



he cases we have selected for this issue address a number of interesting topics: (i) the proposed use of a general unsecured creditors trust in the context of a §363 sale, (ii) the overlap between commercial lenders' individual due diligence and their reliance on independent auditors in the context of a cause of action for fraud and (iii) the "instrumentality" theory of lender liability.

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re On-Site Sourcing, Inc., 2009 WL 1789331 (Bankr. E.D. Va. June 22, 2009) (Bankruptcy court blocks use of a trust for unsecured creditors in the context of a § 363 sale.)

On-Site Sourcing, Inc. filed for Chapter 11 relief on February 4, 2009. As part of its first-day motions, the debtor filed a motion to sell substantially all of its assets under a § 363 sale to a competitor, Integreon Managed Solutions, Inc. Prior to the filing of the Chapter 11 petition, Integreon had purchased all of On-Site's senior secured debt, which had a face value of approximately \$35 million, as well as its mezzanine subordinated debt, which had a face value of approximately \$7 million. In connection with the proposed § 363 sale, Integreon offered to credit bid \$28 million for substantially all of On-Site's assets as a going concern, thus leaving Integreon with a deficiency claim on its secured debt position.

The general unsecured creditors initially challenged the sale, but ultimately agreed to support the sale after Integreon agreed to give up its deficiency claim and to exclude certain assets from the sale. Specifically, tax refunds and certain Chapter 5 causes of actions against officers and directors of the company, valued at approximately \$132,000, were to be excluded from the sale and instead funded into a trust for the benefit of the unsecured creditors. While the bankruptcy court ultimately approved the § 363 sale after a review of the factors set forth in *In re Gulf Coast Oil Corp.*, 404 B.R. 407, 422, a case we previously reported on in the July 2009 issue of *The Secured Lender*, the bankruptcy court did not permit the excluded assets to be placed in trust for the benefit of unsecured creditors.

The court determined that the use of the creditors trust in this case, would impermissibly divert a part of the proceeds of the sale of On-Site's assets outside of the Chapter 11 process. In the

ordinary course, the \$132,000 and other consideration proposed to be paid to the general unsecured creditors trust would be distributed to creditors of the estate pursuant to a confirmed Chapter 11 plan, in accordance with the priority scheme prescribed by the Bankruptcy Code. Pursuant to such a plan, administrative priority claimants, for example, typically would be paid in advance of the general unsecured creditors absent such priority claimants' consent. However, according to the court, by redirecting part of the proceeds of the § 363 sale from the administrative expense claimants to the general unsecured creditors, the payment of funds into the creditors trust violated the Bankruptcy Code's priority scheme.

While it is true that the priority claimants, whose rights were allegedly violated by the sale, could have consented the sale through a confirmed Chapter 11 plan, such a plan would require the preparation, approval and circulation of a disclosure statement – the mechanism specifically designed by the Bankruptcy Code to ensure that each creditor can make an informed decision. The bankruptcy court, reviewing the creditors trust approach through a lens of fundamental fairness, believed this approach distorted the Chapter 11 process. As the court noted, "it is unfair to successfully increase an inadequate sales price to a fair sales price, but then keep that benefit for one's own constituency at the expense of other more senior classes of creditors. It is unfair to other creditors adversely affected. It is unfair to prospective purchasers." *In re On-Site*, 2009 WL 1789331, at *10.

Section 363 sales undoubtedly will continue to be used with greater frequency, particularly in light of the successful use of this tool in the Chrysler reorganization. *In re On-Site Sourcing, Inc.* is an interesting example of a situation where the court upheld the use of a

§ 363 sale, but nevertheless safeguarded the fundamental priority scheme of the Bankruptcy Code.

DDJ Management, LLC, et al. v. Rhone Group L.L.C., et al., 60 A.D.3d 421, 875 N.Y.S.2d 17 (March 5, 2009) (New York state court holds that a lender's cause of action for fraud against an independent auditor cannot be sustained when the lender failed to conduct an independent investigation of financial statements that were represented to be accurate.) In March 2005, DDJ Management, LLC and group of lenders loaned approximately \$40 million to American Remanufacturers Holdings, Inc. A condition to closing the loan was that American Remanufacturers produce an "unqualified" audit for the year ending December 31, 2003. PriceWaterhouseCoopers, a defendant in this case, was employed as the accountant to perform the audit and eventually issued the "unqualified" audit opinion for 2003. However, prior to PwC's issuance of the opinion, American Remanufacturers issued unaudited financial statements for 2004 showing dramatic financial improvement over 2003. The improvement, though, was obtained through an accounting change that was not in compliance with GAAP regarding the reserves that American Remanufacturers took with respect to unsold inventory. Thus, the dramatic financial improvement of American Remanufacturing was merely a bookkeeping change and did not reflect a "real" improvement in its cash position. The lenders were never informed of this change to the reserves, but relied on representations and warranties of American Remanufacturers that the 2004 unaudited financial statements were true and accurate and had

been prepared in accordance with GAAP. Shortly after the loans closed, American Remanufacturers filed for bankruptcy and the lenders lost the entire amount of their loans.

PwC had reviewed American Remanufacturer's unaudited financial statements for 2004 prior to completing its unqualified audit of the 2003 financial statements. However, PwC did not provide a "subsequent events" footnote in the final 2003 unqualified audit or conduct a "going concern" analysis with respect to the 2004 financial statements. As a result, the lenders sued PwC alleging fraud on the theory that PwC had not conducted an independent audit of the 2003 financial statements due to pressure from American Remanufacturer. Further, the lenders alleged that PwC failed to perform standard auditing

procedures, such as providing a "subsequent events" footnote and "going concern" analysis, which, if performed, would have permitted PwC to discover the falsity of American Remanufacturers books (as reported to the lenders) and that American Remanufacturers was actually on the verge of collapse.

