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Potential Lender Claims and Actions

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When examining and analyzing a bankruptcy case or a potential bankruptcy case, it is essential for a lender to take into consideration various issues that could affect the lender's claim and may arise during the pendency of the bankruptcy case. Such issues include, among other things, preferences, equitable subordination, debt recharacterization, the automatic stay, fraudulent transfers, and executory contracts and unexpired leases.

Preferences

A primary goal of the Bankruptcy Code is to achieve equality in distribution of estate assets among the debtor's creditors. In furtherance of this policy, Section 547 of the Bankruptcy Code provides the bankruptcy trustee or the debtor in possession with the power to avoid, or "clawback," transfers of interests in the debtor's property (such as making payments to creditors or granting a security interest in the debtor's property) to a transferee that have the effect of preferring such transferee over other similarly situated creditors. In order to establish that a transfer was preferential, the trustee or debtor in possession must establish the following seven elements:

1. A transfer
2. Of an interest of the debtor in property
3. To or for the benefit of a creditor
4. For or on account of an antecedent debt
5. While the debtor was insolvent
6. Within 90 days before bankruptcy (or within one year where the transfer was to or for the benefit of an insider) -and-
7. That enables the creditor to receive more than it would have received in a hypothetical Chapter 7 liquidation. 11 U.S.C. § 547(b).

For purposes of section 547 of the Bankruptcy Code, the debtor is presumed to have been insolvent during the 90-day period preceding the date of the bankruptcy filing. 11 U.S.C. § 547(f).

Avoidable preferences received by a lender might include the lender's perfection of its security interest or the granting of additional collateral as part of a workout process during the 90-day period preceding a bankruptcy filing. This does not mean that lenders should not take steps to perfect or to improve their collateral position, but they should understand that any such pre-filing improvements may be at risk of clawback if the borrower files a bankruptcy petition during the 90-day preference "hardening" period. The relevant date of the transfer to the lender for preference purposes cannot occur until the debtor acquires its interest in the property. 11 U.S.C. § 547(e)(3). Thus, a secured lender with a perfected lien on after-acquired property of the debtor is also at risk of receiving an avoidable preference where the debtor does not receive an ownership interest in the after-acquired property until sometime during the 90-day pre-filing preference period. 11 U.S.C. § 547(e)(3).

The bankruptcy policy favoring equality in distributions among creditors is not served with respect to all categories of transfers that would qualify as preferences under this standard. As a result, the preference statute provides a number of exceptions to liability, a few of which are particularly relevant to lenders. First, the trustee may not avoid a transfer to the extent that it was intended by the parties as a contemporaneous exchange for new value given to the debtor, and the exchange was in fact substantially contemporaneous. 11 U.S.C. § 547(c)(1). Second, a transfer in payment of a debt incurred by the debtor in the ordinary course of business and payments made by the debtor in the ordinary course of its business or according to ordinary business terms—such as of principal, interest, fees and expenses, as and when due in accordance with the terms of its credit documents—may not be avoidable preferences. 11 U.S.C. § 547(c)(2). Third, valid purchase money security interests perfected within 30 days after the debtor receives possession of the property may not be avoidable preferences. 11 U.S.C. § 547(c)(3). Fourth, a transfer is not preferential to the extent that the lender subsequently gave new value to or for the benefit of the debtor. 11 U.S.C. § 547(c)(4). For example, the lender may be able to retain $3 million of the debtor's repayment of $5 million in unsecured revolving loans where the lender subsequently extended the debtor $3 million in new, unsecured loans. Fifth, a floating lien security interest, as in inventory or receivables, is not a preference, provided that it does not improve upon the lender's position as it existed 90 days prior to bankruptcy (or one year in the case of insiders). 11 U.S.C. § 547(c)(5). The improvement, or preference, is the amount by which the value of the collateral on the filing date exceeds the value of the collateral 90 days prior to bankruptcy (or one year in the case of insiders). For example, if a secured creditor improves its position by acquiring a lien on additional after-acquired inventory or receivables during the 90-day period (or one year in the case of insiders) preceding bankruptcy and makes no new advance to match its improved position, there is a preference to the extent that the security interest increased in value. However, the transfer must be to the prejudice of other creditors holding unsecured claims. 11 U.S.C. § 547(c)(5). Accordingly, secured creditors are protected from preference actions resulting from mere market fluctuations in the value of the debtor's receivables or inventory during the preference period. Finally, any payment on an oversecured loan is not a preference. This is because a secured creditor is entitled to receive the full value of its collateral, so by definition a payment of an obligation to an oversecured creditor cannot result in that creditor receiving more than the creditor would have gotten in a chapter 7 liquidation, which is one of the necessary elements of a preference claim.

