AMERICAN BANKRUPTCY INSTITUTE

Southeast Bankruptcy Workshop

Tragedy of a Lender Liability Claim: A Play in Three Parts

CONCURRENT SESSION

Hon. Jeffery W. Cavender
U.S. Bankruptcy Court (N.D. Ga.) | Atlanta

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2022

7/13/2022

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American Bankruptcy Institute
27th Annual Southeast Bankruptcy Workshop
July 21-24 | Amelia Island, FL

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4 **What is lender liability?**

a. It doesn't exist.
b. A good reason not to repay a loan.
c. You know it when you see it.

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5 **Insurance Claims**

- Lender Liability Endorsement
  - Covers loss resulting from claims brought by borrowers or guarantors due to errors, omissions, misstatements, neglect or breach of duty involving extensions of credit, loan servicing, or incidental insurance services related to the issuance of a loan.
- "Broad Form" Coverage
  - Extends to suits brought by other persons or entities that may be damaged as a result of the lending or foreclosure process.

6 **Insurance Claims *(cont'd)***

- Roughly 40% of paid bank D&O insurance claims fall under Lender Liability Endorsement
- 50% of lender liability paid claims are brought by commercial borrowers
- 18% of paid claims arise from construction lending

7 **ACT ONE: In the Beginning**
Peace and Harmony

"I would not wish any companion
in the world but you."

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8 **The Loan Agreement**

- Venue
- Arbitration
- Limits on Damages
- Attorneys' Fees
- Contractual choice of law provision

9 **<u>Section X</u>. Governing Law**

This Agreement shall be governed by, and construed in accordance with, the law of the State of New York and the validity, interpretation, construction, and performance hereof shall be governed by and

construed and enforced in accordance with, and any claim by any party hereto against any other party (including any claims sounding in contract or tort law arising out of the subject matter hereof and any determinations with respect to post-judgment interest) shall be determined in accordance with, the internal laws of the State of New York for contracts made and to be performed wholly within the State of New York (excluding the laws applicable to conflicts or choice of law that would require the application of the law of any other jurisdiction).

•

10 **Jury Trial Waiver**

Pre-dispute jury-trial waivers are unenforceable under state law in:

- Georgia. *Bank S., N.A. v. Howard*, 264 Ga. 339, 444 S.E.2d 799 (1994)
- California. *Grafton Partners v. Superior Court*, 36 Cal. 4th 944, 32 Cal. Rptr. 3d 5, 116 P.3d 479 (2005)
- North Carolina. N.C. Gen. Stat. § 22B-10

However, contractual choice-of-law provisions may allow for enforcement of waivers in these states. Similarly, because federal courts have found the law governing jury trial waivers in federal court to be procedural—evaluated under the "knowing and voluntary" standard—federal courts sitting in diversity *might* enforce an otherwise unenforceable waiver. *Cnty. of Orange v. United States Dist. Court*, 784 F.3d 520, 531-32 (9th Cir. 2015). The analysis as to the enforceability of a waiver in federal court is nuanced and there is not a uniform approach in the different circuits.

11 **ACT TWO: Onset of Financial Distress *Seeds of Despair***

"And oftentimes excusing of a fault
Doth make the fault the worse by the excuse,
As patches set upon a little breach
Discredit more in hiding of the fault
Than did the fault before it was so patch'd."

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12 **Imminent or Existing Default Stage**

- Pre-negotiation agreements
- Loan officers versus special assets
- Role of non-lawyer consultants
  - Representing Lender, Borrower or Fiduciary?

13 **What NOT to do…**

- Wrongful refusal to honor loan commitment, fund or renew loan
- Negligent processing or administering loan
- Selling collateral below market value
- Wrongful or improper foreclosure or setoff
- Interfering with borrower's operations or relationships with third parties

14 **Recent Broadway Hits**

1 • Excessive involvement in borrower's business

– *Bailey Tool & Mfg. Co. v. Republic Bus. Credit*, 2021 WL 6101847 (Bankr. N.D. Tex. Dec. 23, 2021)

•

2 • Violation of automatic stay or discharge injunction

– *In re DiBattista*, 33 F.4th 698 (2d Cir. 2022)

– *Compare HH Mortgage Corp. v. Sensenich*, 6 F.4th 503 (2d Cir. Aug. 2, 2021)

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15 **ACT THREE:**
Assertion of Liability
Gloves Off

"I'll fight till from my bones
my flesh be hacked."

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Cast
Who's the plaintiff?
Debtor, guarantor,
creditor, trustee
Impact of releases in forbearance stage

17 **Plot**

•

• Breach of contract
• Tortious interference with contract
• Breach of implied covenant of good faith and fair dealing
• Breach of fiduciary duty
• Fraud or fraudulent transfer
• Equitable subordination
• Debt recharacterization

18 **Counterplot**

•

19 **Lender on Lender Violence - Uptiering**

o Recalcitrant lenders in a bank group or class (could be unitranche or a syndicated group) OR the Agent has a more nefarious outcome in mind

o To get the deal it wants, Agent puts consenting and non-consenting lenders in different tiers within the same class in a proposed Plan – different priority levels and changes to the waterfall

Query: can the agent overcome the "sacred rights" voting rights in a credit agreement through this mechanism to change the waterfall?

20 **Uptiering *(cont'd)***

- Mechanism only works via a bankruptcy plan where 2/3rds of class approves plan over objection of non-consenting 1/3. Section 1126(c).

  Query: Can a plan treat members of the same class differently? Should the non-consenting lenders be a different class?
- Can Section 1129(b)(1) be used to overcome this tactic?

21 **SERTA TRANSACTION**

22 **SERTA *(cont'd)***

The Transaction created two new tranches of debt, both of which ranked ahead of the existing first-lien loans: (i) a new-money tranche comprising $200 million of new-money financing and (ii) an exchange tranche comprising $875 million of loans created through an exchange of the Participating Lenders' first- and second-lien loans.

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As a result of the Transaction, the Participating Lenders hold at least $1.075 billion of super-priority loans with rights senior to those of the remaining first-lien lenders, including Plaintiffs.

In order to effectuate the Transaction, Defendant garnered the approval of the Participating Lenders to amend the Agreement to allow Defendant to incur the PTL Loans (the "Amendments"). Among other things, the Amendments modified the definition of "Incremental Equivalent Debt" permissible under the Agreement to include "Indebtedness issued under the PTL Credit Agreement … which may be senior, pari passu or junior in right of payment and/or with respect to security with the Obligations hereunder[.]" The Amendments also altered Section 8.08 of the Agreement to authorize the Administrative Agent to enter into a separate intercreditor agreement establishing senior payment priority for the PTL Loans (the "PTL Intercreditor Agreement"). Furthermore, the Amendments added a new subpart to Section 2.11(b), the provision outlining the circumstances triggering mandatory prepayment of the first-lien loans, which affirmed that the PTL Loans had rights of payment senior to that of the first-lien lenders. In addition, the Amendments excised Section 7.01(l) from the Agreement, which provision previously designated subordination of the first-lien loans as an event of default.

