LEGAL INSIGHTS

Lenders Beware: Lender Liability

BY JONATHAN N. HELFAT AND BOBBI ACORD NOLAND

SFNet's co-general counsels bring readers up to date on recent lender liability cases and the lessons learned from them.

The past few years have seen strong liquidity in the marketplace coupled with unprecedented government support of certain borrowers; increased competition for secured transactions among banks and non-banks; and surprisingly fewer distressed transactions during the pandemic than would have been anticipated. As a result, lenders have not had to focus as much on managing distressed credits and the potential pitfalls and risks that are associated with them. As a few recent cases discussed below show, assertions of lender liability may arise in various contexts to an unsuspecting lender. The review by a court or other third party after the fact of actions of the lender, emails and other communications between a distressed company and its lender, and internal lender strategy discussions may result in unexpected exposure for the lender.

A complicating factor in many cases is that a lender often assumes that a court understands the structure of asset-based credit facilities as well as the lender. The concepts of overadvances, reserves, cash dominion, and the management of a collateral-based facility are generally understood in secured transactions across the finance industry, but may seem unusual to a court, especially when analyzing a distressed-borrower scenario. The recent Bailey case highlights this issue, and the cases discussed in this article also serve as a reminder that lender liability is alive and well, even in the current financing market.

The Bailey Case

In *In re Bailey Tool & Manufacturing Company,* 2021 WL 6101847 (Bankr. N.D. Tex. Dec. 23, 2021), a lender entered into an inventory financing agreement and factoring arrangement with borrowers that were already suffering losses. The borrowers were delinquent on their accounts payable and also owed certain property taxes. The lender generally was aware of the borrowers' financial condition prior to closing, and also agreed to a closing date accommodation for the treatment of a substantial government receivable that later became ineligible after closing to the alleged surprise of the borrowers.

Immediately after the closing, the lender advised the borrowers that they were in default and stopped making advances. The lender cited a cross-default to a term loan from a third party arising from the failure to pay property taxes. The borrowers alleged that they were unable to pay those taxes due to the restricted availability under the financing documents. As a result of that default, the lender deemed itself insecure. The lender refused to make advances, charged additional fees, and imposed reserves. From the collections, the lender allowed Bailey to pay only payroll and essential supplier costs in an effort to pay down its exposure under the inventory financing facility and the factoring arrangement. The lender also required the borrowers' owner to grant the lender a mortgage on his Texas home. The lender used the proceeds from the sale of the home to pay down the loan without advancing additional funds to the borrowers and also charged a termination fee without notice to the borrowers. As a result, the borrowers lost employees and customers and their business failed. The lender was paid in full through collections on accounts receivable but withheld remaining collateral proceeds until the borrowers executed a release of claims. The borrowers refused to execute the release. The borrowers filed for bankruptcy under Chapter 11, but later the cases were converted to Chapter 7. The bankruptcy trustee sued the lender for breach of contract and various torts.



JONATHAN N. HELFAT
Otterbourg P.C.



BOBBI ACORD NOLAND
Parker Hudson Ranier & Dobbs

The court found the lender liable to the borrowers' estates based upon several theories. The court first held that the lender breached the underlying financing documents with the borrowers. The court noted that immediately after closing the lender refused to make advances to the borrowers, wrongly told the borrowers that there was no borrowing base availability while paying its loans down, selected the employees and vendors to pay, charged high fees, demanded a mortgage on the owners' home, and refused to release excess collections after the payoff until the owners' signed a release of claims. The court highlighted that the lender continued to demand performance from the borrowers

even after the lender had terminated the financing arrangements. The court further held that the lender breached its duty of good faith and fair dealing by withholding the collections and basically "micro-managing" and controlling the borrowers' business which led to the borrowers' demise. The court found that the lender repeatedly made false representations and tortiously interfered with the borrowers' business through its actions in managing the distressed credit. In addition, the lender claimed that it owned the receivables under the factoring arrangement after it had been terminated and after the bankruptcy case was filed. The court found that the lender's post-petition demand that customers pay the lender and not the borrowers violated the automatic stay, and the court assessed punitive damages against the lender. Finally, the court equitably subordinated all of the lender's claims under Section 510(c) of the Bankruptcy Code and found that many of the lender's actions were inequitable and caused actual harm to the borrowers and their other creditors.

After the Bailey case, some commentators have questioned whether all of the actions of the lender were outside the scope of a typical asset-based facility or whether some of the actions that appeared especially egregious to the court and were used as a basis for the adverse decision against the lender were instead actually more customary in the asset-based lending industry. The case is a reminder to all lenders that a lender must be very careful in its internal communications regarding a troubled credit and interactions with a distressed borrower. Also, while the underlying contract may give certain rights and remedies to the lender, the lender should weigh the exercise of those rights in the broader context of the specific credit and the desired exit strategy. As the case highlights, any actions that may be viewed later by a third party as exerting too much control over the borrower may result in unexpected liability for the lender.

The WARN Act Revisited

While many times overlooked, one of the most important issues that a lender must evaluate in deciding whether to finance its borrower's Chapter 11 reorganization is the borrower's WARN Act exposure. The lender need only reference the Supreme Court decision in *In re Czyzewski v. Jevic Holding Corp.* 137 S.Ct. 973 v. Jevic (2017), to understand how a substantial WARN Act claim can frustrate the reorganization process.

The WARN Act (Workers Adjustment and Restraining Notification Act) is a federal statute which requires that employees of an entity that employs 100 or more employees receive 60 days written notice in advance of an impending "plant closing" or "mass lay-offs". Employers that fail to timely provide the required notices subject themselves to being liable for wages and benefits for each affected employee for each day notice was not provided during the 60-day window and attorneys' fees. It also is important to note that the sale of a borrower's business (including a sale of assets) that results in a plant closing or mass lay-offs also will require adherence to the WARN Act. The reader should note that there are various exceptions to the statute's application including an unforeseen change in the borrower's business and that there also are various mini WARN Act statutes that expand upon the federal coverage for employees in certain states.

In the Chapter 11 context, the failure to give the affected employee less than 60 days advance written notice of a plant closing or mass layoff that occurred prior to the filing can result in a priority claim in favor of the employee. If, however, the plant closing or mass layoff occurs during the Chapter 11 case and the employer fails to give proper notice, the workers' claims will rise to the level of a Chapter 11 administrative claim that must be satisfied in full before the Chapter 11 case can be confirmed.

A recent case emanating from the Fourth Circuit Court of Appeals, *Pennington v. Fluor Corp,* 2021 U.S. App. Lexis 35307 (4th Circuit Nov. 30, 2021), has brought further clarity to the statute and, in so doing, narrowed the reach of the WARN Act. In a unanimous decision, the Court examined the definition of who is considered an "employer" under the WARN Act. The case involved a South Carolina public utility ("SCANA") which hired Westinghouse Electric Company ("WEC") to design two nuclear reactors and who in turn employed Fluor Corp. as a subcontractor to undertake the actual construction of these facilities. When WEC went into bankruptcy, SCANA began paying Fluor directly. SCANA abruptly ended the project, and WEC and Fluor laid off approximately 4000 workers without any prior notice to any of the affected workers. The affected workers sued SCANA and Fluor claiming that both were the employers who had failed to give the WARN Act notices. While SCANA did in fact order the plant closings that resulted in the mass layoffs, the Court found that SCANA did not actually employ any of the workers who brought the claims. The Court followed the U.S. Department of Labor guidelines as to when an entity is to be considered an independent contractor and concluded that Fluor was not the alter ego of SCANA. The Court found that there was (i) no common ownership between SCANA and Fluor, (ii) no common directors and/or officers, (iii) no defacto exercise of control by SCANA, (iv) no unity of personnel policies emanating from a common source, and (v) no dependency of operations and therefore, Fluor was an independent entity and did not fall under the definition of an employer under the statute. This clarification of the definition of who is an employer under the WARN Act will clearly be a favorable consideration in evaluating the borrower's WARN Act exposure with regard to a potential Chapter 11 filing.

