and benefits, other pre-petition priority claims such as taxes, "critical vendor" programs, and debtor-in-possession financing "rollups" where the lender's pre-petition loans are paid before the post-petition loans.

The effects of Jevic in the critical vendor context have already been felt. In an April 2017 decision, the Southern District of Mississippi Bankruptcy Court in Pioneer Health Services, Inc. applied the reasoning in Jevic, in part, to reject the debtor's request to confer critical vendor status on certain physician employees of the hospitals operated by Pioneer Health. Critical vendor status would have elevated the claims of the physicians over other general unsecured creditors by paying their pre-petition claims early in exchange for their potential (but not assured) continued services. In denying the request, the Court tested the proposal against the potential benefits that the Supreme Court identified in Jevic: Would it preserve the debtor as a going concern? Would it make the disfavored creditors better off? Would it promote the possibility of a confirmable plan? Would it help restore the status quo that existed prior to the bankruptcy case? Would it protect rights acquired by parties in reliance on orders that were issued in the bankruptcy case? While the Court did not rest its decision entirely on these considerations, they informed the Court's decision to deny the debtor's request.

Sixth Circuit Rejects Lender's Good Faith Defense in Accepting Loan Repayments from Fraudster; Declines to Impose Liability for Fraudster's Deposits of Ill-Gotten Funds

Section 548 of the Bankruptcy Code permits bankruptcy trustees to recover pre-bankruptcy fraudulent transfers made by a debtor to its creditors. Section 550 extends the trustee's recovery power to reach not only the original transferee but also subsequent transferees of the original transferee – a power that often embroils depository banks in litigation filed by a trustee seeking to recover a bankrupt customer's deposits for the benefit of the customer's creditors. Subsequent transferees sued by a trustee may avail themselves of certain statutory defenses, including the Section 550(b)(1) defense that the transferee accepted the transfer in good faith, for value and without knowledge that the transfer was subject to recovery as a fraudulent transfer.

In a case decided in February, 2017, Meoli v. The Huntington National Bank, the federal appeals court for the Sixth Circuit (presiding over Ohio, Kentucky, Michigan and Tennessee) addressed whether a trustee may recover deposits made by a debtor with a depository bank as fraudulent transfers, and when a lender's awareness of a customer's possible fraud eliminates its good faith defense to fraudulent transfer actions.

The Backstory

Commencing in late 2002, Huntington provided secured financing and deposit account services to Cyberco Holdings, Inc., a Grand Rapids-based computer services company. Barton Watson (Watson), the CEO of Cyberco, informed Huntington that it needed funds to purchase computer equipment from a company called Teleservices Group, Inc.. Unbeknownst to Huntington, Teleservices was owned by Watson and engaged in no business other than serving as a vehicle for Watson's financial crimes. Cyberco would direct Huntington to deposit the equipment loan proceeds into a third-party deposit account owned by Teleservices, and Teleservices would then transfer the proceeds into Cyberco's Huntington demand deposit account. Watson then diverted the funds to pay for personal expenses and repay prior lenders – the hallmarks of a Ponzi scheme.

After a $2.3 million check from Teleservices to Cyberco bounced in late 2003, certain Huntington employees became suspicious of the relationship between Cyberco and Teleservices. As suspicions mounted, Huntington referred the Cyberco relationship to its security team in early 2004. The security team soon learned that Watson was the subject of an FBI investigation, had been permanently blacklisted by the National Association of Securities Dealers and previously spent three years in jail for mail fraud. The security team failed to communicate this information back to the Huntington team managing the Cyberco relationship, which asked Cyberco to find a new equipment lender but continued accepting payments on the Cyberco equipment loan debt – which were partly made using fraudulently obtained loans from other banks. Shortly after Huntington received the final loan repayment from Cyberco later in 2004, the FBI raided Cyberco's offices, Watson committed suicide and the Cyberco-Teleservices scheme collapsed. Teleservices eventually filed for Chapter 7.

The Teleservices bankruptcy trustee filed a lawsuit against Huntington, claiming that Teleservices had made fraudulent transfers by making approximately $56 million in loan repayments and depositing another $16 million with Huntington through Cyberco, and that Huntington was the transferee of those

transfers. The Bankruptcy Court and District Court concluded that Huntington was a transferee as to the deposits, and found that it could not claim a good faith defense at any time after the breakdown in communication between the security team and relationship manager.