23 **Changes to Ratable Sharing**

Plaintiffs Assert Violation of Sacred Right to Ratable Sharing:

> [T]he consent of each Lender directly and adversely affected thereby (but not the consent of the Required Lenders) shall be required for any waiver, amendment or modification that…waives, amends or modifies the provisions of Sections 2.18(b) or (c) [i.e., the waterfall] of this Agreement in a manner that would by its terms alter the pro rata sharing of payments required thereby (except in connection with any transaction permitted under Sections 2.22, 2.23, 9.02(c), and/or 9.05(g) or as otherwise provided in this Section 9.02…). (Agreement § 9.02(b)(A)(6)) (emphasis added)

24 **Exceptions to Sacred Right to Ratable Sharing**

- Section 2.22 provides that Defendant can issue incremental credit facilities, so long as the new

debt is *pari passu* or junior to the first-lien loans. (Agreement § 2.22(a)(x))

- Section 2.23 permits Defendant to extend the maturity on existing first-lien loans, so long as the extension offer is made to all first-lien lenders on the same terms and the extended loans are *pari passu* with existing first-lien loans. (Agreement § 2.23(a)-(c))
- Section 9.02(c) empowers Defendant to refinance or replace "all or any portion of the outstanding Term Loans under the applicable Class … with one or more replacement term loans … pursuant to a Refinancing Amendment," subject to the requirement that such replacement loans be *pari passu* or junior to the existing first-lien loans. (Agreement § 9.02(c)(i)(C))

25 **Exceptions to Sacred Right to Ratable Sharing *(cont'd)***

- Section 9.05(g) (emphasis added):

  > [A]ny Lender may, at any time, assign all or a portion of its rights and obligations under this Agreement in respect of its Term Loans to any Affiliated Lender on a non-pro rata basis (A) through Dutch Auctions open to all Lenders holding the relevant Term Loans on a pro rata basis or (B) through open market purchases, in each case with respect to clauses (A) and (B), without the consent of the Administrative Agent[.]. (Agreement § 9.05(g)) (emphasis added)

  - Dutch auctions - A type of auction in which all lenders may participate in a sale of loans to borrower in an open auction where a price is offered to all and then adjusted upwards until it hits a level at which willing sellers emerge.
  - Open market purchases - Allows borrower or affiliate to repurchase debt trading in secondary market as a means of effectively retiring debt at a discount no lender requirement to sell.
- The Agreement defines "Affiliated Lender" as any "Non-Debt Fund Affiliate" (i.e., any investor who directly or indirectly controls Serta or an affiliate of such investor), Dawn Intermediate, LLC, Serta, or any of Serta's subsidiaries.

26 **Serta Arguments and Recent Decision**

Defendant contends that the Transaction qualifies as an open-market purchase of the Participating Lenders' loans, which types of transactions are authorized by the plain terms of Section 9.05(g). Plaintiffs submit that no facet of the Transaction occurred in the open market, as Defendant negotiated it in private with only a subset of lenders and arrived at a price that was not set by market forces.

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[T]he Court cannot conclude based on the contractual context, the plain meaning of the words "open market," and the materials cited by the parties that Defendant has proffered the "definite and precise meaning" of the term "open market purchase" about "which there is no reasonable basis for a difference of opinion.".

LCM XXII Ltd. v. Serta Simmons Bedding, Ltd. Liab. Co., 21 Civ. 3987 (S.D.N.Y. Mar. 29, 2022).

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27 ***In re TPC Group Inc.***

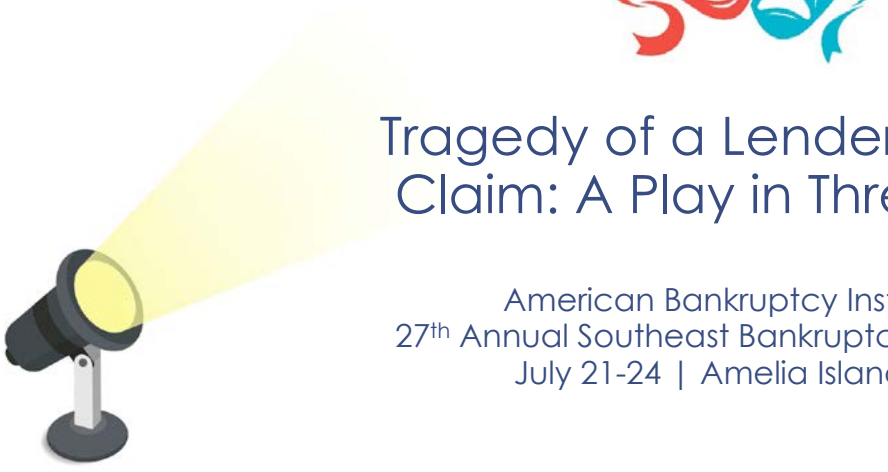
- Ratable sharing provisions "should not be read as an anti-subordination provision in disguise."
- "To the extent such holders want to be protected against self-interested actions by borrowers and other holders, they must include such protections in the terms of their agreements."

Bayside Capital Inc. v. TPC Group Inc., 22-50372 (Bankr. D. Del. July 6, 2022).

28 **Moral of the Story**

"Neither a borrower nor a lender be;
For loan oft loses both itself and a friend,
And borrowing dulls the edge of husbandry."

