2002 BNH 027 Note: This is an unreported opinion. Refer to AO 1050-1 regarding citation.

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEW HAMPSHIRE

In re:

Bk. No. 02-12090-JMD
Chapter 11

Good Stuff Entertainment Corporation,
Debtor

Good Stuff Entertainment Corporation,
Plaintiff

v.

Adv. No. 02-1108-JMD

Commerce Bank & Trust Company
and Roger F. Allard,
Defendants

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MEMORANDUM OPINION

I. INTRODUCTION

The Debtor is a marketing company that conducts special events, promotions and corporate sponsorship activities across the country for a variety of companies which make or sell consumer products. The Debtor was formed in 1987 and filed a voluntary petition under chapter 11 of the Bankruptcy Code on July 9, 2002. On July 11, 2002 the Debtor commenced this adversary

proceeding against Commerce Bank & Trust Company (the "Bank") and Roger F. Allard (hereinafter "Allard") (the Bank and Allard are collectively the "Defendants") and requested a temporary restraining order (the "TRO"). In its request for the TRO the Debtor asks this Court to (1) enjoin the Bank from setting off or recouping any funds in the Bank's control, (2) compel the Bank to turn-over to the Debtor $899,000.00 in funds improperly seized by the Bank from the Debtor's accounts and (3) order the Bank to account to the Debtor for all sums received by the Bank and applied to the Debtor's obligations since January 1, 2002.

The Court held a hearing on the TRO on July 16, 2002. The Debtor and the Defendants appeared at the hearing through counsel; Allard was also personally present. The parties presented oral argument and agreed that for purposes of the hearing the request for a TRO could be considered a request for a preliminary injunction. The parties also agreed that the verified complaint and the affidavits submitted by the parties, together with any exhibits to such affidavits would constitute the evidentiary record for the Court's determination on the Debtor's request for a preliminary injunction. At the close of the hearing the Court ordered that any additional affidavits and memoranda of law which the parties wished to submit should be sent to chambers via telecopier on or before 2:00 p.m. on July 18, 2002 and filed with the Court on or before 2:00 p.m. on July 19, 2002.

Pursuant to the agreement of the parties, the Court has reviewed and considered the following documents, and attached exhibits, as evidence on the request for a preliminary injunction:

1. Debtor's verified complaint dated July 11, 2002 (Doc. No. 1).
2. Affidavit of Michael J. Kelly dated July 11, 2002 (Doc. No. 4).
3. Affidavit of Thomas M. Wilkerson dated July 16, 2002 (Doc. No. 7).

4. Supplemental affidavit of Michael J. Kelly dated July 15, 2002 (Doc. No. 8).

5. Affidavit of Roger F. Allard dated July 16, 2002 (Doc. No. 11).

6. Affidavit of Bruce D. Colley dated July 15, 2002 (Doc. No. 13).

7. Affidavit of Richard D. Bazar dated July 18, 2002 (Doc. No. 14).

8. Supplemental affidavit of Roger F. Allard dated July 18, 2002 (Doc. No. 15).

9. Affidavit of Charles E. Newdorf dated July 15, 2002 (Doc. No. 17).

This Court has jurisdiction of the subject matter and the parties pursuant to 28 U.S.C. §§ 1334 and 157(a) and the "Standing Order of Referral of Title 11 Proceedings to the United States Bankruptcy Court for the District of New Hampshire," dated January 18, 1994 (DiClerico, C.J.). This is a core proceeding in accordance with 28 U.S.C. § 157(b).

II. FACTS

On October 10, 2001 the Debtor entered into a loan agreement with the Bank under the terms of which the Bank advanced $520,000.00 to the Debtor as a term loan and the parties entered into a $1,000,000.00 revolving loan facility (the "Agreement"). As part of the Agreement the Debtor executed and delivered to the Bank a revolving note dated October 10, 2001 (the "Revolving Note"). The Revolving Note incorporated by reference all of the terms and conditions of the Agreement and provided that the Debtor could "borrow, repay and reborrow the principal" under the Revolving Note "through and including the earlier of October 8, 2003 or the occurrence of a Default or Event of Default under the Agreement," up to the lesser of $1,000,000.00 or the Borrowing Base, as defined in the Agreement. The Borrowing Base was defined as eighty percent (80%) of the unpaid amount of "Qualified Accounts," as defined in the Agreement, plus sixty

percent (60%) of "Qualified Pre-billed Accounts," as defined in the Agreement. The revolving loan facility between the Debtor and the Bank is commonly referred to as an "asset based loan" because the maximum amount of money which the customer may borrow at any given time, subject to the amount of the note, is limited by the collateral available to support repayment of the loan. From the inception of the Debtor's relationship with the Bank, the Debtor's primary contact at the Bank and the officer in charge of the Debtor's loans was Allard.

