

Clients & Friends Memo

Junior Creditors Beware: Third Circuit Awards Damages for Breach of Turnover Provision¹

May 26, 2022

On April 13, 2022, the Court of Appeals for the Third Circuit ruled in *CoFund II LLC v. Hitachi Capital America Corp.* that a junior creditor breached a turnover provision in an intercreditor agreement when it applied a senior creditor's collateral to satisfy the junior creditor's claims before the senior creditor's claims had been fully paid.² The Third Circuit also affirmed a judgment that awarded the senior creditor damages for the misapplication of such collateral proceeds in violation of the intercreditor agreement's turnover provision. The *Hitachi* decision serves as a useful reminder to both junior creditors and senior creditors alike as to how their dealings in an intercreditor arrangement may play out following a debtor's bankruptcy, and provides important insight into the potential remedies that a senior creditor may have available should a junior creditor breach a turnover provision.

Factual Background

Forest Capital LLC ("Forest") provided financing to small businesses through "factoring arrangements," whereby Forest purchased its clients' unpaid accounts receivable at a discount and, in turn, received the right to collect the full amount owed on those accounts.³ But Forest needed financing to acquire these accounts. Forest thus entered into a Master Participation Agreement with CoFund II LLC ("CoFund"), pursuant to which CoFund had a participation interest in Forest's factoring arrangements. These participation interests were secured by a "first-priority security interest in the collateral relating to each factoring transaction to the extent of [CoFund's] *pro rata* interest in those transactions" (such collateral, the "CoFund Priority Collateral").⁴

Thereafter, Forest borrowed a line of credit from Hitachi Capital America Corporation ("Hitachi"). Forest provided Hitachi with a security interest in its factoring arrangement proceeds, subject to CoFund's first priority security interest in certain of those proceeds. Under its loan agreement,

¹ Summer associate Alexis Narotzky assisted in the writing of this memo.

² *CoFund II LLC v. Hitachi Cap. Am. Corp.*, No. 21-2078, 2022 WL 1101576 (3d Cir. Apr. 13, 2022).

³ *Id.* at *1.

⁴ *CoFund II LLC v. Hitachi Cap. Am. Corp.*, 16-CV-1790(SDW)(LDW), 2021 WL 689119, at *1 (D.N.J. Feb. 22, 2021).

Forest agreed that all factoring arrangement proceeds would be deposited into a “blocked account” controlled by Hitachi, including the CoFund Priority Collateral. Forest did not have the right to make any withdrawals from this blocked account, including to pay CoFund under its Master Participation Agreement.

To account for the fact that CoFund Priority Collateral could be commingled with Hitachi’s collateral in the blocked account, Hitachi and CoFund entered into an intercreditor agreement. That intercreditor agreement “established CoFund’s right of first recovery” for CoFund’s “pro rata participation interests in” the CoFund Priority Collateral.⁵ Notably, the intercreditor agreement contained a turnover provision, which provided that if Hitachi received CoFund Priority Collateral, it would “hold it in trust” for CoFund and Hitachi was obligated to “immediately turn it over to” CoFund.⁶

Eventually, “Forest became financially distressed” and unsecured creditors initiated an involuntary chapter 7 bankruptcy proceeding against Forest in the Maryland bankruptcy court.⁷ Both prior to and after the commencement of Forest’s involuntary chapter 7 proceeding, factoring arrangement proceeds were deposited into the blocked account controlled by Hitachi, and some of these proceeds constituted CoFund Priority Collateral.⁸ Rather than send these monies to CoFund as required under the turnover provision, Hitachi applied the monies to “pay down its extension of credit to Forest,” and “without paying anything to CoFund, Hitachi released [the] remaining funds” in the blocked account to Forest.⁹

CoFund sued Hitachi in the New Jersey District Court, alleging that Hitachi breached the intercreditor agreement by failing to turn over CoFund Priority Collateral in accordance with the turnover provision. Following a trial, the District Court held that Hitachi breached the intercreditor agreement by using CoFund Priority Collateral to pay down its line of credit and by releasing the remaining funds to Forest.¹⁰ The District Court awarded CoFund over \$1.5 million in damages.¹¹ Hitachi appealed the decision before the Third Circuit.