- William Shakespeare, *Hamlet*



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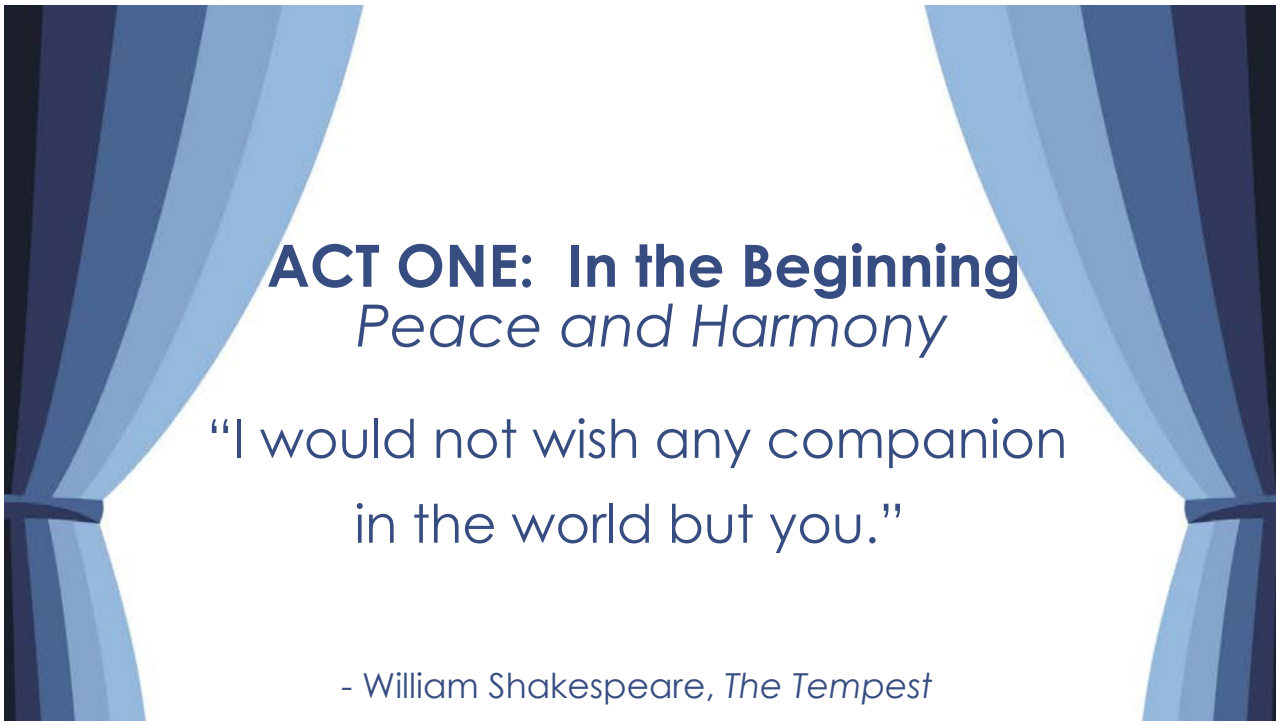
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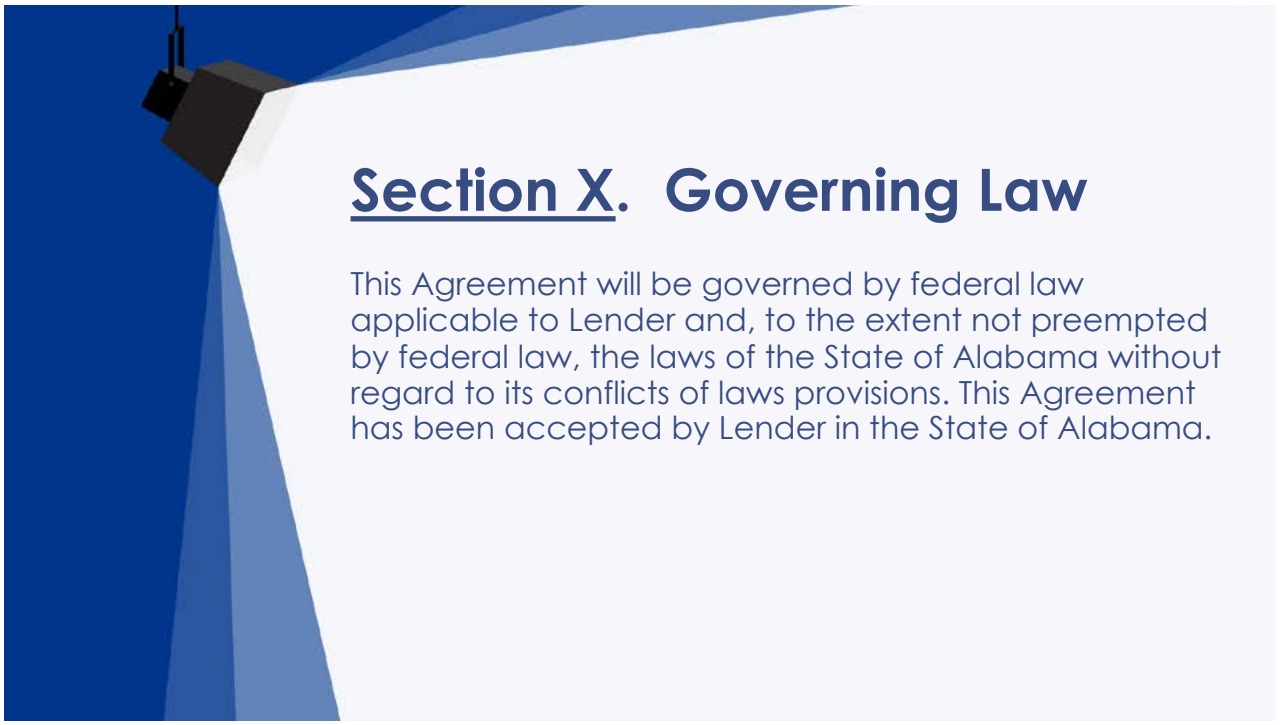

Section X. Governing Law

This Agreement will be governed by federal law applicable to Lender and, to the extent not preempted by federal law, the laws of the State of Alabama without regard to its conflicts of laws provisions. This Agreement has been accepted by Lender in the State of Alabama.

Jury Trial Waiver

Pre-dispute jury-trial waivers are unenforceable under state law in:

- Georgia. *Bank S., N.A. v. Howard*, 264 Ga. 339, 444 S.E.2d 799 (1994)
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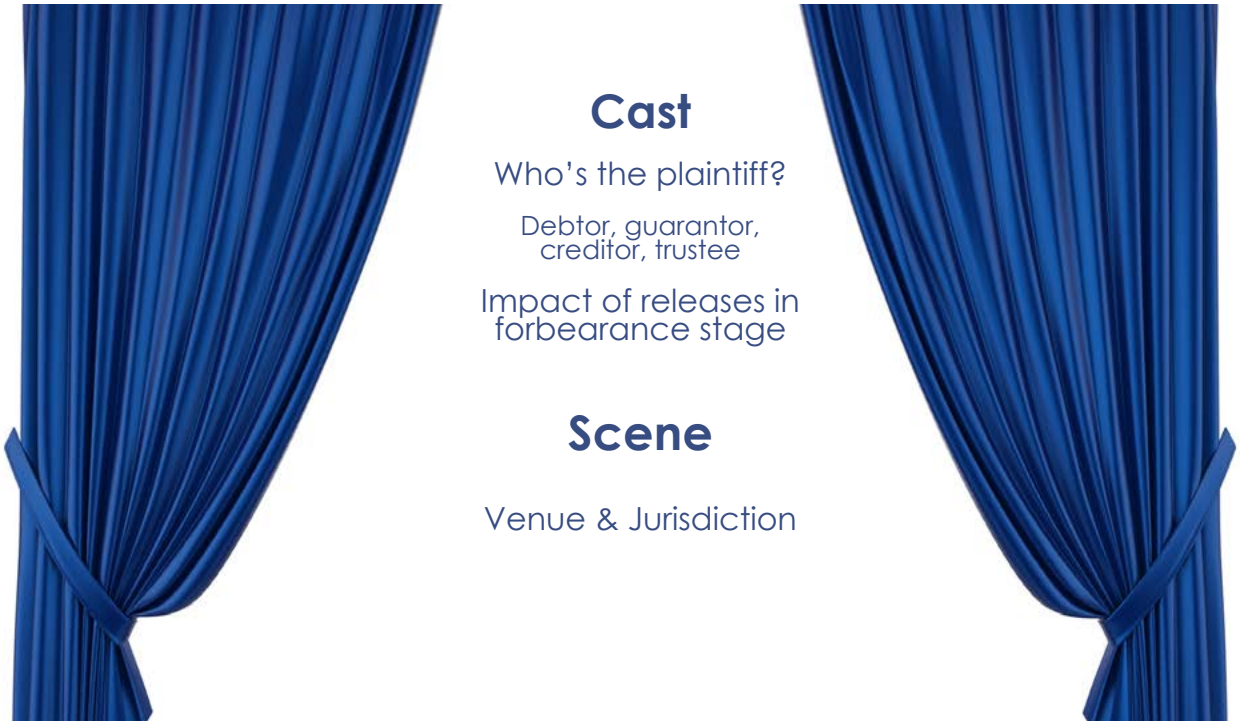

Cast

Who's the plaintiff?

Debtor, guarantor, creditor, trustee

Impact of releases in forbearance stage

Scene

Venue & Jurisdiction

Plot

- Breach of contract
- Tortious interference with contract
- Breach of implied covenant of good faith and fair dealing
- Breach of fiduciary duty
- Fraud or fraudulent transfer
- Equitable subordination
- Debt recharacterization

Counterplot

- **What damages are available?**
- **Proof of damages**
- **Advice of counsel**
  Beckhart v. NewRez LLC, 31 F.4th 274 (4th Cir. 2022)
- **In pari delicto**
  Anderson v. Morgan Keegan & Co. (In re Infinity Business Group Inc.), 21-1536 (4th Cir. April 19, 2022)

Lender on Lender Violence - Uptiering

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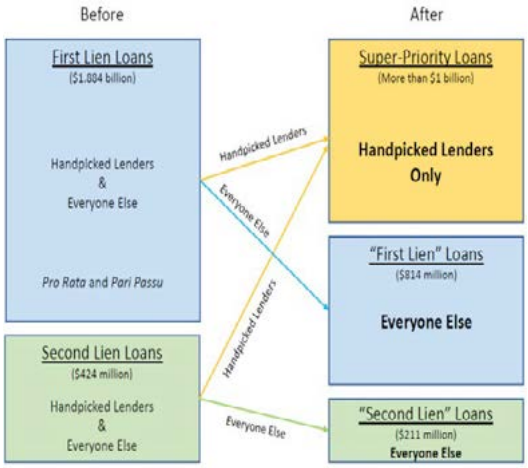

Pl.'s Mem. of Law in Opp'n to Def's Mot. to Dismiss at 4, *LCM XXII Ltd. v. Serta Simmons Bedding, LLC.* (S.D.N.Y. Mar. 29, 2022) (No. 21 Civ. 3987).

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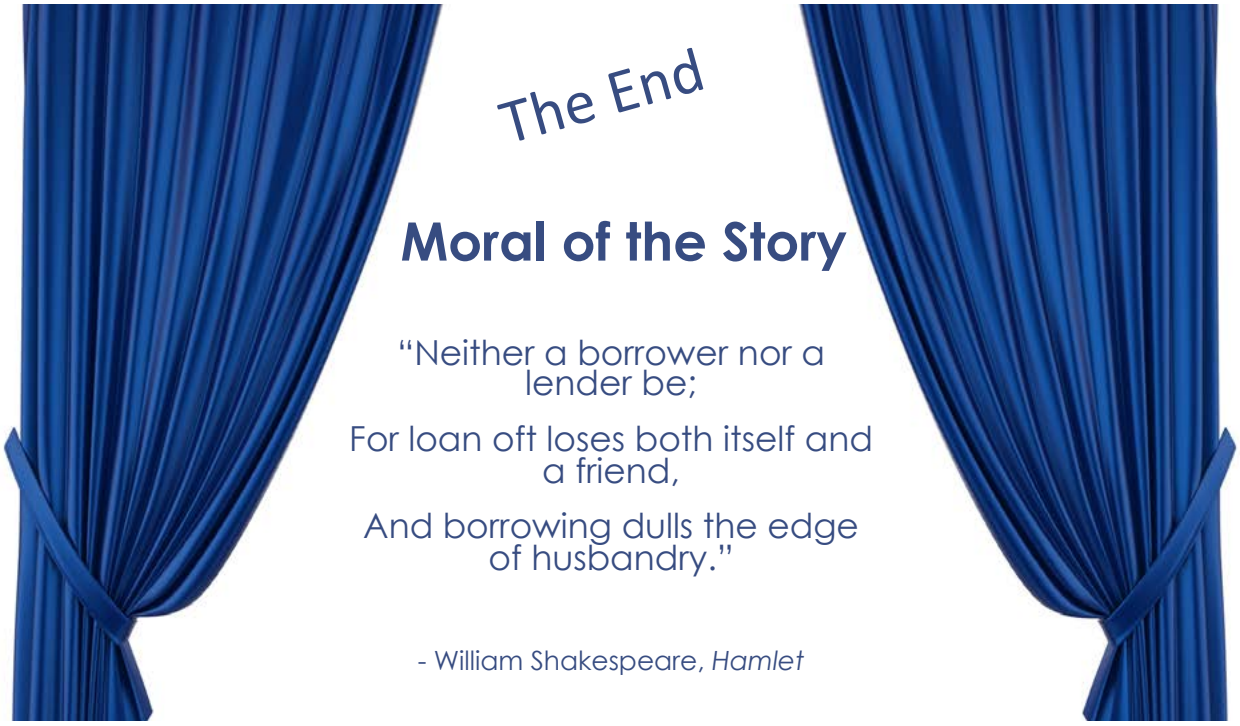

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> "Courts have grappled with the question of lender liability in a wide variety of situations, such that the catch-phrase 'lender liability' has now taken on a broad meaning to refer to any kind of liability that can grow out of the lender/borrower relationship." *Pearson v. Component Tech. Corp.*, 247 F.3d 471, 492 (3d Cir. 2001).