Pursuant to the Agreement, the amount of the Borrowing Base was to be determined from time to time based upon borrowing base certificates and copies of customer contracts supporting pre-billed accounts, all submitted by the Debtor from time to time, as well as records maintained by the Bank regarding the assets supporting the loan, cash receipts applied to the loan and advances made under the loan. The revolving loan portion of the Agreement between the Debtor and the Bank was structured under a "lockbox" arrangement where all payments to the Debtor for either accounts or pre-billed accounts were forwarded to a mailbox controlled by the Bank. Under its Agreement with the Debtor the Bank would deposit all such receipts to an account controlled by the Bank for forty-eight hours, after which the funds were credited to the balance due under the Revolving Note or, if that loan were completely paid, to the Debtor's operating account. When checks were presented on the Debtor's operating account, the Bank would increase the Debtor's revolving loan by transferring the funds necessary to honor such checks to the operating account. Under this arrangement, the Debtor would carry the smallest possible balance under its revolving loan with the Bank, but would not have access to any cash except through advances from the Bank under the Revolving Note.

On December 21, 2001, only seventy-two days after the closing of the loan, the Bank notified the Debtor that certain events of default had occurred under the terms of the loan

documents (the “Notice of Default”). Those events of default included, without limitation, the following:

A. The Debtor’s failure to provide the Bank with an operating budget for fiscal year 2002 prior to 45 days before the end of 2001, as required under sections 4.3.2 and 5.1.3 of the Agreement (the “Budget Default”).

B. The Debtor’s failure to maintain a minimum debt service coverage ratio of at least 1.25 to 1 for the quarter ending September 30, 2001, as required under sections 4.9.1 and 5.1.3 of the Agreement (the “Debt Service Coverage Default”).

C. The Debtor furnishing a false or erroneous borrowing base certificate in violation of section 5.1.2 of the Agreement (the “Borrowing Base Default”).

D. The Debtor being insolvent and/or generally not paying its debts as they became due in violation of section 5.1.4 of the Agreement (the “Solvency Default”).

In the Notice of Default the Bank also accelerated the amounts due under all of the Debtor’s loans and demanded payment in full on or before December 31, 2001. The amounts demanded were $507,004.41 on the term loan and $615,039.00 under the Revolving Note.

Subsequent to the Notice of Default, and notwithstanding the demand for payment in full, the Bank continued to permit the Debtor to repay and reborrow money under the Revolving Note through early June 2002. Affidavits and documents submitted by the parties demonstrate that the ongoing relationship during the first five months of 2002 involved close scrutiny by the Bank of the Debtor’s performance under the loan documents, its financial condition and its efforts to correct various financial and operational items of concern to the Bank.

On or about June 1, 2002, the Bank advised the Debtor that it would no longer advance funds under the terms of the Revolving Note. Since the Debtor’s payroll was paid one week after the close of the pay period, the Bank agreed to advance funds for the Debtor’s payroll through the June 7, 2002 payroll. Once the Bank ceased advancing funds, the Debtor did not have the access

to the cash necessary to conduct operations and the chapter 11 proceeding and this adversary proceeding were filed.

III. DISCUSSION

In order to obtain a preliminary injunction the Debtor must show: (1) a likelihood of success on the merits, (2) that it will suffer immediate and irreparable harm if the requested injunction is not granted, (3) that such harm outweighs any harm to the Bank, and (4) that the public interest will not be adversely affected. New Comm Wireless Services, Inc. v. Sprintcom, Inc., 287 F.3d 1, 8-9 (1st Cir 2002); Philip Morris, Inc. v. Harshbarger, 159 F.3d 670, 673 (1st Cir. 1998). Likelihood of success is the sine qua non of the factors in consideration of the Debtor's request for a preliminary injunction. New Comm Wireless, 287 F.3d at 9; Ross-Simons of Warwick, Inc. v. Baccarat, Inc., 102 F.3d 12, 16 (1st Cir. 1996).

In this adversary proceeding the Debtor contends that (1) the Bank did not have a good faith basis to declare a default on December 21, 2001 and, therefore, breached its contractual obligations to the Debtor under the loan documents, including but not limited to the Agreement and the Revolving Note, (2) even if there was a default the Bank had no interest in the pre-billed accounts that it seized and has refused to return such funds even though demanded by the Debtor, and (3) that the Bank wrongfully setoff against funds received from pre-billed accounts.