⁵ *Hitachi*, 2022 WL 1101576, at *2.

⁶ *Id.* (internal quotations omitted).

⁷ *See id.*; *In re Forest Capital, LLC*, 579 B.R. 56 (Bankr. D. Md. 2017).

⁸ *Hitachi*, 2022 WL 1101576, at *2.

⁹ *Id.*

¹⁰ *See CoFund II LLC*, 2021 WL 689119, at *4 (finding that Hitachi breached the intercreditor agreement by failing to hold the collateral in trust for CoFund, and for failing to immediately turn it over to CoFund).

¹¹ *Id.*, at *1.

Discussion***Breach of the Intercreditor Agreement***

The Third Circuit affirmed the District Court's holding that Hitachi breached the turnover provision in the intercreditor agreement. The turnover provision in *Hitachi* required that Hitachi turn over CoFund Priority Collateral to CoFund and to hold such property in trust prior to remitting the funds to CoFund.¹² This provision is customary in intercreditor agreements. "Turnover" or "payment over" provisions, require that prior to the payment of the senior claim in full, the junior creditor shall hold any payments or collateral proceeds that it receives in trust and pay them over to the senior creditor.¹³

While the application of a turnover provision may depend on the scope of subordination in an intercreditor agreement,¹⁴ the effect of a turnover provision is clear: the junior creditor may not satisfy its claims with collateral proceeds (or in some agreements, any payments) unless the senior claim has been paid in full.¹⁵ The failure to abide by those requirements can result in the junior creditor being held liable for a breach of the provision.

Such was the case in *Hitachi*. According to the Third Circuit, the record showed that at least some of the funds received by Hitachi constituted CoFund Priority Collateral "and therefore belonged to CoFund."¹⁶ Notwithstanding this fact, Hitachi "did not transfer those funds to CoFund" and instead "applied those funds to reduce the amount of money that Forest owed" to Hitachi.¹⁷ The Third Circuit found that these actions were not permitted under the intercreditor agreement. Rather,

¹² *Hitachi*, 2022 WL 1101576, at *3.

¹³ See *In re MPM Silicones LLC*, 596 B.R. 416, 423 (S.D.N.Y. 2018) (describing the effect of a turnover provision); see also *Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force*, 65 BUS. LAW. 809, 847 n.45 (2010).

¹⁴ For example, a turnover provision in a lien subordination agreement might not apply to distributions not derived from collateral or proceeds thereof upon an exercise of remedies. See *In re MPM Silicones LLC*, 596 B.R. at 433-38 (holding that junior creditors did not breach intercreditor agreement by receiving stock in the reorganized debt, because that stock was not common collateral or proceeds thereof); but see *In re La Paloma Generating Co.*, 595 B.R. 466, 475 (Bankr. D. Del. 2018) ("Section 4.2 of the Intercreditor Agreement dictates that if the Second Lien Lenders do collect monies from Plan distributions, collected as a result of their exercising remedies under the Intercreditor Agreement, that such funds must be 'paid over' to the First Lien Lenders.").

¹⁵ *In re La Paloma Generating Co.*, 595 B.R. at 476 (noting that waterfall and turnover provision indicated an intent for the first lien obligations "to be paid in full before the Second Lien Lenders are allowed to receive any recovery on behalf of the Second Lien Obligations"); *Highland Park CDO I Grantor Tr., Series A v. Wells Fargo Bank, N.A.*, No. 08-CV-5723, 2009 WL 1834596, at *3 (S.D.N.Y. June 16, 2009) (noting that turnover provision was "obviously designed to ensure that the senior loan is paid in full before Highland is permitted to keep any money received in repayment of the mezzanine loan").

