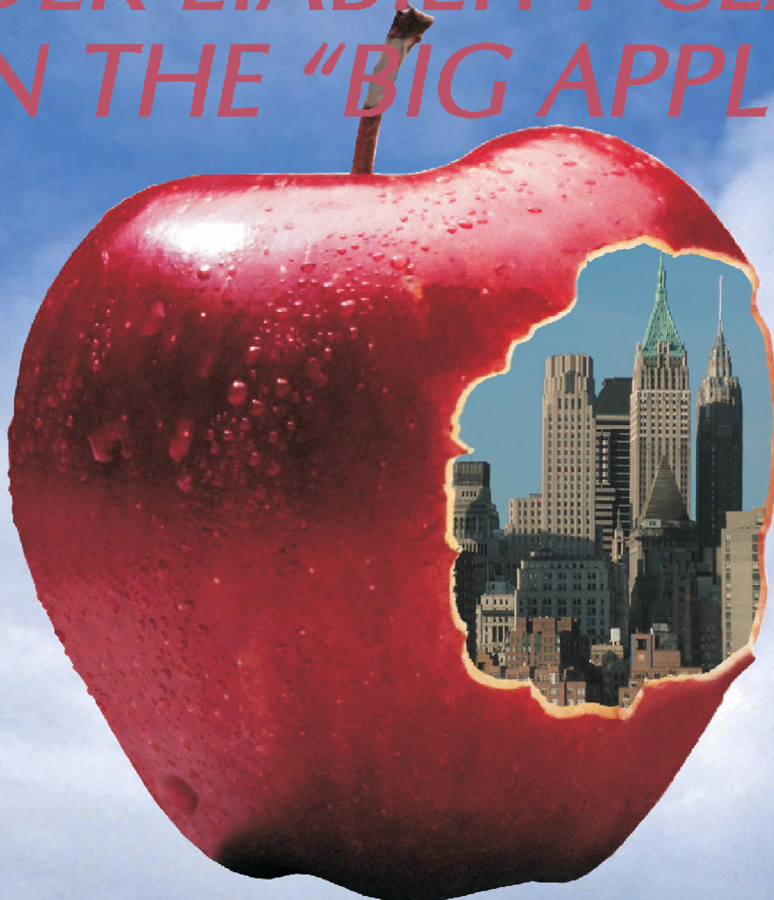
# LENDER LIABILITY CLAIMS IN THE "BIG APPLE"



## IF THEY CAN MAKE IT THERE, THEY'LL MAKE IT ANYWHERE

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by D. Tyler Nurnberg and Michael D. Messersmith

In recent years, the federal courts in New York have imposed significant limits on the prevailing "lender liability" claims favored by bankruptcy trustees, receivers and creditors' committees of failed borrowers. As a result, New York is becoming (if it wasn't already) a haven for lenders sued for their alleged role in a borrower's demise. No lender wants to be sued for enforcing its rights upon a borrower's default or trying to extricate itself from a bad credit but these lawsuits are an inescapable part of commercial lending nowadays and, when it happens, there are far worse places for a lender to be sued and have to defend itself than New York City.

This article discusses three emerging doctrines that make it difficult for trustees, receivers and committees to pursue lender liability claims in New York. First, New York is at the forefront of jurisdictions refusing to allow trustees to sue third parties for collaborating with a debtor's management in a scheme to defraud creditors. Second, New York is increasingly protective of lenders sued under a "deepening insolvency" theory for wrongfully prolonging a borrower's life and allowing it to spiral deeper and deeper into debt. Third, New York recognizes that a lender owes no fiduciary duty to its borrower or other creditors. In fact, after discovering a borrower's fraud, a lender is still under no obligation to disclose the fraud to the borrower or other creditors and may even use that information for its own benefit by, for example, insisting that the borrower refinance its loan through new, unsuspecting lenders.

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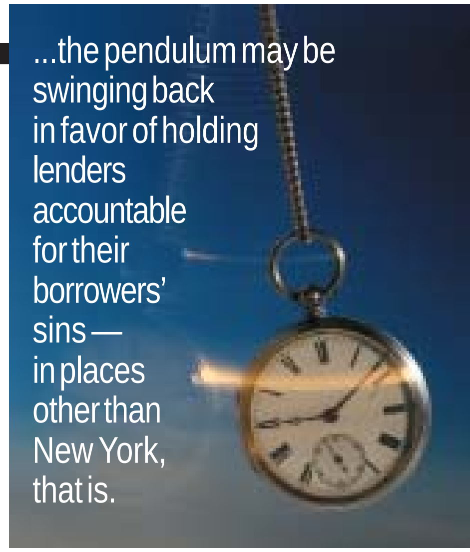
**Background: The lender liability pendulum**

Most lenders are all too familiar with the explosion of lender liability claims in the mid-1980s and the impact on bottom lines. (The term "lender liability claim" is meant to refer not to a specific cause of action, but rather to a variety of claims asserted against lenders enforcing their rights upon a borrower's default such as breach of contract, breach of implied duty of good faith or fair dealing, fraud, misrepresentation, breach of fiduciary duty, etc.) Multimillion-dollar verdicts were commonplace and there was a string of unfavorable court decisions expanding the theories upon which lenders could be held accountable, starting with cases such as *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985) (lender who terminated loan in conformity with loan agreement could nonetheless be sued for lack of good faith and should have notified borrower prior to termination) and *State National Bank v. Farah Mfg. Co.*, 678 S.W.2d 661 (Tex. App.-El Paso August 29,1984) (affirming large jury award against lender who threatened to terminate loan under "change in management" provision to prevent borrower from re-hiring former CEO) (judgment subsequently set aside, cause dismissed on March 6, 1985).

