

## Publications

### Recent Noteworthy Court Decisions Affecting Lenders in Restructuring Matters

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Earlier this year, two federal appeals courts decided cases that are significant to lenders whose borrowers are experiencing financial distress. In one case, the court stripped the lender of its secured status because the lender had failed to investigate the borrower's wrongdoing, despite having notice of suspicious facts. In the other, secured lenders financing single asset real estate borrowers were handed a victory when the court made it more difficult for a borrower to confirm a Chapter 11 plan of reorganization over the opposition of its primary lender.

#### ***A Lender's Failure to Investigate May Result in Exposure for Borrower's Wrongdoing***

In the *Sentinel Management Group, Inc.* bankruptcy case, the federal court of appeals covering Illinois, Indiana and Wisconsin – a court that is influential in bankruptcy matters – recently highlighted the consequences awaiting lenders that fail to follow up on “red flags” discovered during their review or administration of a loan transaction. Failure to heed these warnings can result in a bankruptcy trustee nullifying the lender's lien or even recovering a judgment for money.

#### The Backstory

Sentinel Management Group (Sentinel), a cash management firm, used secured financing from Bank of New York Mellon Corp. and Bank of New York (together, BNYM) to trade in liquid, low-risk securities. In addition to trading on its own behalf, Sentinel traded in similar securities on behalf of its customers, but was prohibited under federal law from commingling its institutional trading accounts with customer accounts and pledging customer assets as security. Lacking adequate assets to secure its loans with BNYM, Sentinel transferred securities from its customers' segregated accounts into its own trading account and pledged those securities to BNYM, all in direct violation of its customer contracts and federal law.

Upon receiving a periodic collateral report reflecting Sentinel's transfer of customer assets to institutional trading accounts in early 2007, BNYM employees reviewing the report expressed concern as to how Sentinel, which disclosed only \$3 million in company-owned assets but over \$1 billion in segregated customer securities, was able to provide \$300 million in collateral to secure its loan. Previous years' audited financial statements also revealed the use of customer-owned securities as collateral for BNYM loans, further casting doubt on the legality of Sentinel's proposed pledge. Despite these concerns, BNYM executives unquestioningly relied on Sentinel's assurances that its customers consented to the transfers and declined to investigate further.

When Sentinel filed for bankruptcy, BNYM was owed \$312 million and claimed a lien on the customer securities. However, the bankruptcy trustee filed a lawsuit against BNYM, claiming that Sentinel committed fraudulent transfers when it moved customer securities into Sentinel's institutional trading accounts, and that BNYM was the recipient of the fraudulent transfers.

## The Ruling

Sentinel's actions were fraudulent, but BNYM could escape liability if it established that it accepted the lien "in good faith." On appeal, the court ruled that BNYM could not have acted in good faith because it was on "inquiry notice" of Sentinel's misconduct. Testimony from BNYM employees and internal e-mails demonstrated that some BNYM employees were suspicious of whether Sentinel was wrongfully pledging customer assets as security for BNYM loans. Those suspicions alone were sufficient to put BNYM on inquiry notice, and thereby triggered a duty to diligently investigate for possible wrongdoing. Furthermore, whether the BNYM employees reviewing the transaction (or their superiors assessing these concerns) were capable of correctly identifying the warning signs of wrongdoing was irrelevant; so long as the facts available to those employees "would lead a reasonable, law-abiding person to inquire further," they were obligated to "conduct a diligent search for possible dirt." Once on inquiry notice, BNYM could no longer receive the pledge from Sentinel in good faith, entitling the trustee to nullify BNYM's lien on Sentinel's customer accounts and render BNYM a mere unsecured creditor.

## The Takeaway

The lesson from the *Sentinel* case is clear: financial institutions must take their diligence and investigation responsibilities seriously. Financial institutions should implement a protocol for identifying "red flags" in loan transaction diligence and encourage a culture of full disclosure and investigation. Failure to appropriately identify and investigate suspicious facts can put a lender on inquiry notice of a borrower's wrongdoing, and thereby eliminate the lender's good faith defense to a future fraudulent transfer action. While the *Sentinel* case dealt with a borrower providing collateral it could not lawfully pledge, the decision could apply to other types of borrower misconduct.

