Schulte Roth&Zabel

Alert

Sixth Circuit Insulates 'Arguably Bad Faith' Secured Lender from Fraudulent Transfer Attack

September 20, 2021

A secured lender's "later arguably bad-faith … actions [cannot] undermine its earlier perfected security interest," held the U.S. Court of Appeals for the Sixth Circuit on Sept. 10, 2021. *In re Fair Finance Company*, 2021 WL 4127430, *1 (6th Cir Sept. 10, 2021). Affirming the district court's dismissal of a trustee's fraudulent transfer attack based on the lender's later conduct, the Court of Appeals reasoned that the debtor's "payments [to the lender were] not avoidable" because "a 'valid lien' encumbered the transferred assets." *Id*., at *3. The Ohio Uniform Fraudulent Transfer Act,[1] made applicable by Code ("Code") § 544(b), "creates an avenue for unwinding fraudulent transfers of 'assets,' but it excludes property encumbered by a valid lien from the definition of asset." *Id*., at *2. "Because "transfers" are limited by the statute to "asset" transfers, the payments here were not "transfers and could not be fraudulent transfers." *Id*. at *3. "[A] 'valid lien' encumbered the transferred assets," making the debtor's payments "not avoidable." *Id*. More importantly, the court rejected the trustee's argument that the lender's "troubling post-lien-creation" conduct invalidated its earlier security interest, "regardless of whether [the lender] directed [its] bad faith toward the debtor's creditors." *Id*., at *4. The trustee had based this argument on the lender's having allegedly "acted in bad faith after it learned about the [debtor's] Ponzi scheme ... [—] knowingly propping up the [debtor's] Ponzi scheme." *Id*., at *2, *3, and *5.

Relevance

Secured lenders are generally at the top of the bankruptcy hierarchy. If they have a valid lien on the debtor's assets, they are least theoretically unaffected by the debtor's bankruptcy. They are entitled to reclaim the property subject to their lien or receive its "indubitable equivalent." *United Sav. Ass'n of Texas* v. *Timbers of Inwood Forest Assocs. Ltd*., 484 U.S. 365 (1988) (value of secured lender's collateral entitled to "adequate protection" under Code § 361, which may be in the form of cash payments, replacement liens or other methods that result in "realization ... of the indubitable equivalent" of the lender's property interest). For that reason, junior unsecured creditors try to challenge the validity of the lender's lien by looking for misconduct that prejudices other creditors. *Fair Finance* underscores the practical problems that a bankruptcy trustee, representing unsecured creditors, may have in attacking a secured lender who has engaged in "arguably bad faith" conduct.

Facts

The debtor had "entered into a $22 million revolving loan agreement with [T, the lender here] and another bank in 2002", giving T a "perfected … security interest in all" of the debtor's assets. Shortly

[1] Section 270(b)(1) of New York's Uniform Voidable Transactions Act ("UVTA"), based on the earlier Uniform Fraudulent Transfer Act, is identical: "'Asset' means property of a debtor, but does not include (1) property to the extent it is encumbered by a valid lien."

thereafter, "new owners (later convicted criminals) bought [the debtor] and began to run it into the ground by using the company to perpetuate a Ponzi scheme." *Id*., at *1. In 2004, the parties "renewed and extended the revolver with conditions designed to protect [T's] interests", with T's being paid in full by 2007. *Id*. Unsecured creditors forced the debtor into bankruptcy during 2010. The debtor's principals were later convicted "of crimes in connection with the Ponzi scheme." *Id*., at *1. T knew nothing about the debtor's fraud when it made the secured loan in 2002, but, by 2003, knew about the debtor's "house of cards," "shaky" related-party loans, and suspicious "financials," among other things. *Id*. But it continued to lend, insuring that its loans "stay out of [the debtor's] shaky loans," making a "side deal" before extending its loan in 2004, helping to "prevent public exposure of" the debtor's "precarious financial condition," and "encouraging [the debtor] to inject more insider-loan money into failing related entities." *Id*., at *2.

The district court "rejected the trustee's attempt to unwind the transfers [i.e., payments by the debtor]" to T as fraudulent. On appeal, the trustee unsuccessfully argued that the district court "mistakenly rejected its arguments at summary judgment and erroneously instructed the jury at trial on an unrelated [novation] claim." *Id*.

Sixth Circuit Analysis

The Sixth Circuit rejected the trustee's argument that T's "2002 security interest is not a 'valid lien' because [T] acted in bad faith after it learned about the [debtor's] Ponzi scheme." *Id*. at *3. It explained why the "payments encumbered by the 2002 security interest [were] not avoidable" here: only if T's "2002 security interest is not valid" might the later loan repayments be "potentially avoidable" as fraudulent transfers. *Id. See*, e.g., *In re O'Day Corp*., 126 B.R. 370 (Bankr. D. Mass. 1991) (debtor's granting of security interest on all assets held to be fraudulent transfer).

The UCC Priority Test. The Ohio version of the Uniform Commercial Code ("UCC"), like its counterpart in other states, determines the validity of a lien and whether a lien would be "effective against a later judicial lien" *Id*., at *4. "[C]onflicting perfected security interests … rank according to priority in time of … perfection [i.e., usually recording]." *Id*. "Perfection is thus the key to determining priority between a creditor's security interest and a competing lien creditor — [the] first security interest to attach … has priority.'" *Id*.

"[T]he priority test is not about invalidation." *Id*., at *6. But the trustee in *Fair Finance* argued that if the lender "acts in bad faith after perfecting his security interest he … forfeits his right to claim priority over" a later lien creditor "regardless of whether [the lender] directed his bad faith toward" that lien creditor, relying on the UCC's duty of good faith." *Id*., at *4.

The Limited UCC Good Faith Test. The UCC imposes an obligation of good faith in the "performance and enforcement of contracts and duties" within the article covering secured transactions. It only limits a "bad-faith actor's ability to 'enforce' its security interest priority rights." *Id*., at *5. The Sixth Circuit stressed that "the duty of good faith does <u>not</u> alter the question that the UCC priority rules answer — relative priority among competing interests." *Id*., at *5. The duty of good faith, therefore, only applies to the "<u>performance and enforcement</u> of contracts and duties." *Id*.

Rejecting the trustee's bad faith argument, the court explained that "the only enforcement right that bad faith can impact is enforcement of a senior priority vis-à-vis a junior creditor's rights — a question of priority, not validity." *Id*. According to the court, "the question is whether as between two or more

specific competing creditor interests, a junior interest should jump in line … And that means as a practical matter that reordering based on bad faith would only ever happen based on a senior creditor's actions directed at, or taken within a relationship with, the junior creditor seeking to jump ahead of the bad actor in line." *Id*., at *6. *See*, e.g., *Thompson* v. *United States*, 408 F. 2d 1075, 1084 (8th Cir. 1969) ("lack of good faith toward the government" justified "alter[ing] priorities ... under [UCC] Article 9.").

"The analysis is necessarily specific to the relationship between the parties in the priority contest. And that means the type of bad faith needed to reorder priority is bad faith within a relationship that involves at least two competing creditors." *Id*. *See*, *e.g*., *Affiliated Foods Inc*. *v. McGinlay*, 426 N.W.2d 646, 648 (Iowa Ct. App. 1988) (senior secured creditor "estopped from asserting [its] secured interest prior to the interests of" a junior creditor because senior creditor had "induced [the junior creditor] to believe that [it] would be given" a higher priority than the senior creditor). According to the Sixth Circuit in *Fair Finance*, this "distinction between the usual priority dispute and the [Uniform Fraudulent Transfer Act] definitional one decides this case." *Id*. T's "perfected 2002 security interest would prevail over" a later judicial lien "absent priority reordering." *Id*.

The Inapplicable Fraudulent Transfer Test. The UFTA "test[, in contrast,] requires ranking the security interest priority against a hypothetical generic subsequent judicial lien." *Id*. at *7. Because "a perfected interest is by definition a 'valid lien' under" the UFTA, the district court had "correctly rejected the trustee's bad-faith-invalidation argument at summary judgment." "[S]ubordination would never happen" in *Fair Finance* because the senior lender, T, never "direct[ed] its bad faith at a non-existent entity." *Id*.

