

# Commercial Law Cases Update

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## 1. **CONSTRUCTIVE FRAUDULENT TRANSFER - APPLICABILITY OF EARMARKING DOCTRINE**

Cooper v. Centar Invs. (Asia) (In re TriGem America Corp.), 431 B.R. 855 (Bankr C.D. Cal. 2010) -- The Korean parents of the debtor, attempting to avert special supervision of the Korean Stock Exchange as a result of its financial condition and the exercise of a put by its bondholders, transferred \$15.6 million to the debtor, its wholly-owned subsidiary, for the express purpose of making payments to the bondholders. Using the money wired to it by the parent, as well as \$250,000 of its own cash and other funds, the debtor, pursuant to its parent's instructions, paid the money to the bondholders and marked receipt of the \$15.6 million as payment on an intercompany account owed by the parent to the debtor. At the time of the transaction, however, the debtor owed the parent an even greater sum of money. Shortly, thereafter, the debtor filed for bankruptcy and the Chapter 11 trustee filed a constructive fraudulent conveyance action against the bondholder defendants in which the trustee sought to recover the funds transferred by the debtor to the bondholders. The bondholder defendants invoked the earmarking doctrine as a defense to the trustee's constructive fraudulent conveyance action. The bondholders contended that the monies transferred by the parent to the debtor were "earmarked" for payment to the bondholders and therefore the transfers does not consist of property of the debtor. The trustee responded that the funds were clearly property of the debtor for at least two reasons -- first, the debtor had actual control over the disposition of the funds and, second, the \$15.6 million transferred by the parent to the debtor was in payment of an intercompany obligation and therefore constituted property of the debtor's estate. The bankruptcy court, on cross motions for summary judgment, granted the motion filed by the bondholder defendants. The bankruptcy court initially observed that, while the earmarking doctrine traditionally had been applied in preference cases, there was no reason not to apply the doctrine in the context of a constructive fraudulent transfer action. The earmarking doctrine is based upon the notion that the property in question does not constitute property of the estate. Creditors of a debtor cannot complain about the transfer of property by an insolvent debtor when the property does not constitute property of the debtor's estate. Turning to the trustee's contentions, the court noted that it was not a requirement under the judicially created earmarking doctrine that the debtor not have actual control over the funds. All that is required is that there be an agreement (even an oral one) regarding the disposition of the property. Here, such an agreement (albeit oral) existed and that was sufficient for the earmarking doctrine to apply. Turning next to the trustee's argument that the funds transferred from the parent constituted property of the estate because the funds were documented as a payment on an intercompany account, the court reasoned that it was necessary "to look at the transaction as a whole." In that regard, the court noted that the intercompany receivable owed by the parent to the debtor was dwarfed in size by the amount of the intercompany

receivable owed by the debtor to the parent. The accounting entry by which the transfer was recorded as a payment on the intercompany account owed to the debtor “was used as a pretext or a camouflage” in connection with the overall effort of the parent company to avoid being placed under special supervision by the Korean Stock Exchange. In truth, but for the pressure applied by the Korean Stock Exchange upon the parent, the purported payment of the intercompany account would not have been made. The debtor subsidiary was nothing more than a conduit for funding payments to bondholders. However, the \$250,000 of funds of the debtor that were used to pay the bondholders could be subject to fraudulent conveyance attack as the funds were property of the debtor and it did not receive reasonably equivalent value in exchange for the transfer of those funds.

## **2. PLAN CONFIRMATION - - IMPAIRMENT OF SECURED LENDER CLAIM**

In re Introgen Therapeutics, Inc., 429 B.R. 570 (Bankr. W.D. Tex. 2010) - - At issue in this case was whether a secured lender that was placed in a class by itself in the debtor’s chapter 11 plan was impaired. If the secured lender’s claim was not impaired, then its vote to accept the plan would not be counted and the plan could not be confirmed because there was not an impaired class that had voted to accept the plan and therefore the plan could not be crammed down over the objections of other creditors. The court found that the claim of the secured lender was, indeed, impaired because the secured lender would receive payment in full only of the allowed amount of its secured claim. The allowed amount of the lender’s secured claim did not include post-petition interest to which it was contractually entitled. Accordingly, while the secured portion of the lender’s claim was to be paid in full on the effective date of the plan, the absence of interest payments under the plan rendered the secured lender impaired for plan voting and confirmation purposes.