I. ACT ONE: In the Beginning - *Peace and Harmony*

- Relevant terms in the loan agreement
  - Contractual choice of law provision. Example:

    Section X. **Governing Law**. This Agreement shall be governed by, and construed in accordance with, the law of the State of New York and the validity, interpretation, construction, and performance hereof shall be governed by and construed and enforced in accordance with, and any claim by any party hereto against any other party (including any claims sounding in contract or tort law arising out of the subject matter hereof and any determinations with respect to post-judgment interest) shall be determined in accordance with, the internal laws of the State of New York for contracts made and to be performed wholly within the State of New York (excluding the laws applicable to conflicts or choice of law that would require the application of the law of any other jurisdiction).
  - Jury trial waiver
    - Pre-dispute jury-trial waivers are unenforceable under state law in:
      - Georgia. *Bank S., N.A. v. Howard*, 264 Ga. 339, 444 S.E.2d 799 (1994)
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    - However, contractual choice-of-law provisions may allow for enforcement of waivers in these states. Similarly, because federal courts have found the law governing jury trial waivers in federal court to be procedural—evaluated under the "knowing and voluntary" standard—federal courts sitting in diversity *might* enforce an otherwise enforceable waiver. *Cnty. of Orange v. United States Dist. Court*, 784 F.3d 520, 531-32 (9th Cir. 2015). The analysis as to the enforceability of a waiver in federal court is nuanced and there is not a uniform approach in the different circuits.
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  - Damages
  - Attorneys' Fees

II. ACT TWO: Onset of Financial Distress - *Seeds of Despair*

- Hit list - popular ways for lender to buy trouble:
  - Insist borrower pay secured lender but continue accruing debt to trade creditors
  - Tell borrower who to hire/fire (management, turnaround consultants)
  - Actively participate in or take control of business operations ("instrumentality theory")
    - Excessive lender control: *Bailey Tool & Mfg. Co. v. Republic Bus. Credit* (*In re Bailey Tool & Mfg. Co.*), 2021 WL 6101847 (Bankr. N.D. Tex. Dec. 23, 2021) ($17 million in damages including full enterprise value of debtor's business, lost profits, administrative expenses, punitive damages)
  - Assume role of property manager
  - Declare default based on technical or non-monetary breach of loan agreement
    - Insecurity clauses
      A term in a security agreement giving the creditor an option to accelerate payment or performance - either at will or when the creditor deems itself to be insecure - means that the option is to be exercised only under a good-faith belief that the prospect of payment or performance is impaired. U.C.C. § 1-309.
  - Premature or improper exercise of right to collect from account debtors or tenants
  - Suddenly declare default based only on a default that lender ignored in past
  - Share confidential information about borrower with a competitor, tenants, etc.
  - Communicate and align with subset/only one faction of divided borrower group
  - Negotiate with third parties about sale of collateral without notice to borrower
  - Fail to comply with notice and right to cure provisions in loan agreement
  - Freeze line of credit/revolver without justification under loan agreement
  - Improper setoff of deposit account
  - Commence foreclosure or repossession based on defective security interest
  - Make oral loan modifications or assurances regarding forbearance
  - File collection action in midst of workout negotiations
  - Serve as petitioning creditor in involuntary bankruptcy
  - Violate the automatic stay or discharge injunction
    - *In re DiBattista*, 33 F.4th 698 (2d Cir. 2022) (debtor entitled to recover attorneys' fees for successful appeal from bankruptcy court order holding creditor in contempt of discharge injunction)
      - *Compare HH Mortgage Corp. v. Sensenich* (*In re Gravel*), 6 F.4th 503 (2d Cir. Aug. 2, 2021) (debtor may recover only compensatory damages, not contempt sanctions, for issuing inaccurate monthly mortgage statements in violation of Bankruptcy Rule 3002.1)
    - *Anderson v. Credit One Bank N.A.* (*In re Anderson*), 15-08214 (Bankr. S.D.N.Y. June 3, 2022) (bankruptcy court can entertain a nationwide class action for violations of the discharge injunction)
  - Lend money to borrower with history of litigation with former lenders

- Use of pre-negotiation agreements

  - Avoids disputes about alleged oral agreements and allows borrowers and lenders to engage in open negotiations without fear of being bound until a formal written agreement is executed
    - Discussions are confidential
    - Non-binding until fully executed written agreement documenting workout terms
    - Discussions may be terminated at any time for any reason
    - Discussions are inadmissible in a court proceeding
    - May include waivers and releases

- Role of front-end loan officer versus special assets
  - Lender's employee may take action that binds the lender and exposes it to liability even if the employee lacked actual authority.
    - Doctrines of apparent authority, implied authority, agency by estoppel, ratification
      - *Sarkes Tarzian, Inc. v. U.S. Trust Company of Florida Savings Bank*, 397 F.3d 577, 583 (7th Cir. 2005) (apparent authority is created by principal's words or conduct communicated to third party that give rise to appearance and belief that agent possesses authority to enter into transaction)

- Role of non-lawyer consultants (turnaround manager, forensic accountant)

- FA can represent either Lender, Borrower or Fiduciary
  - FA Representing Lender
    - Investigate and evaluate Borrower's ability to service and repay debt
    - Existence of collateral
    - Evaluation of guarantor's ability to repay/perform
  - FA Representing Borrower
    - Turnaround services
    - Chief Restructuring Officer
      - Provides Lender comfort that an objective party is in charge
      - Objective evaluation of Borrower's ability to service debt
      - Problems may be a result of management wrongdoing
      - Evaluate restructuring options
        - Bankruptcy
        - Assignment for Benefit of Creditors
        - Receiver
        - Out of court workouts
  - FA Representing Fiduciary
    - Lender liability investigation
    - Collateral fraud schemes
      - Borrowers use fake collateral to obtain loan
      - Lender eventually becomes aware but instead of making the fraud known, encourages Borrower to obtain alternative financing, thus harming other creditors
    - Ponzi schemes or other investment schemes (consumer fraud schemes)
      - Did Lender provide funds in the form of loans that were used to further the fraud?

- Did Lender require Borrower to keep bank accounts at same financial institution?
  - Where the accounts used to conduct/facilitate the Ponzi scheme?
  - Transactions in accounts have characteristics of Ponzi or check kiting scheme?
    - Overdrafts
    - Large round dollar transfers
    - Investor deposits
    - No source of actual business-related income
    - Lack of due diligence on behalf of the bank – Know Your Customer
    - Red flags/suspicious activity reports
    - Bank representative participation
- Did Lender have knowledge of Ponzi but stayed silent?