The Ruling

The Sixth Circuit concluded that the bankruptcy trustee could not recover the deposits from Huntington because Huntington was not a "transferee" as to those deposits. The court found that it is "dominion and control" over, and not simply possession of, the debtor's transferred property that determines whether a recipient of the debtor's property is a "transferee" for fraudulent transfer purposes. The court was unmoved by the fact that Huntington maintained Cyberco's demand deposit accounts, had a lien on the deposits and could use the deposits so long as it maintained sufficient funds on hand to return the deposits upon Cyberco's demand. A depositor's ownership of the deposits and right to demand their return outweighs a lender and depository bank's lien rights and limited right to reinvest the deposits so long as it has enough funds on hand to repay the depositor. Because Cyberco retained ownership of the deposits and could demand their return at any time, it alone had "dominion and control" over the deposits. Without dominion and control, Huntington could not be a "transferee" and was therefore shielded from liability to the bankruptcy trustee.

Unfortunately for Huntington, the Sixth Circuit agreed with the Bankruptcy Court's finding that Huntington could not claim a good-faith defense as to any loan repayment it accepted after the communication breakdown between Huntington's security team and the Cyberco relationship team. Once the security team became aware of Watson's checkered past, its knowledge of Watson's potential fraud was imputed to Huntington as a whole, even if the security team never shared that information with the Cyberco relationship team and that failure to share was wholly innocent. Had the security team shared its knowledge with the Cyberco relationship manager, it likely would have refused further transfers from Cyberco and pursued termination of the Cyberco-Huntington relationship. The failure to communicate was fatal to Huntington's claim of good faith for all payments accepted by Huntington after the communication breakdown. The court remanded the case back to the District Court for further consideration of other issues and an ultimate determination of the dollar amount of the judgment against Huntington.

The Takeaways

The Meoli case provides protection for depository banks (at least in cases within the Sixth Circuit) from fraudulent transfer actions arising from the depository bank's maintenance of a debtor-customer's demand deposit accounts. The mere fact that the depository bank maintains a debtor's demand deposit accounts is insufficient to render it a "transferee" for fraudulent transfer purposes. This case is also a stern warning as to the importance of open and frequent communication between a lender's security team and those responsible for managing the lender's relationships with its customers. Once lender personnel become aware of a possible fraud, their knowledge will be imputed to the bank as a whole, even if it is never communicated to the bank personnel best positioned to act on that information. As the Meoli case demonstrates, breakdowns in communication can have grave and costly consequences for lenders should the fraudster seek the protection of a bankruptcy court.

New York Federal Court Clarifies Applicability of Subordination Agreement "Rule of Explicitness" Outside of Bankruptcy Proceedings

The general rule in bankruptcy cases is that interest on a debtor's obligations ceases to accrue upon the filing of the petition. Exceptions to the general rule include post-petition interest on the claim of an oversecured lender and post-petition interest where the principal amount of all claims can be paid in full. In light of this rule of law, a rule developed in bankruptcy cases for interpreting subordination and intercreditor agreements (we use the terms "subordination" and "intercreditor" interchangeably) as they apply to the payment of the creditor parties' claims vis-à-vis each other. This rule became known as the "Rule of Explicitness". The rule holds that when interpreting a subordination agreement, the agreement must clearly show that the parties intend not to apply, as between themselves, the general rule against post-petition interest – but instead intend that the senior debt will include post-petition interest regardless of whether post-petition interest would be a proper claim in the bankruptcy case. So if the agreement is sufficiently explicit, in cases where there are insufficient collateral proceeds or other distributions to pay all senior and junior debt in full, the payment of post-petition interest on the senior debt will diminish the recovery to the junior debt holders.

The Ruling

In U.S. Bank National Association v. T.D. Bank, N.A., the United States District Court for the Southern District of New York, in January, 2017, held that the Rule of Explicitness applies outside of a bankruptcy proceeding where the contract is governed by New York law. In this case, the Rule of Explicitness was applied to a priority dispute among senior creditors with respect to collateral proceeds that had been released from the bankruptcy estate. The court adopted New York's highest court's prior ruling that the Rule of Explicitness, though rooted in bankruptcy, is how courts should interpret contracts as a matter of New York state law. So the court, applying New York contract law, initially ruled that the Rule of Explicitness can apply outside of a bankruptcy proceeding.

Next, the court made clear that the Rule of Explicitness applies to a priority dispute among senior creditors, as well as a dispute between senior and junior creditors. This is because senior creditors, like junior creditors, have an expectation that, unless there is an explicit agreement to the contrary, interest will stop accruing as of the petition date.

Having established these legal principles, the court then analyzed the collateral waterfall language in the intercreditor agreement and language in the credit agreement to determine whether the agreements were sufficiently explicit in providing that repayment of principal could be subordinated to post-petition interest amounts. In so doing, the court rejected the argument that the explicit language had to be contained exclusively in the intercreditor agreement itself. The court decided that it was sufficient that the language providing for post-petition interest appeared in the credit agreement because such provisions were expressly incorporated into the intercreditor agreement. The court also rejected other arguments that the language was not explicit.

The Takeaways

At a basic level, this decision is significant in declaring that the Rule of Explicitness applies in non-bankruptcy proceedings, at least where New York law governs the dispute. At a higher level, the case stands as an example of the critical importance of clear and unambiguous drafting of subordination and intercreditor agreements. When a borrower does not have enough assets to pay all of its lenders in full, their intercreditor agreement may be placed under the detailed and intense scrutiny of the kind illustrated in this case.

Consignment Sellers and Secured Lenders Settle Collateral Dispute in Major Retail Chapter 11 Case

One of the ways in which a retailer may acquire inventory from a supplier is through a consignment. The supplier, known as the consignor, delivers goods to the retailer, the consignee, to be sold by the retailer alongside its other inventory. However, rather than having the retailer pay for the goods and assume the risk that the goods are not sold, the consignor retains title to the goods until they are sold to the retailer's customer and thereby absorbs the risk of non-sale. In exchange for bearing this risk, the retailer often agrees to pay the consignor more per unit sold. A consignment is typically documented in a consignment agreement governed by Article 9 of the Uniform Commercial Code (Article 9). Article 9 imposes special procedural requirements on consignors seeking to protect their interest in the consigned goods against the retailer's secured lenders, who often obtain a floating lien on the retailer's inventory as security for money loaned. Consignors who satisfy these requirements are protected against the retailer's secured lenders' liens and receive preferred treatment in a bankruptcy case. Failure to comply with Article 9's requirements can result in the consignor being unperfected, leaving the consignor with a general unsecured claim eligible for a distribution of mere pennies on the dollar.

In the Sports Authority bankruptcy case, the Bankruptcy Court for the District of Delaware – a court handling many of the country's largest and most sophisticated bankruptcy cases – navigated a dispute among Sports Authority, a large national sporting goods retailer at one time boasting over 500 nationwide locations, its suppliers and its secured creditors over the disposition of Sports Authority's inventory held on consignment. While the parties consensually resolved the dispute after significant litigation, the resulting agreement provided a recovery to Sports Authority's consignors at the expense of its secured lenders and unsecured creditors, even though there were significant potential issues with the consignors' compliance with Article 9's requirements.

The Backstory

Sports Authority filed for Chapter 11 in March, 2016. At the time of its bankruptcy filing, Sports Authority's inventory included an unusually large amount of consigned goods, valued at more than $85 million. Upon Sports Authority's filing for Chapter 11, it immediately sought court permission to continue selling the consigned goods in the ordinary course of business, offering to grant the consignors replacement liens on the consigned goods to the extent the consignors had enforceable, perfected and unavoidable liens on the consigned goods delivered to Sports Authority.

The consignors objected, claiming that because they retained title to the consigned goods, they were not property of Sports Authority's bankruptcy estate and thus could not be sold without the consignors' permission. Sports Authority's secured lenders also objected, claiming that because they held perfected liens on inventory (including the consigned goods), the Bankruptcy Court could not authorize the sale of the goods – or payment of the sale proceeds to the consignors – without providing adequate protection for the secured lenders' interests. The Bankruptcy Court ultimately authorized the sale of the consigned goods on an interim basis and scheduled a hearing to resolve the matter a week later. Shortly before that hearing, Sports Authority filed over 160 lawsuits alleging that the consignors had not followed the Uniform Commercial Code (UCC) requirements to perfect their interests in the consigned goods and, as a result, they were relegated to general unsecured creditor status.

Presented with these challenges, the Bankruptcy Court presented Sports Authority with a handful of options pending final resolution of the matter: (a) return the consigned goods to the consignors, (b) negotiate an agreement with the consignors or (c) continue to sell the consigned goods on the terms set forth in Sports Authority's pre-bankruptcy consignment agreements. Sports Authority elected to continue selling the consigned goods pursuant to the pre-bankruptcy consignment agreements and paid the proceeds of those sales to the consignors. Given the potentially fatal defects in many of the consignors' Article 9 compliance and the existence of the secured lenders' perfected liens, this was a positive result for the consignors that provided crucial leverage in advance of a potential final ruling by the court. Armed with this bargaining power, the consignors soon engaged Sports Authority and its secured lenders in negotiations to consensually resolve the dispute.

