LESSONS FORGOTTEN:
LENDER LIABILITY MAKES A COMEBACK

Recent Significant Lender Liability Cases
Outside the Sixth Circuit

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3V Capital Fund LTD v. Official Committee of Unsecured Creditors of TOUSA, Inc. (In re TOUSA, Inc.), No. 10-60017, 2011 U.S. Dist. LEXIS 14019 (S.D. Fla. February 11, 2011)

The District Court for the Southern District of Florida quashes the previously stringent standards of diligence and lender liability imposed by the Bankruptcy Court.

TOUSA, Inc. is a large homebuilder with numerous subsidiaries and operations in several states. As its business expanded, TOUSA issued various series of unsecured bonds totaling approximately $1.06 billion, all of which were guaranteed by various subsidiaries (the "Conveying Subsidiaries"). The bond documents were abundantly clear that, although the bonds were issued by TOUSA, the payments would be made from the consolidated assets of TOUSA and its Conveying Subsidiaries. In addition, TOUSA had an $800 million revolving credit facility, under which numerous of the Conveying Subsidiaries were also borrowers and had pledged substantial assets to the revolving lenders. The assets of the various Conveying Subsidiaries were relied upon to determine the borrowing base under the revolving credit facility. The revolving credit facility was the sole source of operating financing for all of the TOUSA entities. Each of the bond indentures and the revolving credit documents had a provision giving rise to an event of default upon entry of a judgment in excess of $10 million against TOUSA.

In June 2005, Home LP, a TOUSA subsidiary, and a third party formed a joint venture (the "Transeastern Joint Venture") to acquire certain home building assets in Florida, funded partially by loans from certain lenders (the "Transeastern Lenders"). The Transeastern Lenders provided approximately $560 million and TOUSA provided an unsecured guarantee. In September 2006, the Transeastern Joint Venture defaulted on its loan obligations and the Transeastern Lenders sued TOUSA for repayment and damages. TOUSA management estimated that the scope of these damages could exceed $2 billion. TOUSA's exposure under the Transeastern guaranty thus had the potential to give rise to an event of default under the bond indentures and the revolving credit facility, thus triggering the guaranties and direct obligations of the various Conveying Subsidiaries. The parties agreed to a settlement which consisted of payment of more than $420 million to the Transeastern Lenders by way of a $300 million first lien term loan and $200 million under a second lien term loan (the "New Financing") with a new set of lenders (the "New Lenders"). TOUSA pledged all of its assets and its Conveying Subsidiaries were required to provide secured guarantees to the New Lenders. The proceeds from the New Lenders and those paid to the Transeastern Lenders never flowed through any of the Conveying Subsidiaries.

On January 29, 2008 under the weight of the housing crisis, TOUSA and its subsidiaries filed for relief under chapter 11 of the Bankruptcy Code. The Official Committee of Unsecured Creditors (the "Committee") instituted an adversary proceeding to avoid, as fraudulent transfers, the Conveying Subsidiaries' $500 million in liens under the New Financing. The Committee argued that the entire approximately $420 million could be recovered from the Transeastern Lenders as "the entity for whose benefit" the alleged fraudulent transfer had occurred under section 550(a)(1) of the Bankruptcy Code. Essentially, the Committee argued that because the Conveying Subsidiaries were not party to the original Transeastern loan transactions, they did not receive "reasonably equivalent value" for agreeing to be borrowers and pledging their assets to secure the New Loans which were used to satisfy TOUSA's obligations to the Transeastern Lenders, that the Conveying Subsidiaries entry into the New Loans and pledge of their assets was a fraudulent transfer, and therefore that the entire $420 million paid to the Transeastern Lenders in settlement should be disgorged and returned to the Conveying Subsidiaries' bankruptcy estates.

After a thirteen-day trial, the Bankruptcy Court found for the Committee and issued a long and detailed opinion. *Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp North America, Inc.* (In re TOUSA, Inc.), 422 B.R. 783 (Bankr. S.D. Fla. 2009). The Bankruptcy Court found that the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for pledging their assets to the New Lenders, that any value they did receive was far less than the loan obligations they assumed, that the Conveying Subsidiaries received no direct benefits from the transaction and received minimal indirect benefits because, ultimately, the Conveying Subsidiaries were required to file for bankruptcy protection and could have found an alternative source of financing if TOUSA filed bankruptcy or could not borrow under the revolving credit facility. In reaching this decision, the Court took an extremely narrow, almost mathematical, view of "reasonably equivalent value." The Bankruptcy Court found that the Transeastern Lenders were entities "for whose benefit the transfer was made" and ordered the disgorgement of $403 million in principal plus interest on the full amount disgorged. The Bankruptcy Court also ordered the New Lenders to disgorge all loan proceeds and reimburse the Conveying Subsidiaries for all amounts paid on the new term loans, including all closing costs and legal and professional fees associated with litigation.

The Transeastern Lenders appealed the decision to the District Court for the Southern District of Florida, which on February 11, 2011 issued an opinion reversing the Bankruptcy Court order as it related to the Transeastern Lenders, for a number of reasons.

Indirect Benefit and Reasonably Equivalent Value

The District Court held that, based on the totality of the circumstances, the Conveying Subsidiaries did receive indirect and intangible economic value, including the opportunity to avoid default and bankruptcy. The District Court held the "touchstone is whether the transaction conferred reasonable commercial value." Further, the Court stressed the interdependence of the TOUSA subsidiaries and the fact that if TOUSA was not able to reach the settlement with the Transeastern Lenders, there would have been an adverse impact on each of the Conveying Subsidiaries. Therefore, the Conveying Subsidiaries obtained sufficient value from the New Financing.

Beneficial Transfer Liability

The District Court held that the Bankruptcy Court erred by imposing strict liability on the Transeastern Lenders as entities for "whose benefit" the transfer was made under section 550(a)(1) of the Bankruptcy Code. It reasoned that this language does not apply where the benefit is not immediate. That benefit "must derive directly from the initial transfer, not from the use to which it is put by the transferee." TOUSA was the transferee and used the New Financing to settle with the Transeastern Lenders. The Transeastern Lenders were not the direct transferees.

Good Faith Defense for Subsequent Transferees

The District Court found that the Bankruptcy Court further erred by not considering whether the Transeastern Lenders were subsequent transferees under section 550(a)(2) of the Bankruptcy Code and thus afforded a good faith defense under section 550(b). The District Court found that the Transeastern Lenders met the standards set out in 550(b) -- that they took for value on payment of an antecedent debt and that the Committee offered no evidence that the Transeastern Lenders acted in bad faith.

Unrealistic Diligence Standards

One of the more notable aspects of the Bankruptcy Court decision was the suggestion that the lenders needed to undertake diligence before accepting payment. The District Court characterized the Bankruptcy Court's diligence standard as requiring a creditor of someone other than the debtor to "first investigate the debtor's internal re-financing structure and ensure that the debtor's subsidiaries had received fair value as part of the repayment, or that the debtor and its subsidiaries, in an enterprise, were not insolvent or precariously close to being insolvent" prior to accepting a valid, tendered debt repayment outside of any preference period. The District Court rejected this standard as imposing unreasonable and unworkable diligence standards.

This appeal did not address the Bankruptcy Court's rejection of the savings clauses in the New Financing transaction documents, which matter remains on appeal. The District Court stayed the New Lenders' appeals pending the Committee's appeal of the Transeastern Lenders opinion to the Eleventh Circuit.

Official Committee of Unsecured Creditors of TOUSA, Inc. v. Citicorp North America, Inc. (In re TOUSA, Inc.), No. 09-cv-60589 (S.D. Dist. Fla. Filed March 4, 2011)

A borrower's obligations under an amended and restated lending agreement can relate back to the original agreement and the original granting of liens if such is the intent of the parties. Furthermore, the filing of new financing statements in connection with the amendment and restatement does not invalidate preexisting liens in the same collateral.

In March 2006, TOUSA and certain of its subsidiaries (the "Conveying Subsidiaries") entered into a revolving line of credit extended by a number of banks under which the borrowers could draw up to an aggregate limit for working capital and other general corporate purposes. Citicorp was the administrative agent for the revolver. The parties amended the revolver in October 2006 to include upstream guaranties by TOUSA's Conveying Subsidiaries and secured the debt with liens on the Conveying Subsidiaries' assets. In January 2008, the parties further amended to allow the Conveying Subsidiaries to borrow on the revolver directly.

On the same day that TOUSA entered into its settlement with the Transeastern Lenders (as described above) TOUSA and the Conveying Subsidiaries amended and restated the revolver (the "July Revolver"). The July Revolver permitted TOUSA and the Conveying Subsidiaries to enter into loans with other lenders -- facilitating the term loan necessary to effect the settlement with the Transeastern Lenders. Under the July Revolver, TOUSA and the Conveying Subsidiaries each agreed to repay their own respective draws and those of the other co-borrowers. The July Revolver also included language indicating "it was the 'intent of the parties…that the security interests and [l]iens granted in the [c]ollateral under and pursuant to the [o]riginal [s]ecurity [a]greement shall continue in full force and effect.'"

The parties further amended and restated the July Revolver two additional times; in October 2007 to cure TOUSA's default that its chief financial officer prompted by his refusal to certify that TOUSA was solvent and again in December 2007. As of the petition date, approximately $316.5 million was outstanding on the July Revolver.