Equitable Subordination

Equitable subordination is a remedy available under Section 510(c) of the Bankruptcy Code permitting the court to subordinate the claim, whether secured or unsecured, of any creditor who has engaged in wrongful conduct. 11 U.S.C. § 510(c). Having a claim subordinated and the lien securing the claim stripped as is permitted by section 510(c) is a rather harsh result for a secured creditor, and courts do not grant this remedy lightly. The leading case on this topic instructs that three elements must be satisfied:

1. The claimant must have engaged in some type of inequitable conduct.
2. The misconduct must have resulted in injury to the creditors of the debtor or conferred an unfair advantage on the claimant -and-
3. Equitable subordination of the claim must not be inconsistent with other provisions of the Bankruptcy Code.

See Benjamin v. Diamond (In re Mobile Steel Co.), 563 F.2d 692, 699-700 (5th Cir. 1977). Equitable subordination is intended to be remedial rather than punitive; if all three elements are satisfied, the court should subordinate the claim only to the extent necessary to disgorge profit or offset harm caused to other creditors as a result of the inequitable conduct. Insiders and fiduciaries of the debtor are subject to more rigorous scrutiny and generally have the burden to prove to the court the fairness of their conduct to the debtor's creditors. See, e.g., Bayer Corp. v. MascoTech, Inc. (In re Autostyle Plastics, Inc.), 269 F.3d 726, 744, (6th Cir. 2001); In re Fabricators, Inc., 926 F.2d 1458, 1465 (5th Cir. 1991); In re 604 Columbus Ave. Realty Trust, 968 F.2d 1332, 1360 (1st Cir. 1992).

Creditors sometimes seek to equitably subordinate a lender's claim when the lender has attempted to enhance its financial position and exert control over the debtor during a pre-bankruptcy, out-of-court workout after defaults by the distressed borrower. In such situations, a lender might seek to amend credit documents, add financial covenants, increase interest rates and fees, add collateral, require more frequent reporting by the debtor to the lender, require the debtor to appoint a chief restructuring officer, or even arrange for representation on the debtor's board of directors. When participating in a workout or otherwise negotiating with a distressed borrower, lenders should be mindful of the risk that the borrower may file for bankruptcy protection, and a court will scrutinize the parties' conduct for fairness, however extensively negotiated the agreements and sophisticated the borrower might be. Lenders may zealously press their contractual rights but should be mindful that certain actions that go beyond typical lender behavior may "cross the line" and expose the lender to equitable subordination risk. There is no bright-line test, but undue control over the borrower and undisclosed fees or other undisclosed arrangements are the types of things that could expose lenders to meaningful risk.

Actions rising to the level of fraud, breach of fiduciary duty, mismanagement, overreaching, or spoliation in the eyes of the bankruptcy court could result in equitable subordination of the lender's claim and a consequent reduction in the lender's recovery. See, e.g., In re Lifschultz Fast Freight, 132 F.3d 339, 345 (7th Cir. 1997); In re Fabricators, Inc., 926 F.2d at 1465; Shubert v. Lucent Techs. Inc. (In re Winstar Communs., Inc.), 554 F.3d 382, 412, (3d Cir. 2009); O'Connell v. Arthur Andersen, LLP (In re AlphaStar Ins. Group, Ltd.), 383 B.R. 231, 276 (Bankr. S.D.N.Y. 2008). If the lender has acquired an equity interest in the borrower or is an insider and is engaged in transactions with the borrower, then it is usually advisable to seek the approval of disinterested directors for any transaction between the lender and the borrower.

