

Lenders Beware

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WHEN IS A LENDER CROSSING THE LINE AND ENTERING LENDER LIABILITY WONDERLAND?

A 2022 decision out of a bankruptcy court in Texas reminded lenders that an overly aggressive approach to a borrower can result in lender liability^[1] and substantial damages. In this case, brought by a Chapter 7 trustee, the bankruptcy court concluded that the lender destroyed the debtor's enterprise value and future as a going concern and ultimately drove the debtor out of business.

The Court found that for the lender's actions, the debtor would not have failed as a going concern and would not have had to file bankruptcy. As a result, the Court awarded \$16,966,928 in damages for breach of contract and breach of the duty of good faith and fair dealing, fraudulent misrepresentation, contractual and business interference, and willful violation of the automatic stay. The lender unsuccessfully tried to argue that the debtor was dead on arrival.

[1] As the bankruptcy court put it, "[l]ender liability" is a broad umbrella term often used to describe various theories through which a borrower (or its trustee in bankruptcy) seeks to impose liability (or a remedy of some sort) against a former lender in a lending relationship that has soured."

THE STORY BEHIND THE AWARD

Bailey Tool & Manufacturing Company and its subsidiaries and affiliates ("Bailey") was the debtor/borrower in this tragic story. Republic Business Credit, LLC ("Republic") was the lender. Before filing bankruptcy, Bailey and Republic entered into a factoring arrangement and an asset-based loan facility in February 2015. Republic performed substantial diligence in late 2014 and early 2015 before entering into the agreements. During the due diligence process, Republic had identified several issues, including unpaid ad valorem taxes, stretched accounts payable, and a major customer (the Department of Defense) that paid on a milestone rather than progressive billing basis. Despite these issues, the underwriter viewed the proposed transaction as a "strong deal" and approved it.

Four months after entering into the agreements, Republic refused to advance funds as expected, declared default and made payments to itself from Bailey's lockbox under the factoring agreement to pay down the ABL (Asset Based Lending) facility.

The Court found that Republic took complete and total control of Bailey's cash. It controlled not only the collections through the lockbox and all disbursements too. All funds advanced from July 2015 forward were sent directly to vendors selected by Republic vendors and a payroll company for the payroll of employees selected by Republic. The Court held that the lender's handling of disbursement was inconsistent with the parties' agreements—specifically, the Factoring Agreements contemplated that Republic would "pay to Seller [Bailey] an Advance." In September 2015, Republic stopped funding altogether.

Republic also became involved in replacing management and otherwise micromanaging the Debtor. It forced the Debtor's Chief Executive Officer to give the Republic a lien on his exempt homestead.

THE DECISION

In a meticulous 145-page decision, the Court analyzed the Republic's conduct, including and highlighting numerous internal lender email communications produced in discovery and presented during the trial.

The Court adopted the bankruptcy trustee's theory of the case, i.e. that the lender: (i) refused to advance funds in good faith and in the manner promised almost immediately after the agreements were signed taking a stance that the businesses were in an "over-advanced" position, which was *not* a defined concept in the agreements and was problematic in light of several weeks of due diligence and awareness regarding certain slow-paying accounts and inventory status; (ii) charged fees, expenses, penalties and other items against "reserves" (contributing to the alleged "over-advanced" position), without any transparency; (iii) exercised excessive control over the businesses by controlling what vendors, employees, and expenses got paid and insisting on direct payments to them by the factoring company rather than funding to the businesses as contemplated by the underlying agreements (*i.e.*, the argument being that this was an improper exertion of control; there were no amendments of documents or forbearance agreements to justify deviating from the underlying agreements).

WHAT ACTION TO AVOID AS A LENDER

This decision can now serve as a roadmap for borrowers to establish lender liability. In summary, the factors considered by the Court include:

Taking over the business function and exercising business judgment – Without the requisite knowledge and experience, Republic approved payments to certain vendors and materials suppliers, reordered the sequence in which different products at Bailey were manufactured, and changed the manufacturing priorities from keeping long-term customers, to doing “quick-turn” projects;

- Controlling the workforce at Bailey through controlling the payroll and ordering who got paid and who did not and what types or classifications of employees could get paid;
- Directing vendors of Bailey to pay Republic instead of Bailey under the threat of litigation, destroying the goodwill that Bailey had built up with these vendors;
- Lack of transparency and misrepresentations as to why: (i) why it considered Bailey to be in default, (ii) the status of funds availability or lack thereof, (iii) application of funds collected and charging numerous fees and expenses.

The conduct of the lender, in this case, appears egregious. Still, it is a reminder for lenders to closely review with counsel contractual remedies and exercise caution in implementing these remedies.