The Official Committee of Unsecured Creditors of TOUSA, Inc. (the "Committee") commenced an adversary proceeding to avoid, as a fraudulent transfer, the July Revolver claiming that TOUSA was insolvent at the time of the amendment and restatement and did not receive fair consideration. The Committee eventually filed three different complaints in this adversary proceeding. In opposing Citicorp's motion to dismiss the Committee's first complaint, the Committee argued that every time TOUSA or a Conveying Subsidiary drew on the revolver, it and the subsidiaries incurred a new obligation for the purposes of fraudulent transfer analysis. The Bankruptcy Court dismissed but gave the Committee leave to amend its complaint. In its second complaint, the Committee claimed that the amendment and restatement in July 2007 and the later amendments constituted new obligations on their execution dates, rather than draw dates. Again, the Bankruptcy Court granted Citicorp's motion to dismiss, finding that the original lien transfer dates flowed through the amendments. The Bankruptcy Court again granted leave to amend, this time to avoid conveyances only of new categories or specific items of collateral transferred as part of the 2007 amendments. The Committee filed a third complaint that did not include any claim that new collateral was fraudulently transferred in 2007. The Committee withdrew its third complaint and chose to appeal the prior dismissal.

On appeal, the Committee presented three arguments in favor of finding the July Revolver constituted a fraudulent transfer under section 548 of the Bankruptcy Code: (1) the Conveying Subsidiaries incurred a new obligation each time they made a draw on the revolver after July 31, 2007; (2) when they executed the July Revolver, each Conveying Subsidiary incurred a new obligation on July 31, 2007 to repay each post-July 31 loan; and (3) the re-perfection of the liens following the July 2007 amendment and restatement constituted a new transfer.

The Committee based its first argument on the Second Circuit's decision in *Rubin v. Manufacturers Hanover Trust Company*, which held, under the former Bankruptcy Act, that a borrower incurred an obligation each time the borrower drew money from a line of credit. 661 F.2d 979 (2nd Cir. 1981). The District Court questioned the validity of reliance on *Rubin* for a number of reasons, including commentator criticism of and the fact that many of the courts that cite *Rubin* do so in dicta. The validity of *Rubin* notwithstanding, the District Court quickly disposed of this point because the Committee waived its right to argue *Rubin* at oral argument before the Bankruptcy Court, when it said it was not relying on *Rubin* and was in fact taking the opposite approach.

In rejecting the Committee's second argument that TOUSA and its Conveying Subsidiaries incurred a new obligation on July 31, 2007 for all of the future draws on the July Revolver, the Court relied on the language of that agreement which stated that the earlier liens and security agreements were in full force and effect. As such, "notwithstanding the general language in the July Revolver that all prior agreements were being restated in their entirety, obligations already incurred were not voided, extinguished, or superseded, and the Committee's argument therefore fail[ed]." The District court also dismissed the Committee's argument that because the July Revolver permitted TOUSA to enter into a term loan, the July Revolver created a new obligation. The Court found the July Revolver was merely permissive and entering into such a term loan was not a requirement, therefore that permission did not create a new obligation under the July Revolver.

Finally, the District Court rejected the Committee's argument that Citicorp and the Conveying Subsidiaries made a new transfer by granting liens under the July Revolver because "Citicorp already held perfected liens to the alleged transferred property." The fact that Citicorp re-perfected its prior liens by filing new financing statements does not change the analysis.

Credit Suisse v. Official Committee of Unsecured Creditors (In re Yellowstone Mountain Club, LLC), 415 B.R. 769 (D. Mont. 2009)

Overt predatory lending practices may lead to equitable subordination and bar recovery on claims despite, allowance in a plan-confirmed settlement.

The four jointly administered debtor entities in *In re Yellowstone Mountain Club* (the "Debtors") were formed to develop the Yellowstone Club, the world's only private ski and golf community, situated on 13,500 acres near the northwest corner of Yellowstone National Park. Three of the four Debtors have ownership control over the Yellowstone Club (the "Controlling Debtors"). During the period relevant to this case, the Blixseth Group ("BGI") owned a controlling 87% share of the four Debtors. Timothy Blixseth ("Blixseth") was the owner, president and CEO of BGI and therefore had complete control over the Debtors. In 2004, Credit Suisse repeatedly attempted to contact Blixseth with information about a new syndicated term loan product that was akin to a home equity loan. Credit Suisse was trying to break new ground by doing real estate loans in the corporate bank loan market. After several months of negotiation, Blixseth, on behalf of the Controlling Debtors, eventually agreed to a loan amount that ultimately grew from the initially proposed $150 million to $375 million at the time of closing.