In the late 1980s and early 1990s, some of the more notorious judgments were reversed on appeal and decisions were issued reining in the more prevalent theories used to sue banks at the time, leading many to conclude that the lender liability "boom" had ended. Since the mid-1990s, however, lenders have witnessed a creeping resurgence in these claims. The trend started slowly, but is accelerating rapidly now due to a number of unrelated factors combining to create virtual "perfect storm" conditions for trustees or committees suing a failed borrower's lenders.

One factor contributing to the wave of lender liability lawsuits is the spate of recent, highly publicized scandals at large public companies such as Enron, Worldcom and Adelphia. Trustees and committees in these cases find themselves under tremendous pressure to maximize investor recoveries and are chasing lenders under increasingly expansive legal theories.

As another contributing factor, companies today are carrying increased debt loads. The trend is attributable largely to low interest rates that have made money cheap and easy to find. As companies file bankruptcy with greater debt, unsecured creditors will face diminished or no recoveries and look for ways to better their position such as by suing the debtor's lenders.




This phenomenon is made worse by the explosion of the second-lien loan market. The use of second-lien loans has skyrocketed over the past two years, with estimates that they are now utilized in ten percent of all asset-based credits. Because second-lien loans are senior to unsecured debt, there is an even greater likelihood that, when these borrowers file bankruptcy, unsecured creditors will be "out of the money" and looking for ways to improve recoveries.

There may be other factors contributing to the spike in lender liability claims — skeptics, for example, argue that lenders are targeted for having deep pockets or for having access to non-public information and, thus, being in the better position to detect fraud and report it. Regardless of which precise factors are causing the explosion, however, the inescapable fact is that lenders now commonly find themselves in the crosshairs of a failed borrower's trustee or committee. The data also reflect that many of these lawsuits are surviving challenges by lenders early in the litigation. This suggests that the pendulum may be swinging back in favor of holding lenders accountable for their borrowers' sins — in places other than New York, that is.

***Wagoner* and "evil zombie" trustees**

When a corporation files bankruptcy, an "estate" is created separate and apart from the corporation itself. The estate consists of, among other things, all legal and equitable interests of the debtor in property as of the filing. See 11 U.S.C. § 541. The trustee becomes the estate's representative and, as such, can sue and be sued. In effect, the trustee stands in the debtor's shoes and can bring any lawsuit the debtor could have brought had it not filed bankruptcy.

In spite of that seemingly broad grant of powers, the Second Circuit, in *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114 (2d Cir. 1991), imposed severe limits on a trustee's ability to pursue litigation on a debtor's behalf. *Wagoner* generally prohibits a trustee (or a committee suing in the trustee's place) from suing a third party for participating with a debtor's management in wrongdoing. That rule, commonly referred to as the "*Wagoner* rule," is a powerful tool for lenders and is cited routinely as the basis for preventing trustees and committees from suing third parties under a broad array of theories including fraud, aiding and abetting, civil conspiracy, tortious interference and deepening insolvency, among others.

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In *Wagoner*, a trustee sued a brokerage firm for its involvement in a trading scheme perpetrated by the debtor. The trustee alleged (1) that the broker manipulated the debtor into excessively speculative trading to gain for itself extraordinarily high commissions and (2) that the broker engaged in fraud by assisting the principal of the debtor in making bad trades that dissipated the debtor's funds. On appeal, the Second Circuit determined that claims against a third party for participating in management's fraudulent scheme accrue to creditors, not the corporation, meaning that the trustee had no legal standing to assert such claims. The Circuit's stated rationale was that, although creditors had suffered harm, the corporation itself had not.

In subsequent decisions, the Second Circuit elaborated on its rationale for *Wagoner*. *See Breeden v. Kirkpatrick & Lockhart LLP (In re Bennett Funding Group, Inc.*), 336 F.3d 94, 120 (2d Cir. 2003). In *Breeden*, the Circuit invoked a fundamental presumption from agency law — that a principal is generally liable for its agent's wrongdoing because it is presumed to know of the agent's wrongdoing — and concluded that the principal may not pursue legal action against a third party complicit in the wrongdoing since the principal was involved in the wrongdoing. Said differently, the rationale underlying the *Wagoner* rule is that management's misconduct must be "imputed" to the corporation and, ultimately, its bankruptcy trustee, thus depriving the trustee of standing to sue third parties who participated in management's wrongdoing.[1]

This rationale traces its roots to the equitable doctrine of in *pari delicto*. In *pari delicto* — literally, "of equal fault"[2] — is invoked by courts to deny claims by a plaintiff complicit in a defendant's wrongdoing because one ought not benefit from its own wrongdoing. The doctrine is grounded on two premises: (1) courts should not mediate disputes between wrongdoers and (2) denying relief to wrongdoers is an effective means of deterring future illegal conduct.

In the rare situation where a borrower sues its lender for a fraud spearheaded by its own management team, the rule probably makes sense — a corporation shouldn't benefit from its own misdeeds by suing a third party with whom it shares blame for the fraud. In practice, however, the rule is difficult to apply because the lawsuit is filed, not by the corporation, but by a trustee or receiver or committee after the guilty or inept management team has been removed.

Many argue that the equities change when a trustee assumes control. The trustee was not a party to the wrongdoing and is seeking recovery for the benefit of innocent creditors who are frequently the victims of the fraud. In the words of the Seventh Circuit, once the debtor's crooked manager is replaced by a receiver, the corporation is no longer that wrongdoer's "evil zombie" and, freed from that spell, may recover from others complicit in the fraud for the benefit of innocent investors. *See Scholes v. Lehmann*, 56 F.3d 750, 754-55 (7th Cir. 1995).

Another criticism of the *Wagoner* rule is that dismissing a trustee's claims against third parties complicit in a debtor's wrongdoing may promote, rather than deter, illegal conduct by shielding wrongdoers from liability. *See BCCI Holdings (Luxembourg), S.A. v. Clifford*, 964 F. Supp. 468, 480 (D.D.C. 1997) (imputation is "not intended to serve as a shield for unfair dealing" by third persons). Also, prohibiting trustees from pursuing these claims may force creditors to assert them, which can lead to perverse results. It may, for example, create competition between creditors and result in a morass of similar lawsuits, wasting judicial resources. In other cases, it may be too expensive or too burdensome for a single creditor to file the lawsuit, particularly if the creditor's injury is minor, meaning wrongdoers escape liability. Creditors may be able to sue as a class, but class actions are "clumsy devices"(*Scholes*, 56 F.3d at 755) and are criticized frequently as benefiting mostly only the lawyers representing the class.

In spite of these criticisms, *Wagoner* is alive and well and controlling law in the Second Circuit. *See*

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*Bennett Funding Group*, 336 F.3d at 99 (trustee lacked standing to sue debtor's former accountants and counsel for failing to blow the whistle on a Ponzi scheme at an earlier point). Variations of the *Wagoner* rule are followed in many other jurisdictions. *See, e.g., Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145 (affirming dismissal of trustee's RICO claims against third parties who facilitated Ponzi scheme)

However, the tenor of the Second Circuit's decisions, and the vigor with which lower courts apply the rule, make New York stand out. In addition, New York is unique because the Second Circuit treats the *Wagoner* rule as a "standing" question, making it an especially powerful tool for lenders.

Standing is a constitutional requirement — in order to sue, the debtor on whose behalf the trustee is suing must have sustained an injury separate and apart from its creditors. Standing questions are addressed early in litigation, often at the pleading stage. By contrast, most courts outside of New York treat *in pari delicto* as an affirmative defense. Affirmative defenses are usually not considered after preliminary discovery. The difference is significant because it means that, in New York, questions as to whether a trustee's claims are prohibited by *Wagoner* will frequently be addressed in the context of a lender's motion to dismiss. The result is usually less time spent litigating, lower costs and, to put it crassly, cheaper settlements for lenders.

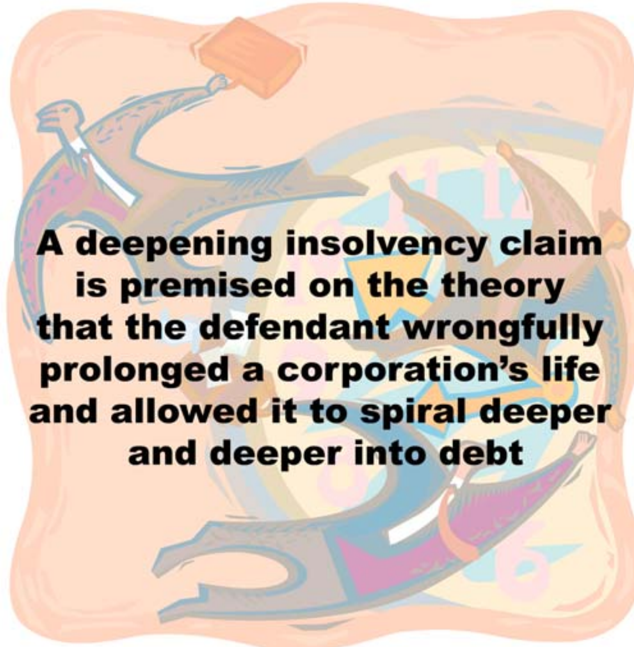
For lenders, the Second Circuit's adherence to *Wagoner* is good news. The rule is not without its criticisms but, until the Second Circuit reverses itself (which appears unlikely since it followed *Wagoner* in several recent decisions) or there is a legislative fix (which appears unlikely since it wasn't addressed in the last round of bankruptcy amendments in October 2005), federal courts in New York, applying New York law, are obligated to follow it. This makes New York an attractive forum for lenders sued under most of today's popular lender liability claims.

**Prolonging the death spiral and getting sued for it: Deepening insolvency**

A second area in which federal courts in New York have distinguished themselves in recent years as lender-friendly is in their handling of "deepening insolvency" claims.

A deepening insolvency claim is premised on the theory that the defendant wrongfully prolonged a corporation's life and allowed it to spiral deeper and deeper into debt, injuring the corporation and its creditors. It has been a theory of recovery since the early 1980s and traces its origins to two cases, the first, ironically, from New York. *See Bloor v. Dansker (In re Investors Funding Corp. of N.Y. Sec. Litig.)*, 523 F. Supp. 533 (S.D.N.Y. 1980); *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983).

Deepening insolvency originated in those cases as a way for courts to avoid imputing a director's or officer's wrongdoing to the corporation's trustee or receiver. These courts determined that prolonging a corporation's life did not necessarily confer a benefit on the corporation. As a result, the interests of the corporation and its guilty insiders were not aligned and a trustee or receiver could, under the "adverse interests" exception to the *in pari delicto* doctrine, sue third parties complicit in the insiders' wrongdoing.




In spite of those humble beginnings, deepening insolvency has evolved and there is an undeniable trend towards recognizing the theory either as a means of measuring damages under another legal theory or, in more extreme cases, as an independent claim. *See, e.g., Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co. (In re R.F. Lafferty & Co.)*, 267 F.3d 340, 347, 350-51 (3d Cir. 2001) (recognizing deepening insolvency as stand-alone claim under Pennsylvania law); *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Tech., Inc.)*, 299 B.R. 732, 751 (Bankr. D. Del. 2003) (same under Delaware law); *but see Official Committee of Unsecured Creditors v. Rural Telephone Finance Coop. (In re Vartec Telecom, Inc.)*, 335 B.R. 631 (Bankr. N.D.Tex. 2005) (creditors' committee sued secured lender; court refused to recognize deepening insolvency as stand-alone claim under Texas law).

As the doctrine has expanded, there has been a meteoric rise in the number of deepening insolvency claims filed by trustees and committees against a debtor's directors, officers, auditors, consultants, lawyers and, with increasing regularity, lenders. There is even a recent case in which the court allowed a committee of administrative claimants, in the context of a failed reorganization, to sue directors and officers for alleged "post-petition" deepening insolvency. *See In re LTV Steel Co.*, 333 B.R. 397, 420-23 (Bankr. N.D. Ohio). In New York, however, it appears that deepening insolvency may be losing some of its traction. Notably, in recent cases, the New York courts have recognized significant obstacles to deepening insolvency claims asserted by a trustee or receiver against a debtor's lenders, starting with *Kittay v. Atlantic Bank of N.Y. (In re Global Services Group, LLC)*, 316 B.R. 451, 458-59 (Bankr. S.D.N.Y. 2004).

In *Global Services*, a trustee sued the debtor's lender claiming that the lender knew or should have known when it made its loan that the debtor could never repay it. The court ruled in the lender's favor and dismissed the claim. The court emphasized that, while some New York courts have regarded deepening insolvency as a theory of damages, no reported New York case has acknowledged it as a stand-alone claim. The court then said that it may be unnecessary to distinguish between the two since merely prolonging an insolvent corporation's life, without more, doesn't trigger liability under either approach. In order to prevail, a trustee must show that the lender breached some separate duty, or committed an actionable wrong, that contributed to continued operations and increased debt. In the court's own words, a lender making a loan it knew or should have known could not be repaid "may be bad banking, but it isn't a tort."

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In August 2005, New York issued another decision, *Bondi v. Bank of America Corp. (In re Parmalat*), 383 F.Supp.2d 587 (S.D.N.Y. 2005), refusing to treat a deepening insolvency claim brought against a lender as a stand-alone claim. Parmalat is a dairy consortium accused of perpetrating a massive fraud on creditors that was placed in receivership in Italy. Following his appointment, the foreign receiver filed a number of lawsuits in New York and elsewhere seeking substantial recoveries from banks and professionals allegedly involved in the international conspiracy. In this particular instance, the receiver sued a bank that helped structure and execute a series of complex, mostly off-balance sheet, transactions that supposedly made Parmalat appear healthier and more creditworthy than the bank knew it was.

The receiver asserted various claims against the bank, including fraud, aiding and abetting fraud, aiding and abetting breach of fiduciary duty, negligent misrepresentation, diversion of assets, deepening insolvency, civil conspiracy and racketeering. On the bank's motion to dismiss, the court threw out most of the claims (mostly on *in pari delicto* grounds), allowing the complaint to proceed on the claim of whether the bank aided and abetted a breach of fiduciary duty and authorizing the receiver to amend its racketeering claims if it chooses.[3]

In relevant part, the receiver argued that deepening insolvency should be recognized as an independent claim under applicable North Carolina law based on the duty a lender owes "not to intentionally, knowingly prolong the life of a business enterprise that it knows to be insolvent[.]" The court declined that invitation, however. Notably, the

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court was critical of the argument that cases like *Lafferty* and *Exide* establish any duty owing from the bank to unsecured creditors. The court also noted a split in the cases on whether deepening insolvency can be a recognizable injury to a corporation. Ultimately, the court reserved ruling on the issue and threw out the claim as duplicative of the receiver's claim for aiding and abetting breach of fiduciary duty.