III. ACT THREE: Assertion of Liability - *Gloves Off*

- Who is the plaintiff?
  - Debtor, guarantor, creditor, trustee
    - Standing of guarantor: *Katzoff v. BSP Agency, LLC*, No. 655823/2020, 2021 WL 6097450, at *3 (N.Y. Sup. Ct. Dec. 22, 2021) (guarantor lacked standing)

- Venue & Jurisdiction – forum selection, removal, availability of certain defenses

- Liability Theories
  - Breach of contract
  - Tortious interference with contract
  - Equitable subordination and debt recharacterization
    - *In re Linn Energy, LLC*, 936 F.3d 334 (5th Cir. Sept. 3, 2019) (claimant's right to receive percentage of debtor's profits as a "deemed dividend" was in nature of "security" and subject to mandatory subordination pursuant to provision of the Bankruptcy Code)
      - *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), cert. granted, 137 S.Ct. 2326 (2017), cert. dismissed as improvidently granted, 138 S. Ct. 41 (2017) (bankruptcy court's decision to recharacterize the $300,000 contributed by LLC's members to pay off earlier loan as equity contribution to debtor was sufficiently supported by evidence, including identity of interest that existed between debtor and LLC, of debtor's inability to obtain financing from any other source, and parties' failure to observe such formalities as payment schedules, actual interest payments or even a ledger)
  - Breach of implied covenant of good faith and fair dealing
    - refusing to release a deed of trust in an effort to pressure the borrower into paying off another loan
    - manipulating an appraisal of the borrower's property to cause a default

- Duty sounding in negligence to process, review and respond to borrower's loan modification application
  - *Sheen v. Wells Fargo Bank, N.A*., 12 Cal. 5th 905, 505 P.3d 625 (2022), reh'g denied (June 1, 2022) (no such duty under CA law in consumer mortgage context)
- Fraudulent or constructively fraudulent transfer
  - A transfer of property was made by the debtor
  - Debtor received no value in exchange for transfer
  - Insolvency at time of transfer (or as a result thereof)
    - Ponzi scheme presumption – does this apply to Ponzi like schemes?
    - Balance sheet test can be a back-up test
    - *Friedman v. Wellspring Capital Management, LLC*, Adv. Pro. No. 19-80071 (Bankr. D.S.C.) Order Granting Motion to Reconsider and Alter or Amend the Judgment (Oct. 14, 2020) [Doc 149] (to survive a motion to dismiss in a constructive fraudulent transfer action based on South Carolina's Statute of Elizabeth, S.C. Code § 27-23-10, plaintiff was not required to plead insolvency at the time of the transfer)
  - For actual fraud – knowledge or badges of fraud
    - Lender had knowledge of the fraud, or should have known
- Breach of fiduciary duty
  - Does Lender have a fiduciary duty and to whom?
    - Elements:
      - borrower places faith, confidence, and trust in the bank,
      - borrower is in an unequal position and has weakness or lack of knowledge, and
      - bank exercises dominion, control, or influence over the borrower's business affairs
  - Fiduciary duties of equity
    - *In re Ashinc Corp*., 629 B.R. 154, 168 (Bankr. D. Del. 2021) (litigation trustee allowed to prosecute breach of fiduciary duty claim against Chapter 11 debtor's controlling equity holder and breach of contract claim because not duplicative claims)

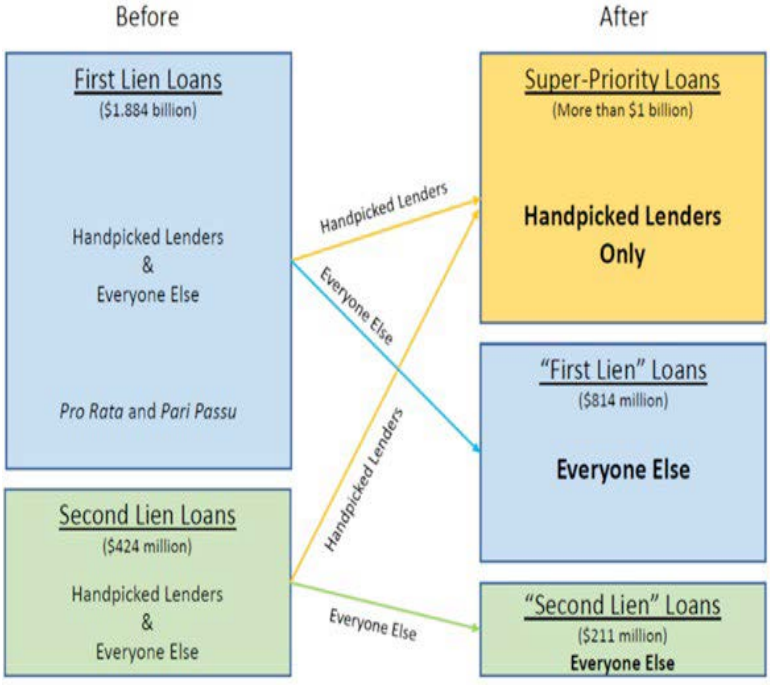
- Defenses
  - Contractual limitation on damages
  - Parole Evidence Rule
    - Partial performance of oral modifications may render modifications enforceable, and equitable estoppel may prevent a party from denying the existence of a modification
      - *New Canaan Bank & Trust v. Pfeffer*, 147 N.H. 121, 784 A.2d 704 (2001) (Co-maker on note successfully asserted defense of equitable estoppel to prevent bank from pursuing him for the remaining amount due on promissory note after he paid bank half of the debt and received a promise from bank that it would aggressively pursue the co-maker, which bank failed to do.)
  - Advice of counsel
    - *Beckhart v. NewRez LLC*, 31 F.4th 274 (4th Cir. 2022) (advice of counsel not a complete defense to civil contempt in bankruptcy court)

- Lender's conduct appropriate exercise of rights in loan agreement
  - *In re Bal Harbour Quarzo, LLC*, 623 B.R. 903 (2020) (even if lender knew of borrower's financial distress or potential fraud and lender's actions resulted in unsecured creditors recovering little on their claims, lender liability claims dismissed under Rule 12(b)(6) because lender did nothing more than seek to minimize losses, maximize recovery, and extricate itself from troubled lending relationship)
- What damages are available?
- Proof of damages (experts?)
  - How to Calculate Damages
    - Who was harmed?
      - Creditors or Borrower
      - In Pari Delicto
        - *Anderson v. Morgan Keegan & Co.* (*In re Infinity Business Group Inc.*), 21-1536 (4th Cir. April 19, 2022) (trustee not immune from in pari delicto simply because he represented debtor's presumptively blameless creditors as well as debtor)
    - Basis for damages
      - Deepening insolvency
      - Investor liability
      - All funds deposited into bank accounts

- "Lender-on-Lender Violence"
  - Up Tiering: Basic Facts/Where Mechanism Occurs
    - Recalcitrant lenders in a bank group or class (could be unitranche or a syndicated group) OR the Agent has a more nefarious outcome in mind
    - To get the deal it wants, Agent puts consenting and non-consenting lenders in different tiers within the same class in a proposed Plan – different priority levels and changes to the waterfall
      - Query: can the agent overcome the "sacred rights" voting rights in a credit agreement through this mechanism to change the waterfall?
    - Mechanism only works via a bankruptcy plan where 2/3rds of class approves plan over objection of non-consenting 1/3. Section 1126(c).
      - Query: Can a plan treat members of the same class differently? Should the non-consenting lenders be a different class?
    - Can Section 1129(b)(1) be used to overcome this tactic?

- *Bayside Capital Inc. v. TPC Group Inc.* (*In re TPC Group Inc.*), *22-50372 (Bankr. D. Del. July 6, 2022):*
  - "If one were simply looking at the words in isolation, reasonable arguments could be made on either side."
  - "As a commercial matter, there are ample reasons why a lender might agree to subordinate its lien to one in favor of a new lender."
  - "As a matter of ordinary logic, an agreement to subordinate thus seems far less drastic than releasing all of the collateral. It therefore would not make sense to read the document to permit a two-thirds majority to take a more drastic action but give every holder the right to block the less extreme measure."
  - Ratable sharing provisions "should not be read as an anti-subordination provision in disguise."
  - "To the extent such holders want to be protected against self-interested actions by borrowers and other holders, they must include such protections in the terms of their agreements."

- *Serta* Case Study
  - Pl.'s Mem. of Law in Opp'n to Def's Mot. to Dismiss at 4, *LCM XXII Ltd. v. Serta Simmons Bedding, LLC.* (S.D.N.Y. Mar. 29, 2022) (No. 21 Civ. 3987):



  - The Serta Transaction created two new tranches of debt, both of which ranked ahead of the existing first-lien loans: (i) a new-money tranche comprising $200 million of new-money financing and (ii) an exchange tranche comprising $875 million of loans created through an exchange of the Participating Lenders' first- and second-lien loans.

- As a result of the Transaction, the Participating Lenders hold at least $1.075 billion of super-priority loans with rights senior to those of the remaining first-lien lenders, including Plaintiffs.

- In order to effectuate the Transaction, Defendant garnered the approval of the Participating Lenders to amend the Agreement to allow Defendant to incur the PTL Loans (the "Amendments"). Among other things, the Amendments modified the definition of "Incremental Equivalent Debt" permissible under the Agreement to include "Indebtedness issued under the PTL Credit Agreement … which may be senior, pari passu or junior in right of payment and/or with respect to security with the Obligations hereunder[.]" The Amendments also altered Section 8.08 of the Agreement to authorize the Administrative Agent to enter into a separate intercreditor agreement establishing senior payment priority for the PTL Loans (the "PTL Intercreditor Agreement"). Furthermore, the Amendments added a new subpart to Section 2.11(b), the provision outlining the circumstances triggering mandatory prepayment of the first-lien loans, which affirmed that the PTL Loans had rights of payment senior to that of the first-lien lenders. In addition, the Amendments excised Section 7.01(l) from the Agreement, which provision previously designated subordination of the first-lien loans as an event of default.

- Changes to Ratable Sharing
  - Plaintiffs Assert Violation of Sacred Right to Ratable Sharing:
    > [T]he consent of each Lender directly and adversely affected thereby (but not the consent of the Required Lenders) shall be required for any waiver, amendment or modification that…waives, amends or modifies the provisions of Sections 2.18(b) or (c) [i.e., the waterfall] of this Agreement in a manner that would by its terms alter the pro rata sharing of payments required thereby (except in connection with any transaction permitted under Sections 2.22, 2.23, 9.02(c), and/or 9.05(g) or as otherwise provided in this Section 9.02…). (Agreement § 9.02(b)(A)(6)) (emphasis added)

- Exceptions to Sacred Right to Ratable Sharing
  - Section 2.22 provides that Defendant can issue incremental credit facilities, so long as the new debt is *pari passu* or junior to the first-lien loans. (Agreement § 2.22(a)(x))
  - Section 2.23 permits Defendant to extend the maturity on existing first-lien loans, so long as the extension offer is made to all first-lien lenders on the same terms and the extended loans are *pari passu* with existing first-lien loans. (Agreement § 2.23(a)-(c))
  - Section 9.02(c) empowers Defendant to refinance or replace "all or any portion of the outstanding Term Loans under the applicable Class … with one or more replacement term loans … pursuant to a Refinancing Amendment,"

subject to the requirement that such replacement loans be *pari passu* or junior to the existing first-lien loans. (Agreement § 9.02(c)(i)(C))

- Section 9.05(g) (emphasis added):

  > [A]ny Lender may, at any time, assign all or a portion of its rights and obligations under this Agreement in respect of its Term Loans to any Affiliated Lender on a non-pro rata basis (A) through Dutch Auctions open to all Lenders holding the relevant Term Loans on a pro rata basis or (B) through **open market purchases**, in each case with respect to clauses (A) and (B), without the consent of the Administrative Agent[.]. (Agreement § 9.05(g)) (emphasis added)

  - Dutch auctions - A type of auction in which all lenders may participate in a sale of loans to borrower in an open auction where a price is offered to all and then adjusted upwards until it hits a level at which willing sellers emerge.
  - Open market purchases - Allows borrower or affiliate to repurchase debt trading in secondary market as a means of effectively retiring debt at a discount no lender requirement to sell.
- The Agreement defines "Affiliated Lender" as any "Non-Debt Fund Affiliate" (i.e., any investor who directly or indirectly controls Serta or an affiliate of such investor), Dawn Intermediate, LLC, Serta, or any of Serta's subsidiaries.

▪ Serta Arguments and Recent Decision

- Defendant contends that the Transaction qualifies as an open-market purchase of the Participating Lenders' loans, which types of transactions are authorized by the plain terms of Section 9.05(g). Plaintiffs submit that no facet of the Transaction occurred in the open market, as Defendant negotiated it in private with only a subset of lenders and arrived at a price that was not set by market forces.

  > [T]he Court cannot conclude based on the contractual context, the plain meaning of the words "open market," and the materials cited by the parties that Defendant has proffered the "definite and precise meaning" of the term "open market purchase" about "which there is no reasonable basis for a difference of opinion.".

  LCM XXII Ltd. v. Serta Simmons Bedding, Ltd. Liab. Co., 21 Civ. 3987 (S.D.N.Y. Mar. 29, 2022).

- Court Denies Motion to Dismiss Breach of Contract and Breach of Implied Covenant of Good Faith and Fair Dealing claims

The ten commandments of lender liability avoidance (44 Am. Jur. Trials 613 § 23):

1. We are real interested, but I ain't shaking hands. Commandment No. 1 goes to the avoidance of any conduct or activity, including oral conversations (even cocktail chatter), that can be construed as a commitment to lend prior to the making of an actual written commitment.

2. Why do you want the dough? Commandment No. 2 goes to the need to scrutinize carefully the purpose of the loan. If the investment for which the customer borrowed money fails, the bank often does not get paid.

3. Send me a postcard. Commandment No. 3 goes to the fact that a common source of litigation is the oral commitment, the oral misrepresentation, or the oral modification. The point is to confirm in writing anything of significance.

4. Do good docs, and stick to 'em. Commandment No. 4 goes to the importance of carefully drafted documents and the need not to waive any provisions of the documents.

5. Comm-you-nee-kate. Commandment No. 5 relates to the standard need in business for consistent communication so that the lender knows what is happening with the borrower and the borrower knows that the lender is relying on and will seek to enforce the transaction as documented. It also stresses the need for officers of the lending institution to talk with one another.

6. Treat the second team nice. Commandment No. 6 involves the importance of dealing with guarantors, who may have special legal defenses.