## **3. APPEAL OF 363 SALE ORDER - - MOOTNESS**

Asset Based Resource Group, LLC v. U.S. (In re Polaroid Corp.), 2010 U.S. App. LEXIS 14012 (8th Cir. 2010) - - The bankruptcy court entered an order approving a sale of the debtor’s assets pursuant to Section 363(f) of the Bankruptcy Code, free and clear of all liens and claims except those expressly assumed under the asset purchase agreement. The order contained the typical provisions that the valid liens of creditors would attach to the sale proceeds. One lienholder appealed the order and moved to stay the sale pending the appeal. Both the bankruptcy and district courts denied the appellant’s request for a stay and the sale closed. The Eighth Circuit dismissed the appeal on the grounds that it was moot under Section 363(m) of the Bankruptcy Code. That section provides that the reversal or modification on appeal of a sale authorized under Section 363(b) or (c) does not affect the validity of the sale to an entity that purchased the property in “good faith,” absent a stay of the sale pending appeal. The appellant argued it was not seeking to reverse the sale order, but only challenged the “free and clear” provision of the order. The Eighth Circuit noted that the requested relief would have the effect of unwinding the sale, as the provisions in the order authorizing the sale free and clear of liens were integral to the sale. The purchaser would not have agreed to acquire the assets absent a sale free and clear of liens.

## **4. REPRESENTATIONS AND WARRANTIES IN CREDIT AGREEMENT - - REASONABLENESS OF LENDER’S RELIANCE**

DDJ Management, LLC v. Rhone Group L.L.C., 2010 N.Y. LEXIS 1182, 15 N.Y.3d 147 (Ct. App. N.Y. 2010)) - - A group of lenders made a \$40 million loan to the borrower and its affiliates. The borrower was owned by private investors, each having two employees on the borrower’s board of directors and one employee assigned to assist the borrower in managing its business. As the financial condition of the borrower declined, the equity sponsors realized that they would need financing. At the direction of individuals assigned by the equity sponsors to assist in

running the business, the borrower made false representations to the lenders regarding the borrower's financial condition and business prospects. The borrower made standard representations and warranties in the credit agreement regarding financial statements that it had presented to the lenders, warranted that there had not been any material adverse change and that the financial statements were presented accurately and omitted no material facts. The financial statements presented to the lenders were materially inaccurate and, not long after the funding of the loan, the borrower filed for bankruptcy. The lenders lost the entire principal amount of their loan and thereafter sued both the equity sponsors and the borrower's accountants for fraud and negligent misrepresentation. The lower court dismissed the fraud claim against the equity sponsors on the grounds that the lenders had not conducted their own due diligence regarding the accuracy of the borrower's financial statements. Since the lenders had not made any efforts to evaluate the borrower's financial records to determine the accuracy of the financial statements, they could not have reasonably relied on the misrepresentations. The New York court of appeals reversed. It held that a lender is not required, as a matter of law, to conduct its own due diligence with respect to financial statements of a borrower and is entitled to rely on the representations and warranties of the borrower respecting the accuracy of the financial statements. The lenders in this case had made significant efforts to protect themselves against the possibility of falsified information by requiring standard representations and warranties that nothing in the financial statements was materially misleading. The lenders were not required to do more than that and, by insisting upon the representations, they were justified in relying upon them without further inquiry.

## **5. SANCTIONS - - LENDER MISREPRESENTATION**

Ameritrust Mortg. Co. v. Nosek (In re Nosek), 609 F.3d 6 (1st Cir. 2010) - - The Court of Appeals for the First Circuit reversed the bankruptcy court's \$25,000 sanction (reducing the amount of the sanction to \$5,000) that was imposed on a lender that originated a mortgage loan. The bankruptcy court concluded in the mortgagor's bankruptcy case that the lender had misrepresented that it was the "holder" of the mortgage when, in fact, the lender had assigned the mortgage to a third party and it was only the servicing agent. While recognizing that a bankruptcy judge has broad discretion in setting sanctions, a reviewing court can find the amount of the sanctions to be unreasonable and an abuse of discretion. Here, the sanction was an unreasonable amount as the lender's claim that it was the holder of the mortgage was not a deliberate falsehood, was not intended to mislead the court, and did not result in any windfall to the lender. The lender as servicing agent arguably could have sued "as if" it were the holder and the debtor was not prejudiced in any way.