¹⁶ *Hitachi*, 2022 WL 1101576, at *3.

¹⁷ *Id.*

Hitachi was obligated to “hold all funds representing CoFund Priority Collateral in trust for CoFund and to immediately turn [them] over to CoFund.”¹⁸

Hitachi’s duty as a trustee extended to the CoFund Priority Collateral. When Hitachi enforced and realized its security interest in the CoFund Priority Collateral in the blocked account, failed to distribute CoFund Priority Collateral to CoFund, and remitted leftover funds to Forest, Hitachi breached the intercreditor agreement with CoFund because CoFund was the superior creditor therein.¹⁹

The Third Circuit also affirmed the District Court’s award of damages against Hitachi. The District Court awarded over \$1.55 million in damages against Hitachi for its breach of the turnover provision, which represented the amount of CoFund Priority Collateral that Hitachi had received in the blocked account and thereafter misapplied in contravention of the turnover provision.²⁰ On appeal, Hitachi disputed the District Court’s calculation of damages because the District Court purportedly failed to “account for CoFund’s entitlement to only a pro rata share of the factoring proceeds or for set-offs from Forest’s bankruptcy.”²¹ The Third Circuit found Hitachi’s arguments unpersuasive because they failed to demonstrate that the District Court made any clear error in calculating the damages.

Hitachi’s Other Defenses

Hitachi raised a number of defenses to attempt to escape liability, but the Third Circuit found that none of these defenses had any merit. First, Hitachi claimed that the District Court lacked jurisdiction to adjudicate its dispute with CoFund because the bankruptcy court presiding over Forest’s bankruptcy case had exclusive jurisdiction over the property subject to the litigation. While reasoning that bankruptcy courts have jurisdiction to hear proceedings “related to,” *i.e.* “non-core”

¹⁸ *Id.*

¹⁹ *CoFund II LLC*, 2021 WL 689119, at *4.

²⁰ The District Court calculated damages pursuant to Michigan law, which provides that measure of damages on a breach of contract claim is “the pecuniary value of the benefits the aggrieved party would have received if the contract had not been breached” and if there is a reasonable basis to ascertain such damages. *Doe v. Henry Ford Health Sys.*, 865 N.W.2d 915, 921–22 (Mich. App. 2014) (internal quotations omitted). The District Court found several credible sources, including in some of Hitachi’s own submissions to the District Court, that showed CoFund was owed approximately \$2.12 million in unpaid participation interest at the end of 2015. This represented the net participation funds funded by CoFund to Forest. In the first three months of 2016, Hitachi collected in approximately \$1.55 million from the twelve Forest accounts in which CoFund had funded participations – “all of which were CoFund Priority Collateral.” *CoFund II LLC v. Hitachi Cap. Am. Corp.*, 16-CV-1790(SDW)(LDW), 2021 WL 1748133, at *3 (D.N.J. May 4, 2021). The Court found that approximately \$580,000 received from a consent order approving the settlement with Forest of the adversary proceeding in the Maryland Bankruptcy Court did not overlap with CoFund’s proposed damages because these funds were not deposited into the blocked account. Therefore, the Court awarded CoFund its proposed \$1.55 million in damages plus prejudgment interest and costs. *Id.* at *5.

²¹ *Hitachi*, 2022 WL 1101576, at *4.

proceedings,²² this dispute did not fall within the bankruptcy court's exclusive, *i.e.* "core," jurisdiction.²³ Rather, the Third Circuit found that the action merely related to Forest's bankruptcy case, as "related to" cases generally include "suits between third parties which have an effect on the bankruptcy estate."²⁴ While this dispute between the two non-debtor parties could "conceivably" have an effect on Forest's bankruptcy estate,²⁵ the Third Circuit found no reason that the dispute should have been before the bankruptcy court because Hitachi did not identify a reason.

Second, Hitachi argued that a "No Recourse" provision barred CoFund from suing Hitachi. That provision provided that "CoFund shall have no recourse against Hitachi as a result of [Forest's] failure to make any payment due to either Hitachi or CoFund."²⁶ The Third Circuit found that this provision did not apply on its face because CoFund did not sue Hitachi for amounts that Forest owed it. Rather, CoFund sued Hitachi for breaching its duties as trustee for the collateral deposited into the blocked account.²⁷

Finally, Hitachi claimed that it could not be held liable for breach of the turnover provision because of the doctrine of impracticability and impossibility. Hitachi claimed that CoFund and Forest failed to earmark any of the funds deposited in the blocked account as CoFund Priority Collateral, and thus determining what portion of the monies in the account qualified as CoFund Priority Collateral was impossible. The Third Circuit rejected these arguments, finding that Hitachi "knew or should have known that some of the money coming into the blocked account would constitute CoFund Priority Collateral."²⁸ The Third Circuit also held that "even if Hitachi were uncertain about the amount of CoFund Priority Collateral," then "the appropriate action would have been to hold the funds (and, if necessary, to interplead them), instead of disregarding its obligations as a trustee under the Intercreditor Agreement and paying the moneys to itself."²⁹

Analysis and Conclusion

The Third Circuit's *Hitachi* decision provides important guidance on the consequences that a junior creditor may face if it misapplies collateral proceeds in violation of a turnover provision. Courts have previously enforced turnover provisions by requiring that a senior creditor receive full payment

²² See *In re Combustion Engr., Inc.*, 391 F.3d 190, 225 (3d Cir. 2004), as amended (Feb. 23, 2005).

²³ See 28 U.S.C. § 1334.

²⁴ *Celotex Corp. v. Edwards*, 514 U.S. 300, 308 n.5 (1995).

²⁵ See *Pacor, Inc. v. Higgins*, 743 F.2d 984, 995 (3d Cir. 1984).

²⁶ *Hitachi*, 2022 WL 1101576, at *3.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

prior to the payment of the junior claims.³⁰ In *Hitachi*, however, the Third Circuit addressed what happens when a junior creditor fails to comply with a turnover provision: the junior creditor is liable for damages for the property that it mishandled. *Hitachi* serves as a stark warning to junior creditors that by agreeing to a turnover provision, they are also creating an obligation on their part to hold collateral proceeds in trust for the senior creditors and to immediately remit such property to the senior creditors. Further, if there is ambiguity as to the collateral proceeds, the junior creditor may be obligated to commence an interpleader action. The failure to comply with those obligations may subject the junior creditor to damage claims as was the case in *Hitachi*.

The *Hitachi* decision also confirms that a junior creditor cannot raise impracticability or impossibility as a defense, particularly where the junior creditor should know that it may come into possession of collateral proceeds. With the outcome of *Hitachi* in mind, if a junior creditor is uncertain as to the amount of collateral proceeds subject to the applicable turnover provision in its intercreditor agreement, then it may be prudent for the junior creditor to either hold the funds in trust or commence a lawsuit to determine the proper recipient of such funds. Junior creditors should therefore be mindful that they may not use such uncertainty to disregard their obligations as a trustee for such collateral proceeds.

* * *

If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Ingrid Bagby	+1 212 504 6894	ingrid.bagby@cwt.com
Michele Maman	+1 212 504 6975	michele.maman@cwt.com
Thomas Curtin	+1 212 504 6063	thomas.curtin@cwt.com
Marc Veilleux	+1 212 504 6782	marc.veilleux@cwt.com

³⁰ See, e.g., *In re La Paloma Generating Co.*, 595 B.R. at 475-77; *AmeriNational Cmty. Servs. v. Ambac Assurance Corp.* (*In re Fin. Oversight & Mgmt. Bd. for P.R.*), 635 B.R. 216 (D.P.R. 2021) (concluding that turnover provision granted bondholders priority over lenders, and thus denying request for declaration that the loans were not subordinate to the bonds).