***Raising the Bar on a Single Asset Real Estate's Ability to "Cram Down" a Plan on Its Lender***

## The Issues

Single asset real estate borrowers in a Chapter 11 bankruptcy face a number of challenges if they attempt to confirm a plan of reorganization that restructures the loan terms over the lender's opposition – a so-called “cram-down” plan. For example, the borrower may try to lower the interest rate, reduce amortization, lengthen the term, provide for a balloon payment that may not realistically be refinancable given the projected loan-to-value ratio, change covenants, etc.

One requirement for a bankruptcy court to approve a cram-down plan is that at least one class of “impaired” creditors must vote to accept the plan. (Class acceptance requires that creditors holding at least two-thirds in amount of claims in the class vote in favor of the plan, and that more than one-half in number of creditors voting vote in favor of the plan.) Many single asset real estate borrowers have debt structures consisting only of the permanent real estate loan and a handful of unsecured creditors, perhaps trade creditors and/or providers of professional services. Assuming the lender opposes the plan, the borrower's ability to confirm the plan requires it to “impair” the unsecured creditor class, yet have that class agree to the impaired treatment. As a practical matter, such unsecured creditors would be “impaired” if the plan proposed to pay them less than 100 cents on the dollar and/or pay them later than the date on which the plan becomes effective.

Another requirement for plan confirmation is that it be offered in “good faith.” In the recent case of *Village Green I, GP v. Federal National Mortgage Association*, the federal appeals court for the Sixth Circuit (presiding over Ohio, Kentucky, Michigan and Tennessee) “giveth” to the borrower when it permitted the plan to “artificially impair” claims of unsecured creditors, but “taketh away” by finding that the plan was not proposed in good faith.

In the *Village Green* case, Fannie Mae financed an apartment building and was owed \$8.6 million when the borrower filed for Chapter 11 bankruptcy. Fannie Mae rejected the borrower's proposed plan, which provided for slow amortization, resulting in a \$6.6 million balance after 10 years. The only impaired creditors supporting the plan were unsecured creditor class, made up of the borrower's former attorney and accountant. These creditors were owed only about \$2,400 in total and they were impaired only because there would be a delay of 60 days to receive payment in full.

## The Ruling

Even though the impairment of the unsecured creditors was contrived or “artificial,” the court considered them to be impaired for purposes of the Bankruptcy Code. The plan therefore passed the one-impaired-accepting-class test. The court then examined the plan for good faith.

The court found that the plan was not offered in good faith because the impairment of the unsecured creditors' claims was clearly designed to evade the purposes of the one-impaired-accepting-class test. One reason is that under the plan, the borrower projected \$857,000 of monthly net income in the first year, which called into question the claim that it could not pay the \$2,400 owed to the attorney and accountant up front. Second, the court was concerned with the close relationship between these professionals and the debtor. These creditors had even refused to accept full payment up front from Fannie Mae. The court found that this alliance, coupled with the projected income of the debtor, showed that the impairment of the creditors was solely to force the plan to be confirmed over Fannie Mae's objections, and thus was not in

good faith.

## The Takeaway

Under certain facts, the *Village Green* case strengthens the hand of real estate lenders (at least in cases within the Sixth Circuit) who contest a plan because it provides for repayment terms that are not economically feasible or contains other unacceptable restructuring terms. A borrower that impairs a class of creditors and obtains that class's favorable vote will nevertheless be subject to the lender's challenge on good faith grounds if the impairment was merely to circumvent the purpose of the one-impaired-accepting-class test. Whether or not the good faith test is met will be a factual issue that will require the court to consider evidence of whether the impairment was for proper purposes. In addition, the lender's position may be strengthened if, like Fannie Mae, it offers to pay off the unsecured creditors who have allegiance to the borrower and are willing to accept the borrower's plan to give them less favorable treatment.

Your Vorys attorney will be happy to discuss with you any questions you may have about the issues in these cases or any other debt restructuring, workout or bankruptcy issues that you may confront.