A. The Bank's Declaration of Default

A declaration of default just seventy-two days after the inception of a $1.5 million loan relationship is virtually unprecedented in the Court's experience. However, the affidavits reflect that from the outset the loan relationship traveled on a rocky road. It appears that the Debtor was out of formula under the Borrowing Base on several occasions in the first sixty days of the

relationship. In addition there were numerous overdrafts in the Debtor's operating account due to an insufficient Borrowing Base to provide for advances under the Revolving Note. The affidavits present conflicting views on whether or not the Bank expressly or impliedly waived these apparent defaults prior to the December 21, 2001 letter. However, there does not appear to be any credible dispute that the Debtor was in default of at least some of its obligation as of that date. Accordingly, it does not appear likely that the Court will ultimately find that the declaration of default on December 21, 2001 was wrongful or was made in bad faith.

Subsequent to the declaration of default the affidavits reflect that the Bank continued to lend and the Debtor continued to work at improving its operations and financial affairs through May of 2002. The affidavits presented by the Debtor contain some evidence that the Bank may have expressly or impliedly waived various defaults during this time period. The Bank's affidavits deny that any such waiver ever occurred. No written evidence of any such waiver was submitted. What little written evidence that was submitted suggests a continuation of the rocky relationship that existed prior to December 21, 2001 and a decreasing level of civility in communications between the Debtor and the Bank through Allard. Based upon the affidavits it is unlikely that the Court will ultimately find that all defaults were waived or that the Bank agreed to forebear from exercising its rights upon default. Absent waivers or agreements to forebear on all events of default, the Debtor cannot succeed on the merits. For the reasons set forth below, even if the Court concluded that Debtor had established a likelihood of success on the merits, no seizure or setoff occurred, and, therefore, it would appear that the Debtor's preliminary remedy would be limited to a reestablishment of its rights under the Agreement and the Revolving Note. Those rights would also be subject to the Bank's rights to enforce the Borrowing Base formula and to declare any post-petition defaults.

B. The Bank's Interest in Pre-billed Accounts

In the normal course of the Debtor's business operations it would enter into contracts with its customers which provided for advanced payments or progress payments before services were actually rendered. In the documentation of its relationship with the Bank invoices for such payments due prior to performance by the Debtor were denominated as "pre-billed accounts" or "pre-billed receivables." Invoices submitted after services were rendered were denominated as "accounts" or "accounts receivable."

Under the terms of the security agreement dated October 10, 2001 (the "Security Agreement") the Debtor granted the Bank a security interest in substantially all of its assets, including accounts, to secure the payment and performance of all of its obligations to the Bank. The Security Agreement provided that all terms defined in the Uniform Commercial Code (the "UCC") as enacted in Massachusetts would have the same definitions in that agreement. Section 9-102(2) of the UCC defines an account as "a right to the payment of a monetary obligation, <u>whether or not earned by performance</u>, . . . for services rendered <u>or to be rendered</u>." Mass. Gen. Laws Ann. ch. 106 § 9-102(2) (emphasis added). The Security Agreement contains no provision which limits this definition of the term "account."

The Debtor argues that under its agreements with its customers and "pursuant to established industry practice" the only right which it has in any portion of pre-billed accounts is to the profit remaining after it has completed its obligation to perform the services required under its agreement with a customer. However, the affidavits and the terms of the Agreement tell a different story. From the inception of its relationship with the Bank the Debtor never segregated funds received from pre-billed accounts from its general corporate bank account. In fact, the Debtor expressly bargained with the Bank to include sixty percent of the pre-billed accounts in the calculation of the

Borrowing Base. Since the pre-billed accounts were included in the Borrowing Base, thereby increasing the amount which the Debtor could obtain under the Revolving Note, the Court finds that the Debtor and the Bank consistently treated the pre-billed accounts as property of the Debtor. The only distinction under the Agreement between pre-billed accounts and accounts for services actually rendered was the percentage of the accounts included in the Borrowing Base, eighty percent for accounts and sixty percent for pre-billed accounts.

The Debtor's attempt to claim that funds received on account of pre-billed accounts were advanced deposits from customers, in which the Debtor had no rights until performance under the contract in question, is equally unavailing. None of the contracts submitted with any of the affidavits reflect any agreement between the Debtor and a customer to escrow advanced payments pending performance. The contracts in the record are either silent on the issue or contain only an obligation on the part of the Debtor upon termination of the contract to refund any unearned payments. Other than this contractual obligation the Debtor was free to use the funds received from pre-billed accounts in any manner that it desired. The Debtor elected to use pre-billed accounts as collateral for borrowings under the Revolving Note. The Court finds nothing in the contracts with its customers which would prohibit such actions by the Debtor.