The Trustee's Convoluted Novation Argument. T and the debtor "renewed, extended and altered the revolver" in 2004 when it "was set to expire." *Id*., at *7. But only if the parties had "novated the 2002" security agreement rather than renewing it, would the debtor "have transferred a new security interest" in 2004 that could be potentially "avoidable as a fraudulent transfer given [T's] knowledge of the Ponzi scheme at that time," as the trustee alleged. *Id*. The jury, however, found "that the [parties'] 2004 changes did not amount to novation." *Id*. Because novation, under applicable state law, extinguishes "a previous valid obligation" and replaces it with "a different one," and because the 2004 agreement "renewed rather than novated the 2002 debt, [the debtor] did not incur a new obligation in 2004 that could be avoidable as a fraudulent transfer." According to the Sixth Circuit, the "district court correctly rejected [the trustee's] convoluted argument" about the debtor's "new obligation" — "a semantic re-cloaking of the novation theory.'" *Id*. at *8.

* * *

Comments

1. The debtor's property interest in T's collateral was defined by applicable state law. If this case arose under the federal fraudulent transfer provision, Code § 548, the debtor's property interests would also be defined by state law. *Butner v. United States*, 440 U.S. 48, 55 (1979). A perfected secured creditor, such as T, would prevail over the trustee on the record developed here. As the Sixth Circuit noted, though, had T's 2002 security interest not been "valid," the debtor's payments to T would be "transfers" and "thus potentially avoidable under state or federal law. *Id*., at *3.

2. The trustee significantly failed to seek equitable subordination of T's lien under Code § 510(c). To do so, he would have had to prove by a preponderance of the evidence that T (a) engaged in inequitable conduct; (b) T's conduct harmed creditors or gave T an unfair advantage; and that (c) equitable subordination would be consistent with the Code. *See*, e.g., *In re Fabricators Inc*., 926 F.2d 1458, 1467-69 (5th Cir. 1991) (creditor's secured claim equitably subordinated when creditor caused "other creditors to extend new credit to [debtor]" and "[caused the debtor] to abstain from collecting" its receivables; obtained "a lien on [debtor's] assets to secure its capital contributions"; presented "a fraudulent corporate resolution to open a checking account" in debtor's name to deposit debtor's receivables "beyond the reach of creditors"; and interfered with debtor's contract to extract benefits for itself); *In re Winstar Communications Inc*., 554 F.3d 382, 412-13 (3d Cir. 2009) (inequitable conduct may be unrelated to "acquisition … of … particular claim"; "threats" to "force debtor" to buy "unneeded equipment"; "deliberately delayed issuing … refinancing notice"; prevented "public disclosure" of debtor's "poor financial health" so as to induce "other creditors to provide funds" to debtor).

3. The Second Circuit has held that a lender has no fiduciary duty to its borrower or other creditors, broadly limiting any lender's good faith obligation. *In re Sharp Int'l Corp & Sharp Sales Corp.*, 403 F.3d 43, 52 (2d Cir. 2005) (New York State law fraudulent transfer suit; Sharp raised new funds from its Noteholders to pay off its debt to a bank; the bank "gave no warnings and blew no whistles, ignored inquiring calls from the Noteholders, preserved Sharp's line of credit when it had the right to foreclose and pull the plug, and gave [the borrower] its needed consent to the new indebtedness ... . One could say that [the bank] failed to tell someone that his coat was on fire; or one could say that it simply grabbed a seat when the music stopped. The moral analysis contributes little. Whatever [the bank] knew about [management's] fraud, [it came] by that information through diligent inquiries that any other lender could have made. Sharp fails to identify any duty on [the bank's] part to precipitate its own loss in order to protect lenders that were less diligent"). The Seventh Circuit reached the same result in *B.E.L.T. Inc. v. Wachovia Corp.*, 403 F.3d 474, 476 (7th Cir. 2005) ("Illinois, like most other states, does not require business ventures to do good turns for their rivals."); *In re Actrade Financial Technologies Ltd.*, 337 B.R. 791, 810 (Bankr. S.D.N.Y. 2005) (following *Sharp* and applying its rule to the Bankruptcy Code, dismissed intentional fraudulent transfer claim because no specific allegation was made that defendant "was complicit with or had knowledge of an intentional scheme to defraud creditors").

Authored by Michael L. Cook.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com