## **6. ARBITRATION - - MANIFEST DISREGARD OF LAW DOCTRINE**

Frazier v. Citifinancial Corp., LLC, 604 F.3d 1313 (11th Cir. 2010) - - The losing party in an arbitration sought to vacate the arbitration award on various grounds, including that the award was in manifest disregard of the law. The Eleventh Circuit concluded that the Supreme Court's decision in Hall Street Associates compelled the conclusion that judicially-created grounds for vacating an arbitration award, such as manifest disregard of the law, are no longer valid. In doing so, the Eleventh Circuit rejected the position of the Second and Ninth Circuits and joined the First and Fifth Circuits.

## **7. PREFERENCE DEFENSE - - SECTION 503(b)(9) CLAIM**

Commissary Operations, Inc. v. Dot Foods, Inc. (In re Commissary Operations), 421 B.R. 873 (Bankr. N.D. Tenn. 2010) - - The question presented in this case was whether a creditor entitled to be paid in full for goods received by the debtor within the twenty-day period prior to bankruptcy pursuant to Section 503(b)(9) of the Bankruptcy Code is able to utilize the amount of the invoices as part of a new value defense in a preference context

under Section 547(c)(4) of the Bankruptcy Code. The latter section authorizes a creditor to reduce potential preference exposure by the amount of unsecured credit extended after receipt of the preference and prior to bankruptcy. The debtor argued that to allow the creditor to obtain an administrative expense claim under Section 503(b)(9) and also to utilize the same claim amount as subsequent new value under Section 547(c)(4) would confer a windfall upon the creditor and allow double counting of the same invoices. The creditor contended that any payment on its Section 503(b)(9) claim arises after the bankruptcy case is filed and therefore does not defeat assertion of the new value defense, which relates to pre-bankruptcy transactions. In addition, the creditor argued that the contrary holding would frustrate the policy underlying Section 547(c)(4), which is to encourage creditors to deal with distressed enterprises prior to bankruptcy. Agreeing that a contrary ruling would ignore the policies underlying Sections 503(b)(9) and 547(c)(4), the bankruptcy court found that there was no double counting and the creditor could assert both an administrative claim under Section 503(b)(9) and a subsequent new value defense under Section 547(c)(4).

## **8. BREACH OF SUBORDINATION AGREEMENT - - PAYMENTS FROM GUARANTOR**

First Choice Bank v. Riverview Muir Duran, LLC, 2010 Minn. App. Unpub. LEXIS 500 (Minn. App. 2010) - - A subordinated lender and a senior lender entered into a subordination agreement. Pursuant to the agreement, the subordinated lender agreed to subordinate its claim against the common debtor to the “prior payment in full” of the senior debt. The agreement further provided that, during any period of default on the senior loan, the borrower would not make any payments pursuant to the subordinated loan documents without the senior lender’s written consent and the subordinate lender would not accept any payments “under or pursuant to” the subordinate loan documents without the senior lender’s prior consent. Finally, the subordination agreement stated that until full payment of the senior loan the senior lender would not take additional collateral for the subordinated claim without the senior lender’s prior written consent. After default on the senior loan, the subordinate lender sued the borrower and certain guarantors. Thereafter, the subordinate lender, the borrower and the guarantors entered into a subordination agreement that required the borrower to deliver to the subordinate lender a mortgage executed by a related company that was not then liable for any of the senior debt or the subordinate loan. The subordinate lender received payments from the guarantors and also received payments from the sale of assets of the related company that had granted the mortgage. Upon discovery of the payments, the senior creditor sued for breach of the subordination agreement. The subordinate lender contended that nothing in the subordination agreement precluded it from receiving payments from the guarantors or accepting collateral from a third party. The trial court and appellate court both concluded that the subordination agreement made clear that it was the subordinated lender’s acceptance, rather than the source, of the payment and collateral that the subordination agreement enjoined.

## **9. EFFECTIVENESS OF NOTICE - - REQUIREMENTS OF LOAN AGREEMENT**

Kladek, Inc. v. American Bank of St. Paul, 2010 Minn. App. Unpub. LEXIS 217 (Minn. App. 2010) - - At issue was whether or not notice given by the lender to the borrower was effective. The loan agreement required that notices given thereunder be in writing and were effective “when actually delivered, when actually received by telefacsimile (unless otherwise required by law), when deposited with a nationally recognized overnight courier, or, if mailed, when deposited in the United States mail, as first class, certified or registered mail postage prepaid, directed to the addresses shown near the beginning of this Agreement.” The bank sent notices by first-class mail. The borrower contended that the use of first-class mail was insufficient and that certified or registered mail was required. In an action against the bank for breach of contract resulting from the bank’s charging the default rate after sending notice of default by first-class mail, the trial court ruled in favor of the bank and the appeals court affirmed. Both found that notice of default was effective under the loan agreement when sent by first-class mail or, in the alternative, certified or registered mail. The borrower argued that the notice provision meant that “registered or certified mail”

was a subset of first-class mail, so that first class mail must also be sent either as registered or certified mail for the notice to be effective upon mailing. In so arguing, the borrower relied on a grammatical rule that if a sentence lists more than two items in a series, the last item was required to be preceded by a comma. Finding that the rule was not universally applied, the appellate court took judicial notice of the U.S. postal service regulations on its website, which stated that certified or registered mail may be used with either priority mail or first-class mail. Finding no ambiguity, the appeals court affirmed the trial court's ruling in favor of the bank.