The court determined that the lenders cause of action for fraud against PwC could not be sustained. In short, the court believed that the lenders, as sophisticated investors, failed to perform their own due diligence with respect to the 2004 financial statements and therefore could not properly allege reasonable reliance on purported misrepresentations. In other words, "[t]o sustain a claim for fraud, sophisticated investors, as here, must have discharged their own affirmative duty to exercise



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ordinary intelligence and conduct an independent appraisal of the risks they are assuming.” *DDJ Management LLC, 60 A.D.3d at 424.*

This decision imposes an unprecedented duty upon lenders to examine a prospective borrower’s books and records even when that borrower has a financial statement certified by an independent auditor and has representations and warranties from the borrower that subsequent, interim financial statements had been prepared in accordance with GAAP consistently applied. The lenders are currently appealing the decision to dismiss their claim of fraud against PwC. The CFA will be participating as one of several organizations seeking to file an amicus brief in connection with the Motion for Leave to Appeal. We will keep you advised of further developments in this case.

FAMM Steel, Inc. v. Sovereign Bank., 2009 U.S. App. LEXIS 12634 (1st Cir. June 12, 2009) (First Circuit Court of Appeals rejects “instrumentality” theory of lender liability in a case brought by a borrower against its lender).

In 1998, FAMM Steel, Inc. entered into a secured credit facility with Sovereign Bank pursuant to which Sovereign made over \$6.1 million in loans to FAMM. After FAMM began experiencing financial difficulties in the fourth quarter 2001, its comptroller resigned.

While it searched for a permanent replacement, FAMM agreed to hire an interim comptroller suggested by Sovereign. A few months later, with the approval of the interim comptroller, FAMM hired a permanent comptroller. However, at the request of Sovereign, FAMM agreed to continue to retain the interim comptroller as a “financial manager” to oversee FAMM’s finances.

Unfortunately, the financial manager and new comptroller overstated FAMM’s revenues in their reports to manage-

ment and Sovereign. They also failed to pay monthly sales taxes and presented financial information to FAMM which showed FAMM was profitable when in fact it was still losing money.

From 2001 until 2003, FAMM suffered continuous losses which resulted in various defaults under its loan documents with Sovereign. In January 2003, after its president learned of the mismanagement by the financial manager and the new comptroller, FAMM notified Sovereign of the situation. A few months later, due to the existence of various defaults under the FAMM loan documents and the inability to reach an agreement with FAMM regarding the terms of a possible forbearance, Sovereign terminated the credit facility. In March 2004, Sovereign “sold” the loan at more than a \$4 million loss. After the sale, FAMM was shut down

and its assets were liquidated.

On December 29, 2006, FAMM commenced a lawsuit against Sovereign, accusing Sovereign of causing FAMM’s collapse by forcing it to hire an incompetent financial manager and then compounding the problem by, among other things, refusing to engage in restructuring negotiations, failing to issue a forbearance after allegedly promising to do so and refusing to respond to inquiries from FAMM’s suppliers and subcontractors. According to FAMM, Sovereign’s goal was to close FAMM, minimize its exposure and maximize the value of its loan.

In its complaint, FAMM asserted several legal theories of liability, including that Sovereign was liable to it under the “instrumentality” theory of lender liability and, in addition, for breach of the

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implied covenant of good faith and fair dealing. After the District Court rejected FAMM's claims and granted summary judgment to Sovereign, FAMM appealed to the First Circuit, which affirmed the District Court's ruling.

Under the common law instrumentality (or "alter ego") theory of lender liability, a lender may be held liable if it exerts such a degree of control over its borrower that the borrower becomes a mere conduit for the lender. In *FAMM Steel*, the First Circuit found that the instrumentality theory of liability was inapplicable for several reasons.

First, the First Circuit noted that the instrumentality theory of lender liability is typically used by third-party creditors to hold a lender liable for the borrower's debts, not by the borrower seeking to recover damages from its own lender (as FAMM was attempting to do in this case). As such, and finding no case law to support what it characterized as a "radical alteration" of the law, the First Circuit held that the instrumentality theory was inapplicable in this case.

Even if FAMM were permitted to seek damages from Sovereign under the instrumentality theory, the First Circuit stated that Sovereign did not exercise sufficient "control" over FAMM to give rise to liability. While Sovereign interacted with FAMM's financial manager, and may have even instructed FAMM to hire this financial manager, the First Circuit found no evidence that Sovereign directed the financial manager's actions or, even if it did, that Sovereign assumed actual, participatory control over FAMM's affairs. As such, the First Circuit held that Sovereign could not be liable under the instrumentality theory of lender liability.

In addition to rejecting the instrumentality theory of liability, the First Circuit found no merit in FAMM's claim for breach of the implied covenant of good faith and fair dealing. According to

FAMM, Sovereign breached this implied covenant by failing to respond to workout proposals and failing to issue a forbearance after allegedly promising to do so. Reasoning that a borrower's default necessarily alters the contours of the covenant of good faith and fair dealing, and that forbearance negotiations between FAMM and Sovereign never resulted in an actual agreement, the First Circuit held that there was no breach of the implied covenant of good faith and fair dealing.

The recent economic downturn has led to an increase in lender liability claims. While *FAMM Steel* was decided under Massachusetts law, the decision is noteworthy for its discussion of the instrumentality theory of lender liability and shows that, at least in the First Circuit, courts are not quick to hold a

lender liable for its borrower's financial troubles, particularly when the borrower is in default and the lender is acting only to protect its investment. **TSL**

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