Debt Recharacterization

Debt recharacterization refers to the process by which the bankruptcy court looks beyond the form of a debt instrument to determine whether the creditor's purported claim is in fact an equity interest (e.g., a capital contribution that was characterized as a loan to be repaid). All circuits addressing the issue agree that bankruptcy courts have power to recharacterize debt as equity. However, the circuits are split as to where the power to recharacterize a claim resides. Currently, the Third, Fourth, Sixth, Tenth, and Eleventh Circuits employ federal law, relying on section 105(a) of the Bankruptcy Code, or the court's equitable powers to protect the sanctity of the priority scheme by ensuring that substance does not give way to form. See, e.g., PEM Entities, LLC v. Province Grande Olde Liberty, LLC (In re Province Grande Olde Liberty, LLC), 655 F. App'x 971, 975 (4th Cir. 2016). The Fifth and Ninth Circuits follow state law and section 502 of the Bankruptcy Code. See, e.g., Grossman v. Lothian Oil Inc. (In re Lothian Oil, Inc., 650 F.3d 539, 542-44 (5th Cir. 2011) (finding that section 502(b) of the Bankruptcy Code provides authority to recharacterize claims).

The risk of recharacterization arises most often in the context of pre-bankruptcy workouts where a creditor assumes multiple roles in relation to the debtor, such as lender, equity holder, director, and/or other insider. Frequently in distressed debt situations, a party in more than one role will provide funding to the debtor, raising questions as to the proper characterization of the contribution. Indeed, a lender holding equity or exerting control over the debtor's decision making has greater opportunity and incentive to disguise equity as a debt transaction. Debt recharacterization should not be confused with equitable subordination, which permits a court to subordinate a creditor's otherwise proper debt claim in order to remedy harm caused by the creditor's inequitable conduct. 11 U.S.C. § 510(c).

Courts considering recharacterizing a claim will examine the underlying transaction to determine whether the parties' relationship was intended to be one between equity owners or debtor and creditor. Courts generally consider a combination of the following factors:

1. The names given to the purported debt instruments
2. The presence of a fixed maturity date and schedule of payments
3. The provision of a fixed rate of interest and interest payments
4. The source of repayments
5. The adequacy of capitalization
6. The identity of interest between the creditor and stockholders
7. The security given for the advances
8. The debtor's ability to have obtained financing from an outside lender
9. The extent to which the advances were subordinated to the claims of outside creditors
10. The extent to which the advances were used to acquire capital assets -and-
11. The existence of a sinking fund to provide repayments

See, e.g., PEM Entities, LLC v. Province Grande Olde Liberty, LLC (In re Province Grande Olde Liberty, LLC), 655 F. App'x 971, 975 (4th Cir. 2016); In re Lothian Oil, Inc., 650 F.3d 539, 542-44 (5th Cir. 2011); In re Hedged-Inv. Assoc., 380 F.3d 1292, 1297 (10th Cir. 2004); In re Autostyle Plastics, Inc., 269 F.3d at 750.

A lender concerned about the possibility of the bankruptcy court's recharacterizing its loan as equity should clearly express and document the parties' intentions, with particular attention to the above factors, within the four corners of the debt instrument.

Automatic Stay

The automatic stay is one of the principal benefits to the debtor of filing for bankruptcy protection. It provides the debtor with a breathing spell from creditors' collection efforts in order to facilitate rehabilitation. It also allows for the orderly administration of estate assets and levels the playing field among creditors to permit equality of distribution, and so can properly be viewed as being beneficial to creditors also (at least when viewed collectively).