In September 2005, the Controlling Debtors entered into a $375 million loan for purposes of, among other things, refinancing Yellowstone Club's outstanding secured debt and distributing a return of capital and/or dividend to Blixseth. Credit Suisse, acting for itself and as the administrative and syndication agent, structured the loan and arranged for a group of participating lenders to provide those funds, secured by a first priority lien in some, but not all, of the Controlling Debtors' assets. Credit Suisse structured the loan so that large portions of the proceeds were available for distributions to members of the Controlling Debtors for purposes unrelated to the Yellowstone Club. Blixseth on behalf of the Controlling Debtors, transferred to BGI approximately $209 million of the loan proceeds in exchange for an unsecured demand promissory note payable by BGI to the Controlling Debtors. BGI in turn disbursed roughly all of those proceeds to Blixseth or to other parties to satisfy Blixseth's personal debt. Blixseth testified that the Controlling Debtors had no interest in the transfer of the $209 million or its subsequent uses.

In the years leading up to the bankruptcy, the Yellowstone Club was persistently behind in its accounts payable. The in-house accountant testified that invoices would often go unpaid for more than 90 days. Rather than make a demand on the BGI note, when money was tight, Blixseth would strike property deals with Yellowstone Club members to raise cash. A combination of mismanagement, the burden of the Credit Suisse loan and the downturn in real estate left the Yellowstone Club with insufficient operating funds.

In November 2008, the Debtors filed for bankruptcy. Subsequently, the Official Committee of Unsecured Creditors (the "Committee") filed an adversary proceeding complaint against Credit Suisse for aiding and abetting breach of fiduciary duty, avoidance of fraudulent transfers and disallowance or subordination of claims. The Committee argued that the entire loan was effectively a personal loan to Blixseth and the Controlling Debtors did not receive reasonably equivalent value in exchange for the liens they provided.

The Bankruptcy Court issued a blistering decision against Credit Suisse. The Court found that the "naked greed in this case combined with Credit Suisse's complete disregard for the Controlling Debtors or for another person or entity who was subordinated to Credit Suisse's first lien position, shocked the conscience of the Court." The Court further found that Credit Suisse engaged in little, if any, due diligence. The diligence consisted of (1) a background check on Blixseth; (2) hiring a law firm to ensure the entities they were financing actually owned the assets they claimed to own; and (3) hiring an appraisal firm to provide an independent assessment of cash flow using a new form of appraisal method that relied on future projections, which were in no way related to historical or present reality. Credit Suisse instructed its independent appraiser to use this new valuation method because in 2004 the Controlling Debtors' assets were appraised for only $420 million under the traditional method, which would yield a 90% loan to value ratio. The Court believed that this ratio would have made the loan virtually impossible to market. Moreover, the Court determined that the loan was unnecessary and believed that Credit Suisse did not care because it was selling loans under a fee structure that increased the fee with the size of the loan. This, according to the Court, effectively lined the pockets of the banks and the developers, while leaving the developments too thinly capitalized to survive.

Based on these findings, the Court held that equitable subordination was appropriate and subordinated the claims of Credit Suisse and its syndicate of lenders to all other claims. The Court also ordered that any credit bid submitted by Credit Suisse for the Controlling Debtors' assets at any auction must include sufficient funds to repay the DIP financing, the administrative fees and costs of the bankruptcy estate and the allowed claims of unsecured creditors -- effectively reducing Credit Suisse's secured claim from $375 to $232 million.

Shortly thereafter, the Debtors, Credit Suisse, the Committee and the DIP lender entered into a settlement under which the Committee dropped its claims against Credit Suisse and allowed Credit Suisse a $232 million secured claim and a $77 million unsecured claim. The next day, the Court approved the sale of the Debtors' assets to the DIP lender for $35 million in cash and an $80 million promissory note to Credit Suisse. In June 2009, the Court confirmed the Debtors' plan of reorganization, which incorporated the settlement, therefore effectively vacating the equitable subordination order.

In September 2010, the Yellowstone liquidating trustee successfully recovered funds from Blixseth in a post-confirmation proceeding. Despite the fact that the settlement allowed Credit Suisse to receive payment on its claim, the Court would not allow Credit Suisse to share in the recovery, refusing to reward it for its "greedy antics."

In re Fontainebleau Las Vegas Contract Litigation, 716 F. Supp. 2d 1237 (S.D. Fla. 2010)

Term lenders do not have standing, under New York law, to sue revolving lenders for their failure to fund under the terms of the credit agreement unless those term lenders are the intended beneficiaries of the revolving loan proceeds.

On May 28, 2010, the District Court for the Southern District of Florida dismissed the claims of the term lenders to Fontainebleau Las Vegas LLC and its affiliated entities ("Fontainebleau") against the revolving lenders for breach of contract and breach of implied covenants of good faith and fair dealing for the revolving lender's failure to fund under the credit agreement.

