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No Reason Needed:

Lender Can End Credit Under Contract Terms

By James E. Clark

LENDER LIABILITY and equitable subordination claims against a secured lender based on allegedly improper termination of financing and alleged misrepresentations to trade creditors were completely rejected by a bankruptcy court. *In re Heartland Chemicals, Inc.*, 136 B-R- 503 (Bankr. C.D. Ill. 1992).

The court rejected arguments that the secured lender made verbal fraudulent misrepresentations to the debtor regarding the lender's willingness to extend or renew the line of credit beyond its expiration date. The court emphasized that verbal statements made by the lender's officer that are inconsistent with the express written terms of a loan agreement cannot give rise to a fraud claim, and that the debtor's sophisticated principals could not have rea-

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Firm Hit With $4 Million Fine

AFTER FINDING a New York law firm in civil contempt, a federal bankruptcy judge has recommended a $4 million sanction be imposed based on the firm's failure to turnover documents to a trustee for 407 days. *In re Stockbridge Funding Corp.*, 91-B-10069 (Bankr. S.D.N.Y. Oct. 8, 1992).

Judge Francis G. Conrad, a visiting judge from Vermont, also recommended that the firm pay $5,000 in attorney fees and ordered a hearing on whether it should pay additional damages for contempt and for violating the automatic stay that was imposed when the debtor filed for protection in January 1991. All of Judge Conrad's recommendations are subject to de novo review by a federal district court judge.

The judge had threatened this action over a year ago when he advised the firm, Stockschlaeder & McDonald, that if the documents in question were not turned over to the trustee by March 4, 1991, the firm would be held in contempt and the sanction would be $10,000 a day.

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First of Its Kind:

An Insider's Waiver Avoids *Deprizio* Rule

By Adam L. Rosen

IN ONE OF the first reported cases on the subject, a bankruptcy court in Tennessee held that a trustee may not recover a debtor's transfer to a non-insider third-party outside the 90-day period under the controversial theory endorsed in *Levit v. Ingersoll Rand Fin. Corp. (In re V.N. Deprizio Constr. Co.)*, 874 F.2d 1186 (7th Cir. 1989). *Hendon v. Associates Commercial Corp. (In re Fastrans Inc.)*, 142 B.R. 241 (Bankr. E.D. Tenn. 1992).

In *Deprizio*, the insider guarantor of the debtor's obligation had waived his right of reimbursement against the debtor and, therefore, was not a contingent creditor of the debtor by virtue of the guaranty.

The trustee in *Fastrans* sought to recover as a preference, under Bankruptcy Code Secs. 547 and 550, the debtor's payment to Associates Commercial Corp. made within one year of the filing of the petition. The trustee contended that the obligation was guaranteed by Stephan Yuhas, an insider of the debtor, and the transfer was for the benefit of a "creditor."

The trustee's theory of recovery was premised upon the U.S. Court of Appeals for the Seventh Circuit's decision in *Deprizio* that was followed by the Sixth Circuit in *Ray v. City Bank and Trust Co. (In re C-L Cartage Co.)*, 899 F.2d 1490 (6th Cir. 1990) and by the Tenth Circuit in *Lowrey v. First Nat'l Bank (In re Robinson Bros. Drilling)*, 892 F.2d 850 (10th Cir. 1989).

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Waiver by Insider Guarantor Protects Creditor

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In *Deprizio*, the court upheld recovery, under Code Secs. 547(b)(4)(B) and 550(a)(1), of payments of debt owing to non-insider third parties made within one year on the theory that such transfers benefitted insiders who were contingent creditors of the debtor by virtue of having guaranteed the debt that was paid. A number of courts have questioned the *Deprizio* decision and it has been subjected to substantial criticism. Congress presently is considering legislation that will overrule *Deprizio*.

The *Deprizio* court reasoned that the guarantor is a "creditor" of the debtor because it holds a contingent claim against the debtor for reimbursement or contribution based upon the possibility it will pay on the guarantee. A "creditor," for the purposes of Sec. 547(b), is one who has a claim against the debtor that arose at or before the order for relief. Sec. 101(10)(A). A "claim" is a right to payment even if, inter alia, it is unliquidated, contingent or disputed. Sec. 101(5)(A).

IRS Payments

Thus, *Deprizio* is based upon the fact that when a guaranteed obligation is extinguished, a guarantor of that obligation is a contingent creditor who has received a benefit by virtue of the extinguishment of his obligation.

The *Deprizio* court also held that a payment made by the debtor to the IRS within one year was not recoverable because, although the corporate insider was liable to the IRS for a 100 percent penalty as a "responsible person," the insider was not a creditor of the debtor because the Internal Revenue Code does not give the insider a reimbursement claim against the debtor. *Deprizio*, 874 F.2d at 1191-92.

Thoughtful lawyers, attempting to sidestep the effect of *Deprizio*, have drafted guaranty agreements that waive any reimbursement and contribution claims the guarantor may have against the debtor.

For example, in *Fastrans*, the guaranty contained the following provision:

"Each guarantor also hereby waives any claim, right or remedy which such guarantor may now have or hereafter acquire against the [debtor]...that arises hereunder and/or from the performance by any guarantor hereunder including, without limitation, any claim, remedy or right of subrogation, reimbursement, exoneration, contribution, claim, right or remedy of Associates against the [debtor]...or any security which Associates now has or hereafter acquires, whether or not such claim, right or remedy arises in equity, under contract, by statute, under common law or otherwise." *Fastrans*, 142 B.R. at 243.

The *Fastrans* court upheld the effectiveness of the waiver in keeping the guarantor from being a creditor and, therefore, denied recovery against Associates. The court held that:

- the waiver contained in the guaranty agreement was enforceable under Tennessee contract law;
- the trustee had no standing, as a third-party beneficiary or otherwise, to contest the terms of the guaranty;
- Mr. Yuhas did not have a "claim" against the debtor arising under the guaranty and, therefore, was not a creditor of the debtor; and
- the trustee was limited to the 90-day preference recovery period with regard to the debtor's transfer to Associates. *Fastrans*, 142 B.R. at 245-6.

General Creditor Insider

The trustee also argued that because Mr. Yuhas was the debtors landlord and was owed prepetition rent, he was a "creditor" of the debtor for purposes of Sec. 547. The court held that being a creditor in a general sense was insufficient to impose liability under *Deprizio*. The court stated in this regard:

"Indeed, in [*Deprizio*], although the insiders were creditors of the debtor as to obligations they guaranteed, they were not creditors as to obligations owed the Internal Revenue Service because the Internal Revenue Code afforded them no right of recovery over against the debtor. In other words, it is not enough that an insider be a creditor or the debtor in a general sense; the insider must have a 'claim' against the debtor attributable to the specific debt he or she guaranteed in order to render transfers made by the debtor on account of that debt to the non-insider transferee avoidable under Sec. 547(b). Absent such a claim, the insider is not a 'creditor' and such transfers cannot have been made 'for the benefit of a creditor.'" *Fastrans*, 142 B.R. at 245.

Suspending Subrogation Rights

It should be noted that in a case similar to *Fastrans*, a bankruptcy court held that a guaranty agreement that merely suspended, without waiving, the guarantor's subrogation rights did not prevent the guarantor from becoming a contingent of the debtor. *Covey v. Northwest Community Bank (In re Helen Gallagher Enterprises Inc.)*, 126 B.R. 997 (Bankr. C.D. Ill. 1991) ("*Gallagher*").

In *Gallagher*, the guaranty in question provided:

"The undersigned shall have no right of subrogation whatsoever with respect to the liabilities or the collateral unless or until the lender shall have received full payment of all liabilities." *Gallagher*, 126 B.R. at 1000.

The *Gallagher* court permitted recovery from the non-insider using the one-year period, holding that a guarantor typically:

"...holds a contingent claim from the moment of the execution of the guaranty. *Kapela v. Newman*, 649 F.2d 887 (1st Cir. 1981); *In re Sprague*, 104 B.R. 352 (Bank. D. Or. 1989). With

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Burial Rite:

Cross-Collateralization: Sinking Ship's Lifeboat

By Alan J. Brody

IN A QUESTION of first impression, the U.S. Court of Appeals for the Eleventh Circuit has held that the practice of securing pre-petition debt with pre- and post-petition collateral, known as cross-collateralization, is an impermissible means of obtaining post-petition financing. *In re Saybrook Manufacturing Co.*, 963 F.2d 1490 (11th Cir. 1992).

The court stated that cross-collateralization, often referred to as *Texlon*-type financing — named for the first appellate court to recognize its use, *Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.)*, 596 F.2d 1092 (2d Cir. 1979) — was neither explicitly authorized by the Bankruptcy Code nor consistent with the Code's basic priority scheme.

In *Saybrook*, the unsecured creditors objected to an order permitting the debtor to receive a post-petition loan of $3 million in exchange for granting Manufacturers Hanover a security interest in all of the debtor's property acquired both pre- and post-petition. At the time the petition was filed, the debtors owed Manufacturers Hanover $34 million, secured by collateral valued at less than $10 million.

Pursuant to the order, the security interest not only protected the $3 million of post-petition debt, but would also secure the bank's $34 million pre-petition debt. This, the court observed, enhanced the bank's position, vis-a-vis other unsecured creditors in the event of liquidation.

The lender argued that the court should assume cross-collateralization as authorized under Sec. 364 and conclude that the appeal was moot pursuant to Sec. 364(e). The court rejected this reasoning, inasmuch as it "put the cart before the horse." The Eleventh Circuit stated that Sec. 364(e) applies only if the challenged lien or priority was authorized under Sec. 364.

Additionally, the court noted that the priority order of claims and expenses against the debtor's estate is fixed by Code Sec. 507. That is, creditors within a given class are to be treated equally, and bankruptcy courts may not create their own rules of superpriority within a single class.

The Eleventh Circuit then determined that cross-collateralization was inconsistent with the Code's priority scheme, as it gives post-petition lenders' unsecured pre-petition claims priority over all other unsecured pre-petition claims. The court concluded that the appeal was not moot since cross-collateralization is impermissible per se under Sec. 364 and, therefore, subsection (e) was inapplicable to a cross-collateralization agreement.

Policy Considerations

There are diverse, as well as conflicting, policy reasons to encourage lenders to extend additional post-petition credit to debtors. Although Chapter 11 is premised on the continued operation of a debtor's business, the urgency to inject fresh capital and the difficulties in obtaining it are obvious. Lenders and suppliers are understandably reluctant to extend credit to a debtor who is in bankruptcy and who may have few, if any, unencumbered assets to furnish as collateral.

In enacting the Bankruptcy Code, Congress intended to encourage post-petition financing by permitting new liens to be acquired on the debtor's assets and offering the lender priority over administrative claimants. *Burchinal v. Central Washington Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484, 1488 (9th Cir. 1987).

Pursuant to Code Sec. 364, a variety of financing arrangements may be approved on an expedited basis after a hearing on notice to all creditors. Subsection (e), in turn, protects the authorization of a priority lien from reversal or modification on appeal, provided that the lender extended such credit in good faith and the authorization was not stayed pending an appeal. 11 U.S.C. Sec. 364.

Other Views

Cross-collateralization, however, is not expressly included on the list of financing procedures authorized by Sec. 364. The plain language of Sec. 364 gives little guidance as to whether Congress intended to include a procedure

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Avoiding Deprizio *Rule*

respect to the typical guaranty, the contingency is the default of the primary obligor. [Citations omitted.] In the present case, there is simply a further contingency — that being payment of the debt in full. Whether that right has ripened into a right of reimbursement as of the bankruptcy filing is not determinative. It is simply a question of timing." *Gallagher*, 126 B.R. at 1000.

One commentator has argued that waiver of subrogation rights should not prevent recovery under *Deprizio* and may make it more likely that the transfer to the non-insider will be found to be a fraudulent conveyance under the Bankruptcy Code.

Pending a decision by the U.S. Supreme Court or a legislative solution, the law in this area remains uncertain.