Since the Debtor had the right to use the funds received from pre-billed accounts, and in fact treated pre-billed accounts as collateral to borrow against, the Court finds that the Bank is likely to have the same interest in the pre-billed accounts, and their proceeds, under the terms of the loan documents.

C. The Bank's Right to Seize or Setoff against Pre-billed Accounts

The Debtor alleges that the Bank wrongfully "seized" or "setoff" the Debtor's obligations against funds received from pre-billed accounts even though it knew the identity and nature of such

accounts. Since only pre-billed accounts which were supported by written contracts acceptable to the Bank could become Qualified Pre-billed Accounts eligible for inclusion in the Borrowing Base it is likely that the Bank knew or should have known which receipts were on account of Qualified Pre-bill Accounts. The loan documentation and the affidavits, especially the dispute over erroneous Borrowing Base certificates, would support a finding that the Bank was aware of the existence of pre-billed accounts and the terms of the Debtor's contracts upon which those pre-billed accounts were based. However, seizure could occur only if the Bank took possession and control over funds which it did not at the time have the right to possess and control. Similarly, setoff is an equitable right that the Bank could exercise against bank accounts of the Debtor over which the Bank did not at the time have the right to possess and control.

After reviewing the affidavits it appears that under the terms of the Agreement and the Lockbox Agreement the Bank had the right and the obligation to deposit all receipts in the lockbox into an account it controlled and to apply such funds against the amounts due under the Revolving Note. Only if the Revolving Note were paid down to a zero balance would funds be transferred to the operating bank account controlled by the Debtor. Accordingly, it is likely that the Court would find that the Bank had a contractual right to apply the funds received from pre-billed accounts in the manner that it did, precluding a finding that it seized or setoff against such funds.

However, even if the Court did not ultimately make such a finding, the Debtor has not demonstrated that the Bank would not have a right of setoff against funds received from pre-billed accounts. The Debtor cites a number of cases which impose equitable limitations on a bank's right to setoff obligations of a borrower against assets in which parties other than the borrower had rights or accounts that were intended for special purposes. See U.S. v. Butterworth-Judson Corp., 267 U.S. 387 (1925) (moneys held in special accounts separate from the customer's other funds);

Energetics, Inc. v. Allied Bank of Texas, 784 F.2d 1300 (5th Cir. 1986) (funds held in trust under agreement with third party in a segregated account); Sisk v. Saugus Bank and Trust Co. (In re Saugus Gen. Hosp., Inc., 698 F.2d 42 (1st Cir. 1983) (setoff against a segregated payroll account); Constructora Maza, Inc. v. Banco de Ponce, 616 F.2d 573 (1st Cir 1980) (setoff against a segregated payroll account); FTC v. Am. Inst. for Research and Dev., 219 B.R. 639 (D. Mass. 1998) (bank's rights subject to preliminary injunction of the court); Cissell v. First Nat'l Bank of Cincinnati, 476 F.Supp. 474 (S.D. Ohio 1979) (decided under former version of UCC where bank had a security interest in "accounts receivable" but not "contract rights"); In re Milano Textiles, Inc., 38 B.R. 964 (Bankr. D. Mass 1984) (setoff against escrow fund established pursuant to court order); Graves Equip., Inc. v. M. DeMatteo Constr. Co., 489 N.E.2d 1010 (Mass. 1986) (assignment of retainage under construction contract); Sherberg v. First Nat'l Bank of Englewood, 222 P.2d 782 (Colo. 1950) (setoff against a deposit knowingly accepted by bank for a specific purpose); Dorsey v. Contemporary Obstetrics & Gynecology, Inc., 680 N.E.2d 240 (Ohio Ct. App. 1996) (interpreting the term "accounts receivable" in a contract). However, in all of those cases the borrower had either established a separate account or the bank had knowledge of the rights of other parties in the asset. Accordingly, each of those cases is distinguishable from the facts established by the affidavits in this case.

IV. CONCLUSION

For the reasons set forth above, the Court finds that the Debtor has not established a likelihood of success on the merits. Therefore the Court need not examine the other factors involved in considering a request for a preliminary injunction. Because the Debtor has not met its burden, the Court must deny the Debtor's request for a preliminary injunction.

This opinion constitutes the Court's findings of fact and conclusions of law in accordance with Federal Rule of Bankruptcy Procedure 7052. The Court will issue a separate order consistent with this opinion.

DATED this 23rd day of July, 2002, at Manchester, New Hampshire.

/s/ J. Michael Deasy
J. Michael Deasy
Bankruptcy Judge