7. "Yoo-hoo, Mrs. Goldberg ...," or, Stay away from the back fence. Commandment No. 7 goes to the importance of confidentiality in the lending transaction and the imperative that confidential information remain confidential. This includes not sharing information with any other creditors of the debtor or with any other customers of the lending institution.

8. You only go around once, or, It ain't gonna get any better. Commandment No. 8 goes to the importance of making a prompt and firm decision not to give pointless extensions to the borrower in the hope that things will get better. Often, there is great pressure on the lending officer who made the loan to make sure that the loan is paid back and, in the effort to get it paid back, he or she may make unwarranted concessions based on increasingly ill-founded hopes.

9. Whose business is this, anyway? Commandment No. 9 involves the importance of not becoming involved in any fashion in controlling, managing, or running the borrower's enterprise.

10. End the tango with style and grace. The last commandment goes to terminating the relationship, and communicating the termination, without suddenly stranding the borrower, misleading the borrower, or bailing the lender out at the borrower's expense. It also goes to avoiding personality conflicts.

Faculty

Hon. Jeffery W. Cavender is a U.S. Bankruptcy Judge for the Northern District of Georgia in Atlanta, sworn in on March 2, 2018. Prior to his appointment to the bench, he was a partner in the financial restructuring practice of Troutman Sanders LLP, where he primarily represented corporate debtors and secured lenders in chapter 11 cases and mortgage servicers in consumer-related litigation and bankruptcy matters. Judge Cavender previously was a partner in the bankruptcy group of McKenna Long & Aldridge LLP (n/k/a Dentons LLP) and served as the general counsel for a national mortgage company. He chaired the Bankruptcy Section for the Atlanta Bar Association from 2017-18 and was a member of its board of directors from 2012-18. During Judge Cavender's tenure as chair, the Atlanta Bar Bankruptcy Section was named the national CARE chapter of the year and received the Pro Bono Award for Excellence and the Small Section of the Year Award from the Atlanta Bar. He is an active member of ABI, having previously served on the advisory committee for its Southeast Bankruptcy Workshop. He currently serves as the chair of the Membership Services Committee for the National Conference of Bankruptcy Judges and on the Federal Judicial Center's Bankruptcy Judges Education Advisory Committee. Judge Cavender received his undergraduate degree in history *summa cum laude* in 1990 from Berry College, and his J.D. *cum laude* from the University of Georgia School of Law in 1993, where he was a member of the *Georgia Law Review* and was inducted into the Order of the Coif.

Soneet R. Kapila is a founding partner of KapilaMukamal, LLP in Fort Lauderdale, Fla. For more than 20 years, he has concentrated his efforts in the areas of consulting in insolvency, fiduciary and creditors' rights matters. Mr. Kapila has been appointed in Federal District Court, bankruptcy court and Florida State Court, and has served in the roles of CRO, SEC corporate monitor, examiner, chapter 11 trustee of operating businesses, liquidating trustee and receiver, among others. He also is ABI's President-Elect. Mr. Kapila represents other bankruptcy trustees, debtors and both secured and unsecured creditors in and out of bankruptcy court. He also regularly advises clients about the insolvency implications involved in business transactions and operation of distressed businesses. As a trustee plaintiff, Mr. Kapila has managed complex litigation in significant cases. As a fiduciary, he has advised and represented debtors and creditors' committees in formulating, analyzing and negotiating plans of reorganization. Recognized as an expert in fraudulent conveyance, Ponzi Sschemes and insolvency issues, Mr. Kapila has provided expert testimony and extensive litigation support services to law firms involving complex insolvency issues and commercial damages. He is a sitting trustee on the panel of U.S. Bankruptcy Trustees for the Southern District of Florida, and he has served in numerous matters in both the Southern and Middle Districts of Florida as a chapter 7, chapter 11 and subchapter V trustee. Mr. Kapila has conducted numerous forensic and fraud investigations, and has worked in conjunction with the Securities and Exchange Commission (SEC), the Federal Bureau of Investigation (FBI) and the U.S. Attorney's Office. He has also provided a wide variety of tax services to clients throughout his career; consulting with and offering tax-planning strategies and ideas to bankruptcy trustees is also a significant part of his responsibilities. Mr. Kapila co-authored *Fraud and Forensics: Piercing Through the Deception in a Commercial Fraud Case* (ABI 2015). He received his M.B.A. in 1978 from Cranfield School of Management.

Joshua J. Lewis is senior counsel to PNC Bank, National Association in Atlanta, where he supports the bank's commercial lending workout teams. He joined PNC in 2021 in connection with PNC's acquisition of BBVA USA, where he had served as the sole workout attorney since 2016. Prior to his in-house career, Mr. Lewis spent more than a decade as a practicing bankruptcy and creditors' rights attorney in Louisiana and Georgia, where he focused primarily on the representation of regional and national banks. He received his B.B.A. from the University of Georgia in 1999 and his J.D./B.C.L. from Louisiana State University in 2005.

Eric J. Silver is a shareholder in the Business Restructuring department of Stearns, Weaver, Miller, Weissler, Alhadeff & Sitterson, P.A. in Miami and is a member of the firm's board of directors. He handles complex commercial restructuring and related litigation matters in both federal and state courts, and he regularly represents court-appointed fiduciaries, secured and unsecured creditors, and purchasers of distressed assets. Prior to joining the firm in 2010, Mr. Silver clerked for Hon. Robert A. Mark in the U.S. Bankruptcy Court for the Southern District of Florida. He is a member of ABI and was president of the Bankruptcy Bar Association of the Southern District of Florida for 2020-21. In addition, he was the Miami chair of its *Pro Bono* Committee from 2016-19 and *Pro Bono* Committee Liaison of the FLSB Bankruptcy Lawyers Advisory Committee from 2018-19, and is a member of The Florida Bar's Business Law Section. Mr. Silver was honored as one of ABI's 2021 "40 Under 40." He received his J.D. *magna cum laude* from the University of Miami School of Law jointly with his M.B.A. from the School of Business Administration.

Lisa P. Sumner is a member of Nexsen Pruet's Bankruptcy & Creditors' Rights Practice Group in its Raleigh, N.C., office. Throughout her years of practice in North Carolina, South Carolina and Virginia, she's represented financial institutions, private equity and trade creditors in out-of-court matters, bankruptcy proceedings and litigation in state and federal courts. Ms. Sumner's representative engagements include distressed loan workouts, collections, appointing receivers, involuntary bankruptcy petitions, contested chapter 11 and 12 plan confirmations, § 363 sales, and defending preference and fraudulent-transfer actions and lender-liability claims. The varied industries involved in her cases include commercial real estate, retail, manufacturing, construction, agricultural and health care. Ms. Sumner received her B.A. from the University of North Carolina at Chapel Hill in 1991 and her J.D. from Duke University in 1994.