## **10. GUARANTOR - - AVOIDANCE OF GUARANTY FOR NONDISCLOSURE BY CREDITOR**

Whisnant v. Carolina Farm Credit, ACA, 693 S.E.2d 149 (N.C. App. 2010) - - The court of appeals in North Carolina reversed a trial court's grant of summary judgment in favor of the defendant with respect to a complaint filed against the lender by two co-signers of the loan funded by the lender primarily for the benefit of third parties related to the co-signing plaintiffs. The plaintiffs sued to avoid their liability on the notes that they co-signed and to prevent the defendant from foreclosing on their residence, which they had pledged as security for the loan. In their verified complaint, they stated causes of action for fraud in the inducement, actual fraud and negligence resulting from the defendant's alleged failure to disclose to them material facts relating to the poor financial condition of the primary borrowers. While the plaintiffs referred to themselves as "accommodation makers" of the notes because they did not receive any of the loan proceeds, the defendant referred to the plaintiffs as "co-makers." The court declined to make a determination as to the status of the plaintiffs as co-makers or accommodation parties, but noted that, viewing the pleadings in evidence most favorably to the plaintiffs, they might very well qualify as accommodation makers of the notes. If the plaintiffs were accommodation makers, then the suretyship law of North Carolina would apply. The court observed that, under general suretyship principles in North Carolina, if a creditor knows or has good grounds to believe that the surety is being deceived or misled, or that he was induced to enter into a contract in ignorance of facts, materially increasing his risk, of which the creditor has knowledge and has an opportunity before accepting the surety's undertaking to inform the surety of such facts, "good faith and fair dealing" demand that the creditors should make such disclosure to the surety. If the creditor accepts the suretyship agreement without making such disclosure, the surety may afterwards avoid it. Although in the ordinary case it may be assumed that the surety will obtain from the principal all of the information that the surety requires, this rule may not be applicable when the creditor knows some fact that the surety may not discover that is of such vital importance to the surety's risk and the creditor must be aware that nondisclosure of that fact would in effect amount to a false representation to the surety, and concealment of such fact may be fraudulent. The appeals court noted that the plaintiffs were not required to allege that the defendant lender made an affirmative misrepresentation to them, as fraud can be perpetrated by silence when there is a duty to speak as well as by a positive misrepresentation. Here, the defendant may have owed a duty to disclose to the plaintiffs its knowledge regarding the primary borrowers' financial state and the state of the project for which the loan proceeds were obtained. The appeals court then pointed to an affidavit obtained by the plaintiffs from an individual who was a commercial lender and real estate specialist in major financial institutions around the country. The affidavit stated that the only basis for entering into the loan transactions was the lien that the plaintiffs granted to the defendant on the plaintiffs' farm/residence property; sound loan practices required the lender to inform the plaintiffs that there was no reasonable basis upon which the monies were loaned to the primary borrowers other than the equity in the collateral pledged by the plaintiffs; and sound loan practices would have required the defendant lender to disclose to the plaintiffs, in writing, that there was no reason or evidence to believe that the primary borrowers could possibly repay the principal amount of the loans (assuming, as they alleged, the plaintiffs repeatedly questioned the lender regarding the ability of the primary borrowers to repay the loan). The appeals court also found relevant the fact that one of the plaintiffs had transacted business in the past with the same representative at the defendant lender who was involved in this transaction and "trusted her" to tell the plaintiffs what they needed to know about the risks of the loan and to respond truthfully to their questions regarding the financial health of the

project. On this record, the appeals court found that there was a genuine issue of material fact as to whether the plaintiffs were induced to enter into the co-signing of the notes and ignorance of facts that materially increased their risk, that the defendant breached a duty to them and was negligent in not informing them of the risks, and that the defendant may have misrepresented or concealed material information regarding the financial state of the primary borrowers and their project in order to induce the plaintiffs to co-sign the loan documents.

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