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## Chapter 11 - "101"



## What Every Secured Creditor (and Its Lawyer) Should Know About Chapter 11

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**Editor's Note:** *This is the fourth in a series of columns on chapter 11 practice for the newly minted chapter 11 professional. In the two most recent installments, the authors provided an overview of a chapter 11 debtor's life, from preparing for bankruptcy through plan confirmation and emergence. Now, the authors switch perspectives and talk about chapter 11 from the secured creditor's perspective.*

There's an old adage that "where you stand depends on where you sit." Nowhere is this more applicable than in chapter 11. Your perspective on the case will depend on the role you play, the risks you face and/or the objectives you hope to achieve. The debtor, its equity-holders, managers, trade creditors, bondholders, bank lenders, customers, potential investors or acquirers, claims traders, the U.S. Trustee and even the judge each bring a unique set of perspectives, concerns and goals to a chapter 11 case. The secured creditor is no

exception. This month, we will discuss the secured creditor's concerns in the chapter 11 context.

First, who is a secured creditor? A secured creditor may be the holder of a real estate mortgage, a bank with a lien on all assets, a receivables lender, an equipment lender, the holder of a statutory lien or any number of other types of entities. It may be a senior lender or a subordinate lender. It may be oversecured, fully secured or undersecured. It may have a long-term business relationship with the debtor and/or its principals, or the loan may be a one-shot deal. The loan may be a big loan for the lender or a minor matter. So, there is no such thing as "THE secured-lender perspective." Even among secured lenders, where you stand is a function of where you sit, and one secured lender may sit in a very different place than another.

But some concerns are common to most, if not all, secured lenders, and this installment is devoted to addressing these issues.

### 1. Can the Debtor Use a Secured Creditor's Collateral During the Case?

The short answer is "yes, probably" (but keep reading). The debtor is typically allowed to continue to use a secured lender's collateral during the bankruptcy case. For example, if you have a mortgage lien on an office building or a security interest in a machine press, the debtor will be permitted to continue to use your collateral, even if the secured loan is in default. However, as discussed in response to question (2) below, under some circumstances, the secured creditor may be entitled to compensation for loss of value caused by the use.

If a lender has a security interest in "cash collateral," which includes both cash and cash equivalents, including the cash proceeds of hard collateral (think cash in a bank account, the proceeds of accounts receivable, rents from an office building or hotel, etc.), there are special rules. In order to use cash collateral, a debtor must have the secured creditor's consent or a court order.

Typically, a debtor will need immediate

access to cash collateral when it files for bankruptcy, and will file an "emergency motion for authority to use cash collateral" as one of its "first-day motions." In most cases, the secured creditor will use this opportunity to negotiate with the debtor to obtain certain rights or concessions in exchange for the creditor's consent to the use of its cash collateral. In such cases, the judge may simply enter a stipulated order reflecting the parties' bargain (assuming such bargain does not appear unreasonable to the judge).

In some instances, however, the parties are unable to reach an agreement, and a contested hearing will be held to determine the debtor's right to use cash collateral. During a contested hearing, the secured creditor must establish that the cash at issue is, in fact, its cash collateral, a task that is ordinarily not very difficult (but don't forget to have competent evidence at the hearing). Once the creditor has met its burden, the debtor must then prove that it can provide "adequate protection" to the creditor in order to obtain permission to use the cash collateral.

### What Is Adequate Protection?

Adequate protection, described in §361 of the Bankruptcy Code, can take on many forms, including periodic cash payments to the secured lender, payment of post-petition interest or the granting of additional liens to the creditor on previously unencumbered assets. The form the protection will take depends on (among other factors) how great the risk is to the secured lender, what the cash collateral is being used for and what types of protection the debtor is able to offer.

For example, where the primary collateral is accounts receivable, it is common for the lender to be granted a "replacement lien" on receivables generated post-petition. Such protection is significant because §552 of the Bankruptcy Code operates to cut off any receivables lien as of the bankruptcy filing date. Under this arrangement, the debtor spends the proceeds of the receivables that are subject to the lender's original lien in exchange for a lien on new "replacement" receivables. If the debtor continues to generate new receivables at the same rate as it spends the proceeds of

old (pre-petition) receivables, then the lender would be compensated for the debtor's use of its cash collateral.

What if the debtor is using the proceeds of a lender's "hard collateral" to preserve that hard collateral (*i.e.*, rents generated by an apartment building are used to preserve and maintain the building)? Often such an arrangement is, without more, considered adequate protection because the maintenance and upkeep of the building benefits the lender as mortgagee. In a similar fashion, if the secured lender has an equity cushion, where the value of the "hard collateral" substantially exceeds the amount of the secured debt, that lender is likely to be deemed to have adequate protection. The theory for this outcome is that if the value of the secured creditor's collateral substantially exceeds the debt owed to it, the use of cash collateral is unlikely to present an unfair risk to the secured lender.

One natural idea for adequate protection would be to give the secured creditor an administrative priority claim to the extent of any diminution in its collateral value. But §361(3) of the Bankruptcy Code provides that this is not adequate protection. However, should a secured lender's adequate protection prove to be insufficient to compensate it for a loss of collateral value during the case, the lender may be entitled to a "super-priority" administrative claim under §507(b), which gives the lender priority over other "regular" administrative claims, and acts as a backstop provision to protect the secured lender.

## 2. What Happens if the Lender's Collateral Decreases in Value During the Case?

There are several reasons why the value of a secured creditor's collateral might diminish during the course of a bankruptcy case. One reason is the debtor's use of that collateral. For example, if your collateral is a new car, and the debtor, during the case, drives the car for a year and puts 15,000 miles on it, the value will be diminished. Another reason for diminution may be market value. This is common, for example, if the collateral is securities. But it also happens with other assets whose value fluctuates over time.

This risk is of particular concern to a secured creditor because, as discussed below, the secured creditor is generally precluded from foreclosing on its collateral during the case. So must a creditor just sit idly by and watch its collateral value erode? Not quite. The Code recognizes that a secured creditor may be entitled to protection against a decline in collateral value over the course of a bankruptcy case.

The concept of adequate protection, described above as it relates to the debtor's ability to use cash collateral, also applies in the event that the value of non-cash collateral should decline. Section 363(e) provides that, on request of a secured creditor, the court may condition the debtor's right to use (or sell or lease) collateral upon provision of adequate protection to the secured creditor. Similarly, §362(d)(1) of the Code provides that the court may grant relief from the automatic stay to a secured creditor (allowing it to exercise remedies against its collateral) if the debtor is unable (or unwilling) to provide adequate protection. As noted above, the court has broad discretion in fashioning the form of adequate protection. But the court will not take the initiative to monitor a lender's collateral value to ensure the presence of adequate protection, nor should a secured lender rely on the debtor to offer adequate protection. Accordingly, if a secured creditor believes that its collateral value is declining post-petition, it is incumbent on the creditor to file a motion for adequate protection (or for relief from the automatic stay) in order to trigger consideration of the issue by the court.

A few more points are worth making on this issue. First, the mere fact that the automatic stay operates to delay a secured creditor's ability to exercise its remedies against the debtor or its collateral is not sufficient to justify an award of adequate protection. You do not get compensated for delay caused by the automatic stay, even if you can show that it is imposing real inconvenience upon you. The automatic stay causes inconvenience for nearly all creditors. This is not enough. Instead, you must affirmatively prove that you are suffering post-petition decline in collateral value. Second, a creditor who is significantly oversecured (where collateral value exceeds debt amount) is unlikely to get adequate protection, even if its collateral value is declining. Courts sometimes refer to a decline in the margin between collateral value and debt amount as "erosion of the equity cushion" and frequently will not award adequate protection in these situations. However, as the collateral value gets closer to the debt amount, the prospects for adequate protection improve; you don't have to wait until you are undersecured to ask for (or receive) adequate protection.

Finally, it should be noted that collateral value is not always obvious. If your collateral consists of shares of a public company or a foreign currency account, you'll be able to figure out its value pretty easily on any given day. And if it's a car,

you can come close enough by looking in the Blue Book. But if your collateral is a farm, an apartment project or a hospital, you will probably need expert testimony to establish collateral value, and the quality of your expert analysis and testimony will be critically important to gaining the relief you are seeking.

## 3. How Can a Secured Creditor Foreclose on Its Collateral During the Case?

As noted above, the automatic stay, pursuant to §362 of the Bankruptcy Code, generally prohibits any action by a secured creditor to recover or foreclose on its collateral during the bankruptcy case. We plan to devote an entire installment to the automatic stay and its various exceptions sometime down the road. For now, however, we suggest you look through §362(b) to see whether the action your client wants to take is excepted from the stay; there are some narrow exceptions for particular situations. But if you're just a regular secured creditor who wants to foreclose, you're pretty unlikely to find an applicable exception. After all, one of the main purposes behind chapter 11 is to give the debtor breathing room to formulate a plan so it can try to preserve going-concern value. If secured creditors could generally foreclose on their collateral, there wouldn't be much breathing room and there probably wouldn't be much chance for a company to emerge from bankruptcy as a going concern. So even if your loan is in default, you're pretty much stuck.

