ALERTS

Seventh Circuit Denies Fees to Breaching DIP Lender

In re Arlington Hospitality, Inc

April 13, 2011

The Seventh Circuit affirmed a district court's ruling that a debtor-in-possession ("DIP") lender had breached its financing agreement, barring its claim for commitment and funding fees from the DIP. *Arlington LF, LLC v. Arlington Hospitality, Inc.*, No. 09-3560, 2011 WL 727981, *9 (7th Cir. March 3, 2011), *aff'g* No. 08 C 5098, 2011 WL 3055350 (N.D. Ill. Sept. 18, 2009). Although the DIP itself had also breached the agreement, that breach was not, in the court's view, effective until *after* the lender had already "walked away." *Id.* at *6. Because the lender first breached the agreement, it could not now recover the fees from the DIP.

Facts

Arlington Hospitality, Inc. and its subsidiaries (collectively, "Arlington") operated a hotel chain. *Id.* at *1. On the eve of its Chapter 11 filing in August 2005, Arlington negotiated a term sheet for a DIP loan to be provided by Arlington LF, LLC ("Lender").[1] The Term Sheet provided for a DIP credit facility of $11 million, including a revolver portion and a term loan portion. *Id.* at *2. Its terms included payment of, among other things, a commitment fee and funding fee (collectively, the "Fees") to Lender. *Id.*

Shortly thereafter, the bankruptcy court entered an interim order ("Interim Order") approving and largely adopting the Term Sheet. *Id.* Critically, though, the Interim Order (but not the Term Sheet) contained a notice provision (the "Notice Provision") requiring Lender to give Arlington notice

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising

of any default and three business days to cure.[2] *Id.* According to the court, the Notice Provision "created a condition precedent which must have occurred before [Lender] stopped dealing with [Arlington]." *Id.* Thus, "Arlington could not, conceptually, be in breach of the Interim Order until *after* it had been given notice and opportunity to cure it" (emphasis added). *Id.* Like the Term Sheet, the Interim Order also provided that the Fees were "payable immediately." *Id.*

Arlington promptly drew $3.53 million under the revolver, but paid no Fees to Lender. *Id.* At the time, Lender never sought payment of its Fees, nor did it give Arlington notice of default pursuant to the Notice Provision. *Id.*

The relationship between Arlington and Lender later soured. *Id.* at *1, *3. Lender became increasingly uncomfortable with both its contemplated asset purchase and the loan, ultimately making these concerns explicit. *Id.* at *3. On Sept. 29, 2005, Lender told Arlington's investment banker that Lender "was unwilling to 'fund any more money under the DIP [loan]'." *Id.* On Oct. 4, Lender's counsel emailed the creditors' committee, stating, "We are not willing to proceed further with the DIP loan; in other words, we will make no further loans to the Debtors … We think the Debtor should find a new DIP lender to pay out our loan and fund the options that expire at the end of this month." *Id.*

Ultimately, Arlington found another buyer willing to buy the assets. Following the closing of that sale, Arlington repaid Lender the $3.5 million it had borrowed, with interest, but did not pay the Fees. *Id.* Lender moved in the bankruptcy court to recover the Fees. *Id.*

The Court's Decision and Analysis

The Seventh Circuit found that Lender, by its Sept. 29 statement to the DIP's agent and Oct. 4 e-mail to the committee, had committed an "anticipatory breach" or "repudiation" of the lending agreement. *Id.* at *6. According to the court, Lender showed a clear intent not to perform any more of its lending obligations. *Id.* Despite Lender's argument that it was merely uninterested in making *additional* lending agreements, the court found that interpretation to be incredible. *Id.*

Once Lender had repudiated the agreement, reasoned the court, Arlington was "free" of its obligations: "[a]t the moment [Lender] repudiated, Arlington was entitled to treat the agreement as having ended and was no longer under any obligation to perform … [Lender]

Copyright © 2024 Schulte Roth & Zabel LLP

clearly stated it would lend no more money and thus breached, and Arlington was entitled to treat it as such and walk away." *Id.* (internal citations omitted). Accordingly, Lender was "quite clearly" not entitled to the Fees. *Id.*

Comments

1. Lender was apparently inexperienced, unaware of the landmines present in DIP lending. Thinking aloud in front of the creditors' committee and the DIP's investment banker doomed its legal position.

2. A lender should call a default with notice when it arises. It can retreat later with a reservation of rights, but Lender's failing to call the earlier default and preserve its rights was fatal here.

Authored by Michael L. Cook and Karen S. Park.

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

---

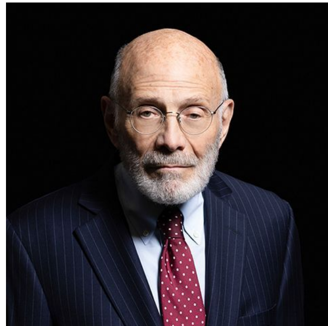
[1] Lender was a special purpose entity formed as a potential purchaser of Arlington's assets. It was initially reluctant to lend because it had never provided bankruptcy financing before, but agreed to lend in order to preserve its ability to purchase the assets. *See Arlington*, 2011 WL 727981, at *1.

[2] Significantly, the bankruptcy court later held that it was the Interim Order, and not the Term Sheet, that constituted the parties' agreement. *See Arlington*, 2011 WL 3055350, at *3.

This information has been prepared by Schulte Roth & Zabel LLP ("SRZ") for general informational purposes only. It does not constitute legal advice, and is presented without any representation or warranty as to its accuracy, completeness or timeliness. Transmission or receipt of this information does not create an attorney-client relationship with SRZ. Electronic mail or other communications with SRZ cannot be guaranteed to be confidential and will not (without SRZ agreement) create an attorney-client relationship with SRZ. Parties seeking advice should consult with legal counsel familiar with their particular circumstances. The contents of these materials may constitute attorney advertising under the regulations of various jurisdictions.

Copyright © 2024 Schulte Roth & Zabel LLP Attorney Advertising

Related People



Michael Cook

Of Counsel

New York

Practices

BUSINESS REORGANIZATION

Attachments

Download Alert

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising