FEATURE STORY

Bankruptcy Preference Risks to Secured Lenders Using Blocked Accounts: Why You Shouldn't Sleep Comfortably at Night

BY NICOLETTE COHEN

Outgoing lenders involved in payoff letters must navigate the hidden risks of preference liability, where payments may be clawed back by bankruptcy trustees. Nicolette Cohen of Buchalter explores how such risks can transform secured claims into unsecured ones and outlines key mitigation strategies to safeguard lender interests.

When negotiating and drafting payoff letters, outgoing lenders should be wary of the risks of potential preference liability to a bankruptcy trustee with certain clawback rights for payments previously made. This event may result in an outgoing lender holding an unsecured claim against the borrower despite having previously been secured.

Definition of a Payoff Letter and Typical Use in Loan Transactions

A payoff letter typically sets forth the total amount owed, along with the certain obligations of the outgoing lender following payment in full. These actions often include executing lien terminations and releases and filing UCC-3 termination statements. Payoff letters also usually contain survival provisions and releases by the borrower.

Survival provisions ensure that certain loan obligations survive the payoff and remain enforceable. Common examples include indemnification obligations and provisions relating to the revival and reinstatement of obligations and liens. These are particularly important in scenarios where a payment made by an account debtor is later challenged as void, voidable, or otherwise subject to recovery under applicable bankruptcy laws. Such survival provisions often state that any previously released or terminated liens shall be reinstated and enforceable.

The Role of Outgoing and Replacement Lenders

In many refinancing transactions, a borrower will request a payoff letter from its existing lender (the "Outgoing Lender") when obtaining a new lender (the "Replacement Lender"). The key terms of a payoff letter from the Replacement Lender's perspective are: (i) an obligation, upon receipt of the full payoff amount, to release all liens granted in favor of the Outgoing Lender; (ii) disclosure of any borrower obligations to the Outgoing Lender that will survive the payoff (e.g., contingent obligations and indemnities); (iii) identification of any liens in favor of the Outgoing Lender that will remain in effect after the payoff; and (iv) any requirements for the borrower to provide cash collateral to the Outgoing Lender post-payoff.

The Outgoing Lender's concerns in this arena are potential avoidable transfer risks (including preference liability) in addition to the actual payoff amount and outstanding letter of credit obligations that are not assumed or reissued by the Replacement Lender.

Preferential Transfers

The relationship discussed herein, involves an account debtor, which owes funds to the borrower, the borrower, and the borrower's lender. In particular, we will analyze the risk of payments by an account debtor within 90 days prior to such account debtor's bankruptcy filing. The risk analyzed below is the risk that a payment by an account debtor is deemed to be an avoidable transfer in favor of the bankruptcy trustee and/or the bankruptcy estate.

Bankruptcy trustees may, under certain circumstances, avoid payments by the debtor, in this case the account debtor, to its creditor within 90 days prior to the bankruptcy. Under 11 U.S.C. §547(b), the trustee can generally avoid payments made for the benefit of a creditor based on an antecedent debt made while the debtor was insolvent within 90 days before filing bankruptcy that enables the creditor to receive more than they would get in a pro rata Chapter 7 distribution.

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Preference Claim Scenarios

In the context of payoff letters, the Outgoing Lender should be acutely aware of circumstances that may give rise to avoidable transfer liability. One key scenario involves the following two conditions:

(1) the borrower maintains a collection account with a depository institution, and the Outgoing Lender exercises sole control over that account—either at the outset of the transaction or as a result of a springing event under the terms of a DACA (defined below) where payments are swept to an account maintained by the Outgoing Lender to repay outstanding loan obligations, and

(2) one or more of the borrower's account debtors shows signs of financial distress that may lead to such account debtors filing bankruptcy prior to the payoff date.

If both conditions are present, the Outgoing Lender may be exposed to avoidable transfer risks, as a result of the Outgoing Lender's dominion over the payments made by the account debtors, and payments received during the 90-day period being subject to clawback by a bankruptcy trustee based on a preference claim.

Initial Transferee v. Subsequent Transferee

Under 11 U.S.C. §550(a) of the Bankruptcy Code, a bankruptcy trustee may recover a preferential payment made from either an initial transferee or, in some cases, an immediate or mediate transferee of an initial transferee. The most interesting aspect of the initial transferee v. subsequent transferee analysis is that a payment instrument designating the borrower as the payee deposited in borrower's account where Outgoing Lender is a depository institution could fall on either side of the fence depending on the circumstances. The same is also true for an Outgoing Lender that utilizes a DACA (defined below).

Initial Transferee Tests

With respect to an account debtor's payment, the test adopted by the majority of Circuits to determine whether the borrower or the Outgoing Lender is the initial transferee is the dominion and control test. In re JVJ Pharmacy Inc., 630 B.R. 388, 408 (S.D.N.Y. 2021). Conversely, a minority of circuits have adopted different or modified tests. For example, the Ninth Circuit has explicitly adopted the less restrictive dominion test. In re Incomnet, Inc., 463 F.3d 1064, 1071 (9th Cir. 2006).

To determine whether an entity has obtained dominion and control such that they will be deemed an initial transferee, courts require that the entity has legal dominion and control, as opposed to merely physical dominion and control. In re JVJ Pharmacy Inc., 630 B.R. 388, 408 (S.D.N.Y. 2021). In contrast, the Ninth Circuit defines the dominion test as "'dominion over the money or other asset, the right to put the money to one's own purposes.'" In re Incomnet, Inc., 463 F.3d 1064, 1070 (9th Cir. 2006). The dominion test "…focuses on whether the recipient of funds has legal title to them and the ability to use them as he sees fit. See Bonded Fin. Servs., 838 F.2d at 893–94. The control test takes a more gestalt view of the entire transaction to determine who, in reality, controlled the funds in question. In re Chase & Sanborn Corp., 848 F.2d at 1199." Id at 1071 (9th Cir. 2006).

For example, the Seventh Circuit found that an "…entity that receives funds for use in paying down a loan, or passing money to investors in a pool, is an 'initial transferee' even though the recipient is obliged by contract to apply the funds according to a formula. See, e.g., In re Columbia Data Products, Inc., 892 F.2d 26, 28 (4th Cir.1989); In re Chase & Sanborn Corp., 904 F.2d 588, 599–600 (11th Cir.1990); In re Incomnet, Inc., 463 F.3d 1064, 1071–76 (9th Cir.2006)." Paloian v. LaSalle Bank, N.A., 619 F.3d 688, 692 (7th Cir. 2010).

There are additional nuances that a court will consider when determining whether the Outgoing Lender is considered an initial transferee, such as (i) the Outgoing Lender's right to convert the balance of the deposits in the borrower's account to repay its outstanding loan and whether such right was exercised by the Outgoing Lender, (See In re Runnymede Cap. Mgmt., Inc., 616 B.R. 67, 73 (Bankr. W.D. Va. 2020)), (ii) the description of the Outgoing Lender's rights to such account set forth in the loan documents, (See Meoli v. The Huntington Nat'l Bank, 848 F.3d 716, 728 (6th Cir. 2017)), and (iii) the borrower's ability to access the funds in its account that is subject to the Outgoing Lender's security interest in such account. (See Id at 720).

Subsequent Transferee Test

Subsequent transferee issues typically arise when the recipient of an avoidable payment desires to assert the good faith affirmative defense under 11 U.S.C. §550(b), which is not available to initial transferees. This frequently occurs when a collection agent, escrow company, fiduciary, or depository institution receives funds in an account subject to certain control, possession or disbursement restrictions. The affirmative defense applies when the subsequent transferee receives the payment in good faith and without knowledge of the avoidability of the transfer.

Secured Lending Scenarios

Representative borrowers generally maintain collection accounts into which account debtors pay outstanding obligations. Whether or not the account is subject to a block by the lender or a springing event causes a block by the lender is based on the terms of the loan documents. Typically, the funds in a blocked account will, at the direction of the lender, be swept or debited from such account to pay down the credit facility.

Generally, a blocked account at inception or as a result of a springing event will more likely than not cause the Outgoing Lender to be deemed the initial transferee of any payment to that account. Conversely, if the borrower's account is not blocked and remains subject to the borrower's control, the borrower will most likely be considered an initial transferee.

Below is a set of scenarios where the initial transferee v. subsequent transferee can apply:

(1) Blocked DACA - Outgoing Lender is not a depository institution and a Blocked DACA (defined below) is in place at the depository institution;

(2) Unsprung DACA – Outgoing Lender is not a depository institution and a Springing DACA (defined below) is in place at the depository institution, but no springing event has occurred;

(3) Sprung DACA – Outgoing Lender is not a depository institution and a Springing DACA is in place, but a springing event has occurred;

(4) Blocked Account – Outgoing Lender is a depository institution and the loan documents require that borrower is blocked from accessing its funds in such account; or

(5) Unsprung Account – Outgoing Lender is a depository institution and the loan documents permit the borrower to access the funds in such account until a springing event has occurred.

As used herein:

"DACA" means a deposit account control agreement among the borrower, depository institution, and Outgoing Lender.

"Blocked DACA" means a DACA that blocks the borrower's access to such account and provides control to the Outgoing Lender.

"Springing DACA" means a DACA that allows the borrower to access funds in the account until a springing event occurs and pursuant to notice by the Outgoing Lender to the depository institution and borrower, the DACA springs into a Blocked DACA.

With respect to scenarios (1), (3) and (4) above, it is likely that in the majority of the Circuits the Outgoing Lender would be determined to be an initial transferee.

With respect to scenarios (2) and (5) above, it is likely that the Outgoing Lender would be determined to be a subsequent transferee.

Risks to Outgoing Lenders as a Result of Preference Claims - Loss of Collateral Priority and Reduced Recovery

The primary risk to the Outgoing Lender is the obligation to return the funds received as an avoidable preference and the loss of secured creditor status. If a successful preference claim is asserted and the payment is clawed back, the Outgoing Lender may find itself with a contractually reinstated obligation from the borrower, but without its original priority security interest.

Most problematic is the fact that the Outgoing Lender would likely not have any insight into whether payments to the borrower's blocked account were made within 90 days before an account debtor's bankruptcy.

Mitigation Tools

There are several contractual and practical tools that Outgoing Lenders and their counsel should consider incorporating into the payoff letter to mitigate preference-related exposure.

Outgoing Lenders can protect themselves vis-à-vis the borrower by requiring the following:

(a) survival and reinstatement provisions for the debt and fees incurred as part of any preference action;

(b) cash collateral hold back provisions for a designated time period to protect against avoidable transfer claims; and

(c) granting of reinstatement of liens as to the reinstated debt.

Outgoing Lenders can protect themselves vis-à-vis the Replacement Lender by requiring any of the following:

(a) indemnification from the Replacement Lender for any avoidable transfers; or

(b) subordinating Replacement Lender's lien to Outgoing Lender's reinstated lien securing the debt as a result of the avoided transfer.

Conclusion

Preference risk in payoff transactions is a nuanced and often underappreciated issue for Outgoing Lenders. While standard payoff procedures—receipt of funds, release of liens, and termination of control agreements—may appear routine, failure to properly address these items may leave the Outgoing Lender with significant exposure.

Most problematic is the fact that the Outgoing Lender would likely not have any insight into whether payments to the borrower's blocked account were made within 90 days before an account debtor's bankruptcy.

Sweet dreams.

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