Well, almost. Section 362(d) provides a few avenues for relief from the automatic stay. To obtain this relief, you must file a "motion for relief from the automatic stay," which is a contested matter pursuant to Bankruptcy Rule 9014 (not an adversary proceeding under Rule 7001). Section 362(e) provides for prompt consideration by the court of stay relief motions. Many such motions are resolved within 30 days after they are filed, although, as you will see, if you read §362(e) carefully, that is not always the case.

The first ground for relief from the stay is "cause, including lack of adequate protection." So if the court finds that the creditor is entitled to adequate protection, but the debtor can't (or won't) provide it, then the creditor is entitled to stay relief. This provision suggests that lack of adequate protection is not the only "cause" justifying relief from the stay, but fails to enumerate any additional basis for demonstrating "cause." This ambiguity obviously gives the judge a lot of discretion. We can't possibly list here all the things that might be found to

constitute “cause,” since they are by nature specific to any individual case, but as a general matter, we think courts tend to balance the harm imposed on the secured creditor by continuing the stay against the benefit of the stay to the debtor, with a significant presumption in favor of the debtor.

The second ground for stay relief is satisfied if (1) there is no equity in the property and (2) the property is “not necessary to an effective reorganization.” The first prong (no equity) means that the debt secured by liens on the property exceeds the value of the property. The second prong (not necessary) means either that the debtor can reorganize without this particular piece of property or that the debtor is unlikely to be able to reorganize at all (if the debtor cannot reorganize at all, then no property is “necessary” for its reorganization). The secured creditor has the burden of proof on the “no equity in the property” issue, but the debtor has the burden of proof on the “necessary for an effective reorganization” issue.

The final stay relief provision applies only to single-asset real estate cases involving secured debt of less than \$4 million. If you’re involved in such a case, have a look at §362(d)(3).

#### **4. Will a Secured Creditor Continue to Get Interest (and/or Other Payments) During the Case?**

Secured creditors (even those who are oversecured) ordinarily do not receive principal payments during the case—even if they are due under the terms of the loan. This includes loans that mature during the case. However, if a creditor is oversecured (where the collateral value after deducting any senior liens exceeds the debt), the secured creditor will be entitled under §506(b) to post-petition interest (and reasonable attorneys’ and other professional fees, if provided for in the loan documents) to the extent it is oversecured. If a secured creditor is undersecured (the collateral value is less than the debt), post-petition interest is rarely awarded.

But even for the oversecured creditors, there are a couple of caveats. First, note that we said you get post-petition interest (and fees) “to the extent” you’re oversecured. In other words, if the collateral value is \$1 million and the debt amount is \$950,000, then the secured creditor should only receive post-petition interest (and fees) up to a total of \$50,000. Second, many courts hold that even if the secured creditor is entitled to accrue post-petition interest, that does not mean it will necessarily receive payment of that

interest. Instead, the interest will accrue to the creditor’s claim (although in some circumstances, the creditor may be able to negotiate for current interest payments in exchange for consent to use of cash collateral). Third, a secured creditor may or may not receive interest at the default rate, even if the loan is in default. Finally, keep in mind that collateral values often vary throughout the case, and just because you are oversecured at the beginning of the case does not mean you will be oversecured throughout.

#### **5. Is There Any Chance Someone Will Take the Position that a Secured Loan Isn’t Really a Loan, or Should Be Subordinated, and How Likely Is That to Happen?**

Two bad words in the lender community are “recharacterization” and “equitable subordination.” These doctrines are more often talked about than actually applied, but they are worth mentioning here because (1) it is an area where a little forethought can go a long way, and (2) in the relatively rare circumstances that these doctrines are applied, the consequences can be disastrous for the lender.

There is a principle in bankruptcy law called “recharacterization,” by which a bankruptcy court may characterize a transaction in accordance with its economic substance rather than its form. One example of this is the recharacterization of debt as equity. Factors that courts look to in determining whether to recharacterize debt as equity include whether (1) the “lender” was also a stockholder, (2) the “lender” obtained control of the borrower in exchange for the “loan,” (3) the corporation could obtain outside funding, (4) the “lender” received additional equity in exchange for the investment, (5) there was a fixed maturity date for the “loan,” (6) the debtor had adequate capital at the time of the “loan” and (7) the transaction was documented as a loan. If the transaction is an arms-length one, *i.e.*, the lender is not a shareholder or affiliated entity, then recharacterization is a remote risk, if it is a risk at all. But when dealing with insider loan situations, it is particularly worth thinking about.

Another doomsday scenario for the secured lender is “equitable subordination.” Section 510(c) of the Bankruptcy Code allows the court to subordinate any claim to any other claim(s), and/or to transfer a secured lender’s lien to the estate (where it will benefit all creditors rather than just the secured creditor). The risk of equitable

subordination is highest when the lender is held to have acted inequitably, to the detriment of other creditors. A common fact pