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## Bankruptcy Judge Awards $17 Million Dollars in Damages Against Lender

A Texas bankruptcy court judge awarded $17 million in damages against a secured lender for a variety of lender-liability claims, including: breach of contract, fraud, negligent misrepresentation, breach of duty of good-faith and fair dealing, tortious interference of contract and willful violation of the automatic stay. In *In re Bailey Tool & Manufacturing Company et al*., 2021 WL 6101847 (Bankr. N.D. Tex. Dec. 23, 2021), Bankruptcy Judge Stacey G.C. Jernigen held that the lender was liable to the Debtors' estates and their principal for compensatory and exemplary damages and attorney's fees and expenses (which award will be the subject of further litigation), and subordinated its claims to general unsecured creditors and equity interests.

The Debtors were in the business of manufacturing, metal fabrication and project engineering and design. Its customers included auto manufacturers and suppliers and the U.S. Army. Republic Business Credit, LLC ("Lender") agreed to provide bridge funding while the Debtors exited their existing credit facility and prior to entering into a new credit facility. After five months of due diligence, the Lender and the Debtors entered into inventory loan agreements secured by substantially all the Debtors' assets, and a factoring agreement contemplating the "sale" of accounts receivable.

The Lender identified several issues relating to the collateral prior to the parties entering into the lending relationship, but decided to proceed notwithstanding those issues. Specifically, the Lender debated whether certain receivables, including those from the U.S. Army, would be eligible, and expressed concern over outstanding judgments for unpaid real estate taxes.

The parties entered into the various agreements in February, 2015. Less than one month later, the Lender unilaterally determined that certain receivables, including receivables from the U.S. Army, were ineligible. Lender asserted that the Debtors had negative availability and refused to make the requested advance. Ultimately, the Lender made a wire in the amount of $135,000, but treated it as an "over-advance" resulting in additional fees and expenses. The Bankruptcy Court later held that on the date that the Lender advised the Debtors that it did not have any availability under the facility, an internal email indicated that the Debtors, in fact, had approximately $100,000 in availability. It was later determined that there may have been as much as $160,000 of availability at that time.

Lender was aware that the Debtors had an overdue real property tax obligation for the 2013 calendar year for which a payment plan was in place. However, because the Lender had deemed itself to be insecure, and was advancing at substantially reduced rates, the Debtors were unable to make the May 2015 installment. Debtors' prior lender immediately sent a default letter for failure to pay the installment, as well as property taxes for 2014. In response, the Lender declared a default on June 29, 2015, less than three and a half months after entering into the credit facility. Lender ceased making advances to the Debtors.

Debtors missed payroll and employees walked off the job causing the plant to shut down. This had a ripple effect of adversely impacting the Debtors' customers. At the same time that it refused to make advances, Lender sought to improve its position by unilaterally, and without notice, transferring funds from the lockbox to pay down the inventory loans, which had not matured, and required only interest payments.

The Debtors filed for Chapter 11. Individuals at the Lender celebrated the Debtors' bankruptcy filing, as evidenced by an email from its risk manager to its COO in which she rejoiced at the Debtors' "implosion" and expressed interest in attending the hearing so that she could watch "the walls come crashing down". Ultimately, the Debtors were unable to reorganize. A Chapter 7 Trustee was appointed resulting in the action against the Lender. The Debtors' principal asserted separate claims.

In addition to damning inter-company emails, including admissions that the Debtors had availability and that the Lender was adequately secured, the Trustee submitted evidence from its forensic accountant that the Lender withheld over $584,000 that it had over-collected from Debtors, which testimony went unchallenged by the Lender. The Court characterized the Lender's conduct as conducting an "unannounced liquidation" of the Debtors by engaging in numerous actions which the Bankruptcy Court considered to support its findings of breach of contract, lender liability, fraud, negligent misrepresentation, breach of duty of good-faith and fair dealing, tortious interference of contract and willful violation of the automatic stay, including:

- Refusing to advance funds under the factoring agreements in good faith.
- Refusing to advance funds to Debtors and instead paying third-party vendors and employees selected and approved by Lender.
- Exercising excessive control over the Debtors' businesses.
- Misleading the Debtors about availability, without being transparent that it was prepaying the inventory loans, which reduced or eliminated "availability" from the cash generated by the receivables.
- Wrongfully placing a lien on Debtors' principal's residence which constituted exempt property and extorting the Debtors' principal to pay a portion of the proceeds of the sale with a false promise to resume funding.
- Declaring a default, without reasonable basis (*i.e.*, because the Company had been temporarily shut down) when Lender essentially had caused the shut down by withholding funding based on a false premise that there was no availability.
- Charging an undisclosed termination fee of $75,000 with representations that Lender would resume funding after getting the homestead proceeds.
- Wrongfully exercising control over proceeds of accounts receivable created on or after the termination of the facility and charging the termination fee.
- Wrongfully demanding releases while withholding approximately $584,250 of the Debtors' funds.
- Charging undisclosed fees, charges and penalties.
- Thwarting the Debtors' ability to obtain debtor-in-possession financing claiming that Republic owned Debtors' accounts in perpetuity.
- Thwarting the Debtors from maintaining existing customers or developing new customers and from reorganizing in bankruptcy.

The Bankruptcy Court held that the Lender violated the automatic stay by: (i) wrongfully withholding over $584,000; (ii) continuing to collect receivables belonging to the Debtors while it demanded releases; (iii) notifying third-party vendors that the lending agreement remained in place, and that paying the Debtors directly could result in claims being asserted by the Lenders, thereby making it impossible for the Debtors to continue to operate.

The Bankruptcy Court held that the Lender's actions were a precipitating factor of the Debtors Chapter 11 filings. The Court did not mince words in its interpretation of the acts by the Lender stating, "but for the actions of the Lender, the Debtor would not have failed as going concern and would not have had to go into bankruptcy."

Lenders must navigate a fine line between protecting their credit, and overreaching. The *Bailey Tool and Manufacturing* decision is an instruction manual for lenders on what not to do in dealing with a distressed credit facility. The Lender identified numerous red flags, but proceeded with the arrangement. The Lender may have successfully exited the facility, had its documents been more precise, was transparent with the Debtors and developed a well-defined plan to address the issues that predictably arose in this case.

**For more information, please contact:**

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