The filing of a petition for bankruptcy operates broadly as an automatic stay of the commencement or continuation of any judicial or administrative proceeding against the debtor that was, or could have been, commenced before the bankruptcy petition was filed. 11 U.S.C. § 362(a)(1). In addition to in personam actions, the stay prevents acts to obtain possession of, or exercise control over, property of the estate, which includes all of the debtor's legal or equitable interests in property as of the petition date. 11 U.S.C. §§ 362(a)(3), 541(a)(1). The stay also prohibits any act to create, perfect, or enforce a lien against property of the estate. 11 U.S.C. §§ 362(a)(4), (5).

The Bankruptcy Code provides certain narrow exceptions to the automatic stay. For example, the automatic stay does not apply to the post-petition perfection of a security interest or statutory lien where applicable non-bankruptcy law permits the perfection to apply retroactively to the prepetition creation of the security interest. 11 U.S.C. § 362(b)(3). Exceptions also permit stockbrokers, commodity brokers, financial institutions, and other participants in financial and derivatives markets to exercise rights under repurchase agreements and other specifically defined financial contracts. 11 U.S.C. § 362(b)(6).

At any time after the borrower's bankruptcy filing, a lender can seek relief from the stay by filing a motion with the court. The court must grant relief from the stay, such as by terminating, annulling, modifying, or conditioning the stay: (1) "for cause," including the lack of adequate protection of the lender's interest in property; or (2) where (i) the debtor lacks equity in the subject property and (ii) the property is not necessary to an effective reorganization. 11 U.S.C. §§ 362(d)(1), (2). Under the first ground, a court might find a lack of adequate protection where the lender's collateral is exposed to physical or economic depreciation or unreasonable risk of loss due to inadequate insurance coverage. Under the second ground, the requisite lack of equity is satisfied if the property's value is less than the sum of all encumbering liens and charges. Under either ground, the court has discretion to fashion appropriate relief, which might include permitting the lender to, among other things, record a notice of default, accelerate a debt, commence a lawsuit, or enforce a judgment against the debtor.

Fraudulent Transfers

In furtherance of the Bankruptcy Code's intent to equalize distribution among creditors, the trustee has the power to avoid, or unwind, actual or constructive fraudulent transfers made within two years before bankruptcy. An actual fraudulent transfer is a transfer made, or obligation incurred, with actual (i.e., subjective) intent to hinder, delay, or defraud existing or future creditors. 11 U.S.C. § 548(a)(1)(A). A constructive fraudulent transfer or obligation is a transfer or obligation that is deemed fraudulent, without any showing of the debtor's state of mind, where the debtor received less than "reasonably equivalent value" in exchange for the transfer or the obligation and was insolvent at the time of, or rendered insolvent by, the transaction. 11 U.S.C. § 548(a)(1)(B). While the "reachback" period of the fraudulent transfer avoiding power is two years, a transfer is deemed to occur when it is perfected under non-bankruptcy law as against a subsequent bona fide purchaser; thus, a transfer older than two years may be avoided if perfection was delayed. In addition, the trustee may utilize applicable state law fraudulent transfer statutes, which often allow the trustee to avoid transactions occurring earlier, for example, under New York law, up to six years before the bankruptcy. See 11 U.S.C. § 544(b). When an obligation or debt is avoided, the creditor is not entitled to recover any amount on account of that claim. When a transfer is avoided, the asset or its value is restored to the estate. See 11 U.S.C. § 550. The trustee may recover the property transferred or its value from the initial transferee or the entity for whose benefit the transfer was made or any immediate or mediate transferee of the initial transferee. 11 U.S.C. § 550(a). The trustee may not recover (a) from transferees subsequent to the initial transferee (and, in turn, their transferees) that have taken for value, in good faith and without knowledge of the voidability of the transfer, (b) from a non-insider of property preferentially transferred for the benefit of an insider if the transfer was made between 90 days and one year prior to the filing of the petition, (c) from multiple transferees such that the total recovery is in excess of the value of the property transferred or (d) the property transferred after one year after avoidance of the transfer is sought or when the case is closed or dismissed, whichever is earlier. 11 U.S.C. § 550(b)-(f).