It is apparent from the decisions in *Global Services* and *Parmalat* that there are imposing obstacles for a trustee or committee to overcome to successfully sue a lender in New York on the theory that the lender wrongfully prolonged a borrower's life and deepened its insolvency.

### ***Sharp*: Lender owes no duty to other creditors**

Finally, lenders should be especially pleased with two recent decisions issued by the New York courts — one by the Second Circuit and the other by a state court — in separate lawsuits filed in connection with a massive fraud perpetrated by the owners of Sharp International Corp. *See Sharp Int'l Corp. v. State Street Bank and Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43 (2d Cir. 2005) and *Albion Alliance Mezzanine Fund, L.P. v. State Street Bank and Trust Co.*, 797 N.Y.S.2d 699 (N.Y. Sup. Cit. 2003), *aff'd* 2 A.D.3d 162 (N.Y. App. Div. 2003).

The two *Sharp* decisions confirm that, under New York law, a lender owes no fiduciary duty to a borrower or the borrower's other creditors. To the contrary, these cases suggest that a lender who knows of a borrower's fraud is under no obligation to disclose the fraud to the borrower or other creditors and may even use that information to its own advantage by insisting that its loan be repaid

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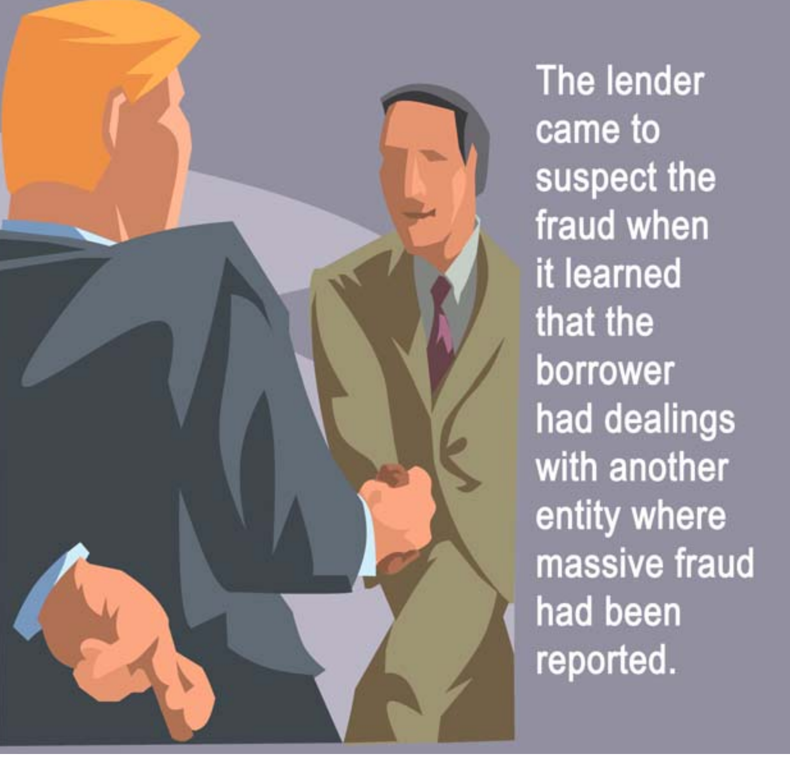


early or refinanced by new, unsuspecting lenders or investors.

Sharp imported and sold cheap watches and pens to retailers. The company was owned and operated by three brothers who, between 1997 and 1999, engaged in a massive fraud that allowed them to loot more than $44 million from the company. In 1999, Sharp's noteholders filed an involuntary Chapter 11 case in New York, following which the company continued to operate as a debtor in possession under the supervision of a third-party consulting firm.

In 2001, the debtor filed a lawsuit in its bankruptcy court against a former lender that learned of the brothers' fraud and extricated itself from the credit in a way that facilitated the victimization of other lenders and allowed the looting to continue. The debtor's noteholders also filed a virtually identical lawsuit against the lender in state court in New York.

The lender came to suspect the fraud when it learned that the borrower had dealings with another entity where massive fraud had been reported. The lender determined that the borrower had a history of failing to comply with the loan's reporting requirements or utilize a lockbox set up by the lender to monitor the company's receivables. That and other factors prompted the lender to commence an investigation that consisted of, among other things, contacting the borrower's customers to verify their business, reviewing audit work papers and hiring a forensic accountant to review the books and records. The lender also analyzed the borrower's receivables and determined that some customers were fictitious or in entirely different business lines.

Once the fraud was confirmed, the lender quietly arranged for its loan to be repaid from proceeds the borrower raised from new investors — the noteholders — who were unaware of the fraud. The lender knew of the negotiations with the noteholders and signed a consent allowing the borrower to incur the additional debt necessary to repay its loan, but never disclosed the fraud and, when called for a reference, refused to accept or return the noteholders' calls.

Several months after the lender was repaid, the borrower's auditor refused to issue an audit for the prior year, withdrew several prior audits and ended the engagement. The noteholders subsequently filed the involuntary case and, in 2000, the bankruptcy court entered a $44-million judgment against the brothers, who later also pleaded guilty to criminal charges.

In its adversary proceeding against the lender, the debtor alleged that the lender aided and abetted the principals' breach of fiduciary duty and that it was the beneficiary of fraudulent transfers made with constructive or actual intent to hinder, delay or defraud other creditors. As damages, the complaint sought to recover the $19 million the brothers looted after the lender discovered the fraud, plus the $12 million the lender was paid from the new investor monies.

On the lender's motion, the bankruptcy court dismissed the complaint and the district court affirmed. On further appeal, the Second Circuit agreed and held that the claims were properly dismissed. Critical to the Circuit's decision was its determination that the lender owed no duty to disclose the fraud to other creditors or even the new, unsuspecting investors who refinanced the borrower's debt. The lender simply "relied on its own wits and resources to extricate itself from peril, without warning persons it had no duty to warn." The Circuit concluded that the lender learned of the fraud through diligent inquiries that any other lender could have made, and that it owed no duty to protect lenders that were less diligent. *See also B.E.L.T., Inc. v. Wachovia Corp*., 403 F.3d 474, 476 (7th Cir. 2005) (lenders that lost money loaned to insolvent borrower sued lender that accepted repayments when it knew or should have known of borrower's fraud; *held*, dismissal of claims was proper because lender owed no duty under Illinois law to disclose fraud to the borrower or the borrower's other creditors).

The lender also prevailed in the state court lawsuit filed by the noteholders. There, the noteholders alleged that the lender engaged in fraud, negligent concealment, aiding and abetting fraud and civil conspiracy. The lender moved to dismiss, the trial court granted the motion and, on appeal, the lender prevailed. The state court denied the fraud claim on grounds that the lender owed no duty to disclose the suspected fraud to the borrower's investors, even though the lender benefited from its own silence. The state court also concluded that the noteholders' complaint was devoid of any claim that the lender "substantially assisted" the fraud (a necessary element of claim for aiding and abetting liability under New York law) or that there was an agreement between the lender and the brothers to engage in fraudulent scheme to defraud the noteholders (a necessary element of a civil conspiracy claim under New York law).

These two decisions are important not so much in terms of their conclusion that a lender owes no duty to other creditors, which is important, but not exactly "new" law,[4] but more from the standpoint that, upon learning of the fraud (or, in the state court's view, upon learning facts from which the lender should have suspected the fraud), the lender not only withheld the information but used the information to its own advantage. Stated differently, these cases suggest that a lender has considerable freedom to act in its own best interests when confronted with evidence of fraud by a borrower. The Second Circuit even acknowledged that the lender's conduct seemed morally repugnant, but concluded that it had done nothing wrong and simply came by the information through diligent inquiries that any lender could have made.


**Gaining access to New York courts, or at least New York law**

If a lender accepts the notion that New York is a desirable forum, the next logical question is what can it do to avail itself of New York's protections? That raises two questions: Where will the trustee or committee file the lawsuit and what governing law will be applied?

*Contractual solutions — Making picks in advance*: Most lenders try to decide these issues in advance, as a matter of contract, by including specific provisions — a "forum selection" clause and a "choice of law" clause — in their loan agreements. A forum selection clause will designate the court or courts in which the parties may litigate loan-related disputes. A choice of law clause will specify that a loan's terms must be interpreted and enforced under the laws of a particular state, oftentimes New York.

While it is a prudent practice to make these picks in advance, it may give lenders a false sense of security because the picks are not enforceable in every case. Forum selection clauses are, for example, void by statute in some places (e.g., Montana) and not legally binding in others (e.g., Iowa). And even courts inclined to respect the parties' choice of forum must, as a matter of federal law, consider whether enforcing that choice would be "unreasonable" under the circumstances. *See M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 10 (1972).

The courts' concerns about the enforceability of these provisions are even greater if the borrower is a debtor in a bankruptcy case. In cases where the lender is sued by a committee, courts tend to disregard forum selection and choice of law provisions because the committee's constituents, i.e. the debtors' unsecured creditors, were not parties to the loan agreement. Those same concerns are absent when a lender is sued by a trustee "standing in the debtor's shoes," but even then, the enforceability of a forum selection clause may be in question. Some courts say that a trustee is not entitled to special treatment and that the lawsuit should be litigated in the forum the parties selected, not the court where the bankruptcy case is pending. Other courts disregard choice of forum provisions entirely in deference to a "strong" public policy favoring centralization of these types of related lawsuits in the debtor's "home" bankruptcy court.

Choice of law provisions, by contrast, are enforceable against a trustee. The question there will usually be whether the claims are sufficiently related to the lending arrangement or whether they exist outside of the contract (e.g., a preference or fraudulent transfer claim).

*"Venue" — Picking the court:* A trustee's first and sometimes only option is to sue a lender in the court presiding over the borrower's bankruptcy case. *See* 28 U.S.C. § 1409(a). Hence, in cases where it appears likely that the lender will be sued, this places even greater emphasis on the borrower's initial choice of where to file bankruptcy (and on the lender's ability to influence that decision).

Where the trustee is suing in his capacity as successor to the debtor or its creditors, he will also have the option of suing the lender in any forum in which the debtor

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or creditors, as the case may be, could have filed the lawsuit if there was no bankruptcy case. *See* 28 U.S.C. § 1409(c). This means that a borrower could file its bankruptcy case in New York and its trustee or committee could sue the debtor's lenders in a completely separate jurisdiction. This happened in Enron's Chapter 11 case, where a special employee committee filed lawsuits to recover extravagant bonuses paid to certain employees in bankruptcy court in Houston as opposed to New York, where Enron's Chapter 11 case is pending. In practice, however, it is exceedingly rare to see these lawsuits filed anywhere other than the debtor's "home" court.

The federal rules provide that a debtor may file bankruptcy in any district in which, for the prior six months (or, for a longer period of the six months than anywhere else), the debtor was "domiciled" (i.e., its state of incorporation), resided, maintained its principal place of business in the U.S. (generally, its nerve center) or kept its principal assets in the U.S. *See* 28 U.S.C. § 1408(1). In addition, the rules say that a debtor may file its bankruptcy case in any district in which an affiliate has a bankruptcy case pending. *See* 28 U.S.C. § 1408(1).

These rules are interpreted liberally by the courts, meaning that most large business enterprises will have a number of venues to choose from. It also means that, in many instances, a debtor will file bankruptcy in a location with only a loose (if any) connection to its core business. Troubled companies are quick to take advantage of the latter provision allowing them to file in any jurisdiction in which an affiliate has a bankruptcy case pending, no matter how large the affiliate and no matter how long the affiliate's case was pending. This was the case when Eastern Airlines filed its Chapter 11 case in New York City because a minor affiliate, Ionosphere Clubs, a New York corporation, filed in New York first. More recently, Enron filed its Chapter 11 case in New York and not its headquarters of Houston because an affiliate, a New York corporation, filed in New York first. In both cases, the lead affiliate filed at the same time as the main debtors; it was just on top of the stack of petitions handed to the bankruptcy clerk.

All this means is that in prebankruptcy planning, a lender asked for input or looking to influence a borrower's decision of where to file bankruptcy should consider, among other factors, the likelihood that it will eventually be sued in the bankruptcy case. If the chances look good then, all else being equal, the lender may want to encourage the debtor to file in New York. This also means that, in instances where the lender's relationship with its borrower is contentious, it may want to consider filing an involuntary bankruptcy case against the borrower in New York or another forum of the lender's choice. There are other factors that go into these decisions, but when a relationship can't be resurrected and it's clear that the lender is going to be sued, making the preemptory move to New York may be an astute litigation strategy.

*Transferring the bankruptcy case, or maybe just the trustee's lawsuit, to New York*: Once a borrower files a bankruptcy case, it becomes harder, but not impossible, for a lender to steer related litigation to another court. One option: to request a transfer of the entire bankruptcy case. The federal rules say a court may transfer the entire bankruptcy case to another jurisdiction on "timely" motion of a party if "in the interest of justice or for the convenience of the parties."Fed.R.Bankr.P. 1014(a); *see also* 28 U.S.C. § 1412. These requests are seldom granted, however, due to a strong presumption in favor of the debtor's choice of where to file its bankruptcy case. Judges in places other than New York or Delaware may also be predisposed to hang onto the larger, "sexier" Chapter 11 cases, which garner media and academic attention and can break up the monotony of court dockets overwhelmed with consumer bankruptcy cases.

From time to time, however, a court will transfer an entire bankruptcy case to another court, making the effort worthwhile. Winn-Dixie, for example, is a Florida-based grocery chain that filed Chapter 11 in New York. In an admitted attempt to manufacture venue, Winn-Dixie incorporated a subsidiary in New York two weeks prior to its filing. Three weeks into the case, a creditor moved to transfer venue to Florida, arguing that the debtors picked New York in an effort to neutralize creditor involvement. In its decision about transferring the case, the court held that venue was technically proper in New York and the "convenience of the parties" weighed in favor of New York, but the "interest of justice" warranted the transfer because the subsidiary was formed for the sole purpose of establishing venue and had no other reason for existence.

In instances where a court is reluctant to transfer the entire bankruptcy case, the next best option may be for a lender to request a transfer solely of its particular lawsuit. The rules permit it, saying simply that a court may, on motion of a party, transfer all or part of an adversary proceeding to another district. *See* Fed.R.Bankr.P. 7087; *see also* 28 U.S.C. § 1412.

Requesting a transfer solely of the lawsuit, versus the entire bankruptcy case, may be a prudent move where there are discrete issues applicable to the litigants, but not the creditor body at large. Courts considering these requests will usually look at a host of factors such as where the claim arose, the convenience of the parties and witnesses, the location of books and records, where the trial will be resolved most easily, most quickly or most cheaply, the possibility of conflict between the two courts, and whether the court has a particular interest in resolving the related dispute.

The burden will be on the lender, as the party seeking to move the lawsuit, to overcome the presumption that related litigation should be tried in the "home" court where the debtor's bankruptcy case is pending. Nevertheless, the courts do, from time to time, grant these requests and a well-drafted forum selection clause may facilitate that outcome. A lender making such a request would be well advised to do so promptly after the lawsuit is filed to reduce the likelihood that the bankruptcy court will decline the request on grounds that it is too invested in the case.

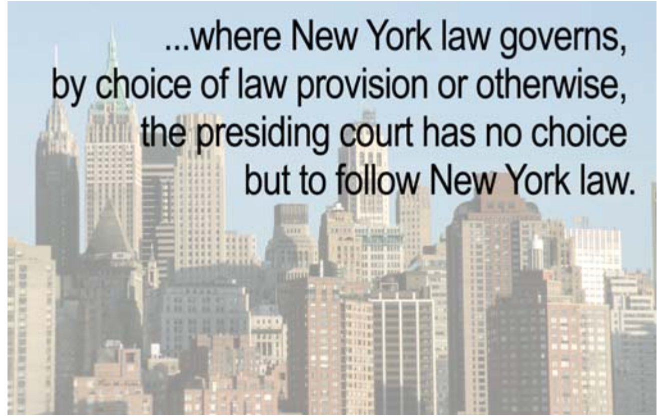
*Picking governing law*: Of the two questions posed — where will the lender liability claims be litigated and what law will be applied — the second is usually the more important. Federal courts are obligated to apply the law applicable to a claim regardless of where the presiding court may be located. This means that, where New York law governs, by choice of law provision or otherwise, the presiding court has no choice but to follow New York law. In most cases, that will be the next best option to having a New York court actually preside over the lawsuit.

Choice of law provisions are generally enforceable against a trustee. The issue will be which of the trustee's claims are covered by the operative "choice of law" language, which usually depends on whether the claims are sufficiently related to the lending relationship. In instances where there is no choice of law provision, or a claim isn't covered by the clause (such as a preference claim or another bankruptcy-specific right), there is a complex system of rules in place to decide what law should be applied. Those rules are beyond the scope of this discussion. There may also be other factors a lender should consider when picking governing law and these issues should be examined closely with legal counsel when documenting the loan. However, for purposes of this discussion, it is enough to say that, in general, picking New York law as governing law shouldn't prejudice a lender's rights and, when the lender is sued by a failed borrower's trustee or committee, should make available New York's lender protections.

In sum, lenders would be well advised to consider the advantages of New York law early in a credit, when considering whether to insist on forum selection and choice of law provisions, as well as later, if in a position to influence a borrower's decision of where to file a Chapter 11 case. Lenders should also move quickly, once a bankruptcy case or one of these lawsuits is filed, to analyze whether there are grounds to move the matter to a better venue such as New York.

**Conclusion**

The Second Circuit's *Wagoner* rule and the recent decisions in *Sharp* are powerful tools for lenders sued under New York law. Following *Global Services*, there is also an apparent reluctance on the part of New York courts




to hold a lender liable for wrongfully prolonging a borrower's life and deepening its insolvency. In many cases, trustees and committees may determine that they have no choice but to brave these perils in an effort to provide some recovery to unsecured creditors. It is clear, however, that these doctrines pose serious obstacles for those who must decide whether, and where, to sue a lender for its role in a debtor's fraud and ensuing collapse. Or, put another way, if a lender is going to be sued for a borrower's demise, there are far less friendly confines in which to be sued than federal court in New York City. ▲

**Endnotes**

1 The general rule of imputation is subject to a number of exceptions beyond the scope of this article, such as the "innocent insider" exception (agent's wrongdoing will not be imputed to corporation where there was at least one innocent decisionmaker who would have stopped the wrongdoing if he had known about it) or the "adverse interest" exception (agent's wrongdoing will not be imputed to corporation where the agent, though appearing or purporting to act for the company, is really committing the wrongdoing for his or another's benefit).

2 The entire phrase is "in pari delicto, potior est conditio defendentis," which translates roughly to "in a case of equal or mutual fault ... the position of the defending party ... is the better one." *See Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985) (citation to *Black's Law Dictionary* omitted).

3 The receiver subsequently filed an amended complaint and, on the bank's motion to dismiss, the court determined that the RICO claims could go forward and were not barred by *in pari delicto*. *Bondi v. Bank of America Corp. (In re Parmalat Sec. Lit.), ___ F.Supp.* ___, 2006 WL 225776 (S.D.N.Y. Jan. 31, 2006).

4 *See, e.g., Glidden Co. v. Jandernoa*, 5 F.Supp.2d 541 (W.D. Mich. 1998) (parent sued banks that financed management-led buyout of subsidiary; complaint dismissed on grounds that, under Michigan or New York law, lender owes no fiduciary duty to borrower); *Athey Products Corp. v. Harris Bank Roselle*, 89 F.3d 430. 435-36 (7th Cir. 1996) (manufacturer accused insolvent distributor's bank of scheme to defraud creditors by financing partial payments for sweepers and applying sale proceeds to loan; affirming summary judgment for bank, court held that, under Illinois law, lender owes no duty to protect other creditors from borrower's credit risk).