



Bankruptcy & Financial Restructuring ADVISORY ■

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Actions Speak as Loud as Words in *Deprizio* Waivers

On May 6, 2015, the Court of Appeals for the Ninth Circuit considered whether so-called “*Deprizio* waivers,”¹ where an insider guarantor waives indemnification rights against a debtor, can insulate the guarantor from preference liability arising from payments made *by the obligor* to the lender. The Ninth Circuit held that if such a waiver is made legitimately—not merely to avoid preference liability—then the guarantor is not a “creditor” and cannot be subject to preference liability.

Under the Bankruptcy Code, one of the requirements for avoiding a potential preferential transfer is that the transfer must be “to or for the benefit of a creditor.” If a debtor pays down a loan to a creditor, that payment is “for the benefit of” a guarantor of that loan. Such a guarantor can also be a creditor of the debtor because the Bankruptcy Code defines “creditor” to mean an entity that holds a pre-bankruptcy claim. The term “claim” is further defined to include “a right to payment” or a “right to an equitable remedy for breach of performance if such breach gives rise to a right to payment.” Unless waived, a guarantor has a right of indemnification against the debtor.

Adamson Apparel, Inc., was a manufacturer of clothing and accessories. In 2002, Adamson borrowed several million dollars from CIT Group Commercial Services, Inc., secured by a lien on Adamson’s inventory and accounts receivable. The loan was also personally guaranteed by Arnold H. Simon, Adamson’s president and CEO.

In December 2003, Adamson caused approximately \$5 million to be transferred to CIT in partial payment of the loan. In March 2004, Simon paid off the balance of the loan, approximately \$3.5 million, from his personal funds. Adamson filed for Chapter 11 bankruptcy protection in September 2004.

During the course of Adamson’s Chapter 11 case, a lawsuit was filed against Simon to recover the approximately \$5 million transferred in December 2003. The lawsuit alleged that Simon was a corporate insider who received a preference on account of that transfer because he had guaranteed the loan and thus any reduction in that debt was for his benefit.

¹ The term refers to the Seventh Circuit Court of Appeals’ decision in *In re Deprizio*, 874 F.2d 1186 (7th Cir. 1989).

As an initial matter, there was disagreement among the parties as to whether Simon had waived all of his indemnification rights against the debtor Adamson in connection with his personal guarantee or whether his indemnification rights were merely deferred until after CIT was first paid in full. The underlying agreements contained conflicting language in this regard. The importance of this fact is that if Simon fully waived his rights, then he would hold no claim and therefore would not be a creditor that could be subject to preference liability under these circumstances.

The bankruptcy court found the agreements to be ambiguous and thus turned to extrinsic evidence on this point. Simon testified that CIT had insisted upon a full waiver of his indemnification rights in connection with the guarantee, and the record further showed that Simon never filed any proof of claim in the bankruptcy case. As a result, the bankruptcy court held that Simon unconditionally waived his indemnification rights. The Ninth Circuit agreed.

The plaintiff, however, further urged the court to follow a line of cases holding that such *Deprizio* waivers by insider guarantors of their indemnification rights are invalid. Those cases take the position that “such a waiver has no economic impact—if the principal debtor pays the note, the inside guarantor would escape preference liability, but if the principal debtor does not pay the note, the insider could still obtain a claim against the debtor, simply by purchasing the lender’s note rather than paying on the guarantee.” Those cases further consider *Deprizio* waivers to be an attempt to contract around provisions of the Bankruptcy Code and thus unenforceable as a matter of public policy.

The Ninth Circuit rejected the argument that such waivers are per se invalid. Instead, it held that the waiver must be considered in context and within the totality of the circumstances. In this case the court determined that the waiver was legitimate and not a sham. Among other things, the court found it important that Simon never filed a proof of claim in the bankruptcy case even though he paid over \$3.5 million to CIT from his personal funds to satisfy the debt and the contracts did not provide Simon with the unilateral right to purchase the note from CIT in the event Adamson defaulted.

Although the Ninth Circuit held that *Deprizio* waivers are not per se invalid, it did not go so far as to hold that all such waivers will insulate insider guarantors from preference liability. Instead, the court announced that it must be determined whether there was a “bona fide basis” for the waiver and whether the guarantor refrained from taking any “subsequent actions that would negate the economic impact of that waiver.” If so, the *Deprizio* waiver will be deemed legitimate and will shield the insider guarantor from preference liability in these circumstances.

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Kit Weitnauer
404.881.7780
kit.weitnauer@alston.com

David Wender
404.881.7354
david.wender@alston.com

William Hao
212.210.9417
william.hao@alston.com

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WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ■ 18th Floor ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ■ Suite 400 ■ Durham, North Carolina, USA, 27703-85802 ■ 919.862.2200 ■ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ■ Fifth Floor ■ East Palo Alto, CA 94303-2282 ■ 650.838.2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.756.3300 ■ Fax: 202.756.3333