On June 6, 2007, Fontainebleau entered into a syndicated credit agreement (the "Credit Agreement") with a number of lenders (the "Lenders") to facilitate the construction of the Fontainebleau Las Vegas Resort and Casino (the "Project"). The Credit Agreement provided for, among other things, the syndicate of lenders to establish three different lending facilities: (1) a $700 million initial term loan (the "Initial Term Loan") funded by certain lenders (the "Initial Term Loan Lenders"); (2) a $350 million delay draw term loan (the "Delay Draw Term Loan") funded by certain lenders (the "Delay Draw Term Lenders"); and (3) an $800 million revolving loan facility (the "Revolving Loan") funded by certain lenders (the "Revolving Lenders"). Fontainebleau had immediate access to the Initial Term Loan proceeds but only restricted access to the other two facilities. For example, the restrictions required Fontainebleau to submit a Notice of Borrowing to the Administrative Agent and prevented Fontainebleau from drawing more than $150 million of the Revolving Loan proceeds unless the Initial Term Loan and the Delay Draw Term Loan were "fully drawn." The Disbursement Agreement also required the Disbursement Agent to issue a Stop Funding Notice if an event of default had occurred.

In March 2009, Fontainebleau submitted a Notice of Borrowing to Bank of America, as Administrative Agent, simultaneously requesting the entire amount under the Delay Draw Term Loan and the Revolving Loan. Bank of America rejected this request because the Credit Agreement prevented Fontainebleau from borrowing more than $150 million under the Revolving Loan until the Delay Draw Term Loan was "fully drawn." Though Fontainebleau had never before drawn on the Delay Draw Term Loan, it argued that "fully drawn" meant "fully requested" not "fully funded" thus Fontainebleau's initial simultaneous Notice of Borrowing should have been sufficient. To remedy this matter, Fontainebleau issued another Notice of Borrowing -- requesting only the full amount of the Delay Draw Term Loan -- which Bank of America funded.

Prior to disbursing the Delay Draw Term Loan proceeds, Bank of America had received notice that Lehman Brothers, a Lender, had failed to comply with its funding obligations under the Retail Facility Agreement. Under the Disbursement Agreement, such notice should have prompted Bank of America to issue a Stop Funding Notice.

Because of this default, and the Project's continuing economic troubles, the Revolving Lenders, through Bank of America, sent a termination letter to Fontainebleau, the Lenders and other parties advising that one or more Events of Default had occurred and the Revolving Loan was terminated immediately. Directly thereafter, Fontainebleau sent a Notice of Borrowing requesting the full amount under the Revolving Loan, which Bank of America denied.

Fontainebleau's financial troubles continued and in June 2009, it filed a chapter 11 case in the Southern District of Florida. The day that it filed bankruptcy, Fontainebleau commenced an adversary proceeding against the Revolving Lenders under section 542 of the Bankruptcy Code for turnover of the Revolving Loan funds requested under the original Notice of Borrowing. The District Court withdrew the reference and held as a matter of law that, "for the purposes of the Credit Agreement, 'fully drawn' unambiguously means 'fully funded'". *Fontainebleau Las Vegas, LLC v. Bank of America, N.A.,* 417 B.R. 651 (S.D. Fla. 2009).

The instant case adjudicates allegations filed in two separate complaints in different jurisdictions against the Revolving Lenders and Bank of America, as Administrative and Disbursement Agent. The Joint Panel on Multi-District Litigation ordered the centralization of both cases in the District Court for the Southern District of Florida. One complaint was filed by a group Initial Term Loan Lenders and Delay Draw Term Lenders while the other was filed by successors in interest to such lenders (all referred to collectively herein as the "Plaintiffs"). The Plaintiffs alleged the Revolving Lenders' failure to meet their funding obligations under the Credit Agreement and Bank of America's material breaches of the Credit and Disbursement Agreements derailed the Project, thereby reducing the value of the Plaintiffs' investment.

The Revolving Lenders and Bank of America (together, the "Defendants") moved for dismissal alleging that the Plaintiffs lacked standing to assert claims for failure to fund and that the facts do not give rise to a breach of the implied covenant of good faith and fair dealing. Bank of America moved to dismiss the claim for breach of the Credit and Disbursement Agreements.

The Court found that to have a "legally enforceable right" sufficient to sustain a claim for breach of contract under New York law, the claimant must be an "intended beneficiary" of the breached promise. The Court quickly disposed of this matter by finding that the Credit Agreement unambiguously required the Revolving Lenders to fund Fontainebleau thereby giving the Fontainebleau the legally enforceable right, not the Plaintiffs. The Court dismissed the breach of contract claim against the Defendants for failure to fund, with prejudice.

Similarly, the court quickly dismissed the claim that the Defendants breached an implied covenant of good faith and fair dealing in connection with the Credit Agreement because under New York law, such an implied obligation is unsustainable if it is inconsistent with the terms of the contract. The Plaintiffs alleged that the Defendants "adopted a contrived construction of the Credit Agreement in order to justify their refusal to fund," by not adopting Fontainebleau's interpretation of "fully drawn." The Court held, as a matter of law, that imposing such an implied covenant of good faith and fair dealing was inconsistent with the Credit Agreement because the Court had already determined that "fully drawn" meant "fully funded."

The only claim that the Court did not dismiss was that Bank of America breached the Disbursement Agreement. The Plaintiffs alleged that Bank of America should have issued a Stop Funding Notice prior to disbursing the Delay Draw Term Loan proceeds because it had knowledge that Lehman Brothers had defaulted under the Retail Facility Agreement, an Event of Default.

State Farm Bank, F.S.B. v. Manheim Automotive Financial Services, No. 10-CV-00519, 2010 U.S. Dist. LEXIS 80698 (N.D. Tex. 2010)

Lenders secured by the same collateral do not owe a duty to one another, under Texas law, to abide by industry standards.

This case addresses the question of whether one lender has a duty to another lender to comply with industry standards in the perfection of a security interest in collateral. The competing lenders are Manheim Automotive Financial Services ("Manheim") and State Farm Bank, F.S.B ("State Farm"). Concord Autoplex, LTD ("Concord"), a used vehicle dealer, obtained inventory financing from Manheim secured by blanket liens, including a security interest in Concord's vehicles perfected by possession of the vehicle titles. Buyers subsequently purchased cars from Concord with financing from State Farm. Ordinarily, Manheim released the applicable vehicle titles upon a buyer's purchase at which time State Farm's lien would attach through possession of the title. However, when Concord defaulted on the Manheim financing, Manheim foreclosed on its collateral and refused to release certificates of title to the State Farm borrowers who had already purchased cars from Concord.

State Farm sued Manheim in the District Court for the Northern District of Texas alleging wrongful conversion of the certificates of title and seeking declaratory judgment that each State Farm borrower was a buyer in the ordinary course of business, that Concord's sale of each vehicle cut off Manheim's security interest, that each borrower's purchase was free and clear of Manheim's security interest and that Concord and State Farm were entitled to new titles.

Manheim filed counterclaims for negligence, setoff and unjust enrichment. Manheim alleged that State Farm breached its duty to Manheim by failing to follow industry practices by not requiring Concord to turn over the vehicle titles at the time of sale and such breach proximately caused damage to Manheim. Manheim sought the wholesale auction value of the vehicles plus interest and expenses. Manheim also argued that a successful ruling would unjustly enrich State Farm because if it had followed industry practices and demanded the liens at closing, it would not have entered into the financing transactions with the customers. Manheim demanded that State Farm pay the remaining balance on the loans and sought a declaration that it has a superior lien and no liability to State Farm. The District Court dismissed Manheim's counterclaims.

In its counterclaims, Manheim argued that State Farm should have recognized both the potential risk to third parties and its superior position to control the relationship with Concord by demanding titles before funding and should have been aware of the consequences of not following industry practices regarding title transfers.

State Farm moved for dismissal of the negligence claim because Texas law does not recognize this duty to a third party. The District Court ordered dismissal with prejudice, citing the risk-utility balancing test for a common law duty of care, recognized by Texas law. In applying this test courts look at factors such as risk and foreseeability weighed against social utility. The District Court noted that Texas courts that applied this analysis generally found that banks do not owe any duty to an entity that is not a customer or has not had a prior relationship with the bank.

Manheim asserted that State Farm would be unjustly enriched if it prevailed on its claims because its "lending practices [had] deviated from 'the standard and regular lending practice utilized in Texas for financing motor vehicle sales'" and it should not benefit because of this mistake. State Farm argued (1) that there was a split in Texas courts about whether unjust enrichment is an independent cause of action and (2) Manheim failed to demonstrate how State Farm was enriched by fraud, duress or taking undue advantage.

The District Court disposed of State Farm's defense about split authority by citing Texas Supreme Court recognition and disposition of unjust enrichment claims. Manheim argued that State farm mistakenly paid Concord when it should have paid Manheim for the vehicles and such mistake amounted to the retention of a benefit obtained from another that was not legally justifiable. The District Court found that Manheim might be able to sustain an action for unjust enrichment against State Farm if it alleges State Farm received undue benefit. However, its pleading was insufficient. The District Court dismissed the unjust enrichment claim without prejudice, allowing Manheim the ability to replead its case.

Reger Development, LLC v. National City Bank, 592 F.3d 759 (7th Cir. 2010)

A lender can demand payment on a demand note, regardless of the economic stability of the borrower and the absence of any default.

In June 2007, National City Bank ("National City") offered Reger Development, LLC (the "Company") a line of credit to fund potential development opportunities. During the parties' initial loan negotiation, National City insisted that its form of the loan documents was non-negotiable. The parties agreed to execute National City's form documents for a $750,000 line of credit consisting of a promissory note and a commercial guaranty by Kevin Reger ("Reger"), the Company's principal and sole member. The note contained language allowing for payment on demand to the lender -- including a section outlining the consequences of not paying on demand. Additionally, several transaction documents referenced the demand nature of the loan. There was also a "No Commitment" clause stating the lender shall have no obligation to extend credit and, therefore, all draws on the note were, at all times at the discretion of the lender, regardless of the borrower's financial condition or default status.

In June 2008, a year after extending the loan, National City requested and reviewed Reger's personal financial statements and tax returns as part of its annual review of the Company's line of credit. Although the Company had been making timely payments on the line of credit, National City requested a meeting to discuss its usage. At this meeting, National City asked the Company to pay down $125,000 on the line of credit, as was its right under the demand provisions of the note. The Company made the payment on the next business day. Less than a month later, National City asked the Company to "term out" $300,000 of the note by obtaining the agreement from one of Reger's other businesses "to take out a three year loan in that amount secured by a second mortgage on some real estate." National City also informed the Company that it intended to reduce the commitment on the line of credit from $750,000 to between $400,000 and $500,000. The Company inquired of National City the consequences of not complying with the "term out" request -- specifically whether National City would call the note. National City acknowledged that the Company was not in default but that "there is a possibility that [it] may demand payment of the line."

The Company then commenced an action in Illinois state court alleging that National City breached its contract and used its form documents to perpetuate a fraud by inducing borrowers into taking out loans by concealing the demand nature of the instruments. National City removed the matter to Federal District Court which granted the bank's motion to dismiss for failure to state a claim upon which relief may be granted. The District Court found that the plain language of the agreement directly contradicted the Company's breach of contract allegation and it dismissed the Company's fraud allegations as without merit, noting that the Company cannot "close its eyes to the contents of the [note] and then claim…fraud merely because [National City] followed its contract." The Company appealed the dismissal to the Seventh Circuit Court of Appeals.

The Seventh Circuit reviewed the dismissal *de novo*. The Company argued that certain provisions of the transaction documents were inconsistent with a demand note -- notably (1) an Interest After Default clause, which increased the interest rate on the note after an event of default; (2) a prepayment clause, which allowed the Company to pay all or a portion of the loan prior to its maturity; and (3) a clause that granted National City the right to access the borrower's financial information, that the Company claimed was a financial insecurity provision that, if triggered, allowed the right to demand payment. Finally, the

Company argued that National City's mention, during negotiations, of its right to demand payment was a breach of the loan provision requiring the consent of the borrower to any loan modifications.

The Court of Appeals affirmed the dismissal of the complaint in its entirety. On the contract breach claim, the Court was not persuaded that the allegedly inconsistent provisions were sufficient to overpower the explicit contract language giving National City the right to demand payment at any time. Furthermore, National City did not violate the loan modification provision requiring borrower consent, it simply presented the Company and Reger with two options -- live by the terms of the note or renegotiate. National City was justified in attempting to renegotiate the note before taking the extreme measure of demanding its payment. On the fraud claim, the Court found that the Company failed to plead National City's alleged intent with any particularity. The Court refused to accept the Company's argument that no reasonable borrower would have paid $5,000 to enter into a line of credit that had clearly allowed the lender to demand payment at any time and, therefore, National City must have drafted the documents to mislead borrowers.

Lehman Commercial Paper, Inc. v. Palmdale Hills Property, LLC (In re Palmdale Hills Property, LLC, et al), 423 B.R. 655 (B.A.P. 9th Cir 2009)

A debtor violates the automatic stay of its creditor, who also is a debtor, when, without seeking relief from the stay, it proposes to equitably subordinate the creditor's claim and transfer the lien securing the claim under section 510(c) of the Bankruptcy Code.

Lehman Commercial Paper Inc., ("Lehman Commercial"), the appellant, was a debtor in a chapter 11 bankruptcy case in the Southern District of NY. Palmdale Hills Property, LLC was a debtor in a chapter 11 case being jointly administered along with seventeen of its related entities' in the Central District of California (together, the "Palmdale Debtors"). The Palmdale Debtors were an integrated network of companies that were formed as part of a joint venture to develop residential real estate projects with affiliates of Lehman Brothers, Inc.

Lehman Brothers, Inc. and certain affiliates, including Lehman Commercial (together, the "Lehman Debtors") and non-debtor Lehman ALI, Inc. ("ALI") provided over $2.3 billion in financing for the Palmdale Debtors' various real estate projects through a series of loan agreements and equity arrangements for such residential real estate projects. The Palmdale Debtors alleged that the financing arrangements constituted manipulative lending practices and fraudulent conveyances. Moreover, the Palmdale Debtors maintained that Lehman Commercial and ALI (together, the "Lehman Lenders") exerted complete and improper control over the use of the Palmdale Debtors' funds, resulting in a debt burden that forced the Palmdale Debtors to seek bankruptcy protection.