To show that a transfer constituted an actual fraudulent transfer, the Bankruptcy Code requires that the trustee establish the debtor's subjective intent to hinder, delay, or defraud creditors. Because the debtor's state of mind cannot readily be determined, courts consider a number of circumstantial "badges of fraud" for this purpose, including, but not limited to:

1. Inadequacy of consideration received by the debtor
2. Transfer to an insider of the debtor
3. Failure to disclose the transaction
4. Debtor's retention of control of the property after the transfer
5. Threat of litigation or a judgment against the debtor before the transaction

6. Debtor's incurrence of substantial debt shortly before or after the transfer

7. Secrecy, haste, or unusualness of the transaction –and–

8. Financial condition of the debtor before and after the transaction

See UFTA § 4(b), reprinted in 7A Unif. Law. Ann., part II, at 58-59 (2006); Uniform Voidable Transactions Act § 4(b) (2014).

To show that a transfer constituted a constructive fraudulent transfer, the Bankruptcy Code requires the trustee to show (1) lack of reasonably equivalent value and (2) insolvency. The reasonably equivalent value necessary to save the transaction from avoidance need not be 100% equivalent to the value taken from the debtor, but it must have been received by, or at least must have benefited, the debtor. Generally, a debtor is insolvent for purposes of constructive fraud where its balance sheet shows debts in excess of property, it is left with unreasonably small capital as a result of the subject transaction, or it intended to, or believed it would, incur debts in the future beyond its ability to pay as they matured. 11 U.S.C. §§ 548(a)(1)(B)(ii), 101(32).

Because issues of fraudulent intent, reasonably equivalent value, and insolvency are fact intensive, it is important for a lender to note that motions to dismiss fraudulent transfer claims may not be successful. As a result, fraudulent transfer litigation can be prolonged and expensive.

Executory Contracts and Unexpired Leases

Subject to limitations, Section 365 of the Bankruptcy Code authorizes the trustee or debtor in possession to reject or assume (or assume and assign to a third party) the debtor's unexpired leases and executory contracts. 11 U.S.C. § 365. A contract is generally considered executory if, as of the petition date, the obligations of the debtor and counterparty are so far unperformed that the failure of either party to perform would constitute a material breach excusing the other party from performance. See Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 MINN. L. REV. 439, 460 (1973). The debtor in possession or the trustee cannot assume or reject contracts and leases that have been fully performed before the petition date.

A debtor assuming a contract or lease agrees to continue performing under, and to be bound by, the agreement. The debtor must cure prepetition defaults, or provide adequate assurance that it will promptly cure such defaults, as well as provide adequate assurance of future performance. 11 U.S.C. § 365(b). The debtor's rejection is not a rescission or termination, but rather a court-approved breach deemed to have occurred immediately before the petition date. 11 U.S.C. § 365(g). The contract counterparty is entitled to a prepetition claim for rejection damages. 11 U.S.C. § 502(g). The bankruptcy court must approve the trustee's decision to assume or reject, subject to appropriate notice and a hearing. 11 U.S.C. § 365(a). The court considers such requests under a business judgment standard. See, e.g., COR Route 5 Co., LLC v. Penn Traffic Co. (In re Penn Traffic Co.), 524 F.3d 373, 383 (2d Cir. 2007) ("that the debtor's interests are paramount in the balance of control is underscored by the business judgment standard employed by courts in determining whether to permit the debtor to assume or reject the contract").

Lenders should monitor which contracts are being assumed or rejected during a bankruptcy case. In fact, DIP facilities often include a provision requiring the debtor to confer with the DIP lenders before assuming or rejecting contracts. Only those contracts that are necessary for the company's ongoing business should be assumed; other contracts that are burdensome or unnecessary to the company's reorganization should be rejected. This determination is typically fact specific regarding the particular contract in question and involves a detailed analysis of the contract. Contracts may be assumed or rejected only in whole and not in part (i.e., the debtor may not "cherry pick" benefits and avoid burdens; all benefits and burdens must be assumed or rejected).