The Deal

After several abortive attempts to reach an agreement, Sports Authority, its secured lenders and a significant number of its consignors agreed that the consignors would receive somewhere between a quarter and half of the sale proceeds of consigned goods, with each consignor's share determined based upon the relative strength of its Article 9 compliance and various business considerations. On July 7, 2016, the Bankruptcy Court approved the settlement.

The Takeaway

The Sports Authority saga illustrates the importance of lenders thoroughly investigating and understanding a potential borrower's business and legal relationships with its suppliers. While Sports Authority's inventory consisted of an unusually large amount of consigned inventory, even a more modest share of consigned inventory can lead to costly and time-consuming litigation to defend the secured lender's position should its borrower file for bankruptcy protection. This may be true even if the consignors have not taken the UCC-mandated steps to protect their interests. The importance of the consigned inventory to a borrower's business, as well as the borrower's possible need to conduct an expedited sale of its assets in bankruptcy, may provide consignors with outsized leverage in negotiating the disposition of consigned inventory and the distribution of the proceeds thereof among a retailer's creditors.

Bankruptcy Trustee May Reach Back 10 Years to Avoid Fraudulent Conveyance

In bankruptcy cases, the trustee or debtor-in-possession has the ability to bring claims to unwind (or "avoid" in bankruptcy-speak) fraudulent transfers using provisions contained in the Bankruptcy Code itself or provisions found in applicable non-bankruptcy law such as state law. Under the Bankruptcy Code, transfers made by the debtor (or obligations incurred by the debtor) may be set aside if they were made with fraudulent intent. But they may also be unwound if they were "constructively" fraudulent, meaning that without receiving equivalent value in exchange, the debtor transferred assets (or incurred debt) while insolvent or under other circumstances demonstrating a shaky financial condition.

While a state's law defining these elements of avoidable transfers is often very similar to the Bankruptcy Code's, the statute of limitations or reach-back period that applies can vary dramatically. Under the Bankruptcy Code, the transfer must have occurred within two years before the bankruptcy petition date. Under state law, however, it is common for the reach-back period to be four years or longer. For example, in Ohio, the reach-back period is generally four years after the transfer was made or the obligation was incurred, although for transfers or obligations involving actual fraudulent intent, the period may be extended to four years after the transfer or obligation could reasonably have been discovered.

Section 544(b)(1) of the Bankruptcy Code enables the trustee or debtor-in-possession to "step into the shoes" of an unsecured creditor – the so-called "golden creditor" – who actually has a claim in the bankruptcy case and also has a claim under the state fraudulent transfer provisions (among other state causes of action) to pursue that claim in the bankruptcy court. Thus, a trustee may, and often does, seek to set aside transfers that occurred before the Bankruptcy Code two-year period and within, for example, a four year state reach-back period.

The Ruling

What has occurred far less frequently, but should nevertheless be a concern, is that some (but not all) courts have permitted trustees to use the Internal Revenue Service as the golden creditor – and the Internal Revenue Code (26 U.S.C. §§ 6502(a)(1) and 6901(a)) provides the IRS with a 10-year collection window. This was the ruling in a recent bankruptcy case, Mukamal v. Citibank (In re Kipnis), decided by the U.S. Bankruptcy Court for the Southern District of Florida. There, the court held that the language of Section 544(b) is clear and allows the trustee to step into the shoes of the IRS to take advantage of the 10-year collection period. The court noted that four other courts have ruled the same way, while only one has reached the opposite result and denied the trustee's effort to use the IRS's 10-year period.

Importance to the Secured Lender

Voidable transfer law has particular relevance to secured lenders in leveraged acquisition financing where, for example, the target borrower and other credit parties become liable for the new debt and use their assets as collateral for that debt, but the loan proceeds flow out to selling shareholders. These transaction structures present risk to the lender, who may face a challenge that its lien should be avoided and its debt disallowed as a constructive fraudulent transfer if the company later runs into financial difficulty as a result of the additional debt burden. While litigation of this sort is very complex and involves other significant issues, one issue always is whether the lien transfer and debt obligations occurred within the relevant reach-back period. And certainly, the longer the period of time between the LBO and the borrower's

descent into insolvency and bankruptcy, the more difficult it will be to prove that it was the debt incurred in the LBO that caused the borrower's insolvency and not some other factor such as industry or general economic conditions or poor management. Nevertheless, when a lender is considering its risk exposure to a fraudulent transfer claim of this type, it needs to be mindful of the possibility that a longer reach-back period may be applied than it had perhaps previously considered applicable.