The Palmdale Debtors sought blanket relief from the automatic stay in the Lehman Debtors' case to allow them to "generally administer their California chapter 11 cases," by taking actions that may affect the Lehman Debtor's rights, such as filing motions to: (1) authorize the use of cash collateral, (2) approve DIP financing that might subordinate the Lehman Debtors' position; and (3) approve the sale of assets. This would have avoided the need to file multiple, more specific stay relief motions each time the Palmdale Debtors desired to take an action that affected the Lehman Debtors' rights. The Lehman Court denied the blanket relief without prejudice -- allowing the Palmdale Debtors to file more specific stay relief motions, as necessary.

The Palmdale Debtors' subsequently commenced an adversary proceeding in the Palmdale court (the "Palmdale Adversary Proceeding") to equitably subordinate the Lehman ALI claim and filed a joint plan of reorganization predicated on equitable subordination of the ALI and Lehman Commercial claims. The Palmdale Debtors did not name Lehman Commercial in their adversary complaint because, as noted in their plan of reorganization, such treatment of Lehman Commercial's claims is "conditioned upon a determination by a court of competent jurisdiction that the automatic stay in Lehman Commercial's chapter 11 proceeding is… not implicated." The Palmdale plan of reorganization also calls for the equitable subordination of certain other Lehman entities; however, they play a minor role by comparison and were not involved in this litigation.

In response, the Lehman Lenders filed a motion for relief from stay in the Palmdale Debtors' case to allow them to foreclose on and sell the collateral securing their loans in the approximate amount of $650 million. The Lehman Lenders maintained that the collateral securing the loans was declining in value and the Palmdale Debtors had no equity in the collateral. The Lehman Lenders also argued that the Palmdale plan was not feasible because it required equitable subordination of their claims without first seeking relief from the automatic stay in the Lehman Debtors' case to pursue such equitable subordination. The Palmdale Debtors maintained they had equity in the collateral because the Lehman Lenders' claims could be equitably subordinated and the liens transferred to the estate.

The Palmdale bankruptcy court denied the Lehman Lenders' stay relief motion, holding: (a) the stay relief motion "sufficiently states an express demand referencing the nature and amount of the claim, and therefore [the Lehman Lenders'] Motion constitutes an informal proof of claim;" (b) it has concurrent jurisdiction to determine the scope and applicability of the Lehman Commercial automatic stay; (c) the Lehman automatic stay does not prevent the Palmdale Debtors from objecting to Lehman Commercial's claim, from commencing an action for equitable subordination of Lehman Commercial's claim or from transferring a subordinated lien to the estate; and (d) the Palmdale Debtors may object to Lehman Commercial's claim, seek equitable subordination of the claim and/or seek to transfer a lien securing a subordinated claim to the estate via an adversary proceeding or plan, without violating Lehman Commercial's automatic stay.

The Ninth Circuit BAP reversed, finding that, although equitable subordination can be used as a defense to a stay relief motion, because the Palmdale Debtors were seeking affirmative relief and not merely asserting a defense, they violated the Lehman automatic stay. The BAP found that the bankruptcy court inappropriately merged the defense of equitable subordination to a motion for relief from stay with the use of equitable subordination as an objection to a claim. The equitable subordination claim must be independently adjudicated.

The BAP also rejected the Palmdale Debtors' argument that their equitable subordination claim was a defensive action because they are asserting it to defeat Lehman Commercial's claim. The Palmdale Debtors had argued that courts have held that a debtor may defend itself against a suit brought by another debtor without violating the moving debtor's automatic stay. Accordingly, the Palmdale Debtors asserted that, because a complete elimination of a claim can be achieved through a claim objection without violating the automatic stay, then the "lesser defensive remedy" of claim subordination should not be considered an offensive remedy in violation of the automatic stay. The BAP disagreed and noted that if a court disallows a claim, then the creditor never had a right to payment, whereas equitable subordination reprioritizes property interests based on the equities of the case. Though at times these may be functionally equivalent, the BAP recognized them as legally distinct remedies.

Finally, the BAP found that to allow this decision to stand in the Palmdale Debtors' case failed to provide sufficient notice to Lehman Commercial creditors in the Lehman case who stood to lose as a result of equitable subordination.

This case serves as a warning to debtors that they should know their creditors and conduct proper due diligence prior to attempting to equitably subordinate their claims because such actions might violate an automatic stay in another case. Moreover, in such a circumstance, only the creditor's own bankruptcy court may grant relief to allow subordination of the creditor's claim in another bankruptcy.