Recharacterization of Loan as Equity

In the context of a motion to dismiss, the Bankruptcy Court for the Southern District of New York held in *In re TransCare Corporation, et al.,* 602 B.R. 234 (2019), that the Trustee in bankruptcy had successfully pleaded the facts necessary for the reclassification of the lender's loan from debt to equity.

The reclassification or subordination of a lender's debt is a rare occurrence and, as such, this case is a cautionary tale of what can happen when the "borrower" and the "lender" are

affiliated entities.

The facts, while complex, relate to a medical transportation company, TransCare Corporation ("TransCare"), which is majority owned by Ark Investment Partners II, L.P. ("Ark II") and which, in turn, is owned and controlled by Lynn Tilton ("Tilton"). Tilton also is the sole director of TransCare.

Tilton also controls an entity known as Patriarch Partners Agency Services ("PPAS"), which agented a 2003 secured credit facility in favor of TransCare. While the lending group for this facility had certain independent lenders, the majority of the debt was held by two entities affiliated with Tilton. TransCare also had a secured line of credit from Wells Fargo Bank, N.A. ("Wells Fargo"), which was senior in priority to the PPAS facility.

TransCare, while initially profitable after being acquired by Ark II in 2003, began to experience financial difficulty starting in early 2015 and by late 2015 was clearly insolvent, unable to satisfy its vendors and various taxing authorities (including payroll taxes) in the normal course of business. At the same time, its customer base was eroding and its senior lending facility with Wells Fargo was in default.

In danger of losing the ability to operate its fleet of ambulances due to non-payment of insurance premiums and in order to keep the fleet insured, in January 2016 PPAS advanced $1,500,000 to TransCare. At the time of this advance, no terms or conditions were provided to TransCare.

Anticipating that a Chapter 7 liquidation of the TransCare entities was inevitable, in February 2016 Tilton started to execute a plan pursuant to which PPAS would foreclose its liens on the assets of TransCare and transfer these assets to a sister company also controlled by Tilton.

As the plan to transfer the assets of TransCare was being formulated, on February 10, 2016 (nearly four weeks after the January 2016 advance by PPAS to TransCare), TransCare executed a loan agreement with Ark II, dated "as of " January 15, 2016, converting the January 2016 advance into a loan, as well as granting Ark II a security interest in the assets of TransCare, and further requiring an intercreditor agreement which subordinated the 2003 credit facility to the Ark II loan.

After a detailing recitation of the facts, the bankruptcy judge then considered what are referred to in the decision as the Autostyle factors. Autostyle is the leading case in New York that outlines the criteria that distinguishes between a loan document and an equity infusion, including such factors as (i) the name of the document, (ii) whether it contained a fixed maturity date and a schedule of payments, (iii) whether there was a fixed rate of interest, (iv) was it secured, etc.

The Court ultimately denied the motion to dismiss and concluded that:

1. The January 2016 advances were made by a different entity several weeks before the Ark II Credit Agreement was executed and, at the time of these January 2016 advances, there were no loan terms or documentation.
2. Given the financial condition of TransCare at the time of the January 2016 advances, no reasonable creditor would have made such a loan because there would have been no reasonable expectation of repayment.
3. The January 2016 advances were made for the purpose of keeping TransCare "alive" so that it could effectuate the Article 9 sale.

The takeaway is clear – loans among affiliated entities face a high level of scrutiny, and the failure to contemporaneously document a transaction and the lack .

As head of the Commercial Finance practice at Parker Hudson Ranier & Dobbs, Bobbi Acord Noland guides global banks, regional banks and finance companies through domestic and cross-border transactions ranging from $5 million to more than $1 billion. She has handled practically every aspect of commercial lending, from single-lender deals to syndicated facilities involving multiple lenders, borrowers, creditors and multi-tiered debt tranches. In addition, Acord Noland frequently advises her clients on workouts and restructurings.

Acord Noland is an active participant in the finance community and serves as co-general counsel for the Secured Finance Network. She has served as an adjunct professor at Emory University Law School in Atlanta. Bobbi is also the past Chair of the Business Law Section, UCC Committee of the Georgia State Bar and the Business and Finance Section of the Atlanta Bar.

Jonathan N. Helfat is partner at Otterbourg P.C. and is co-general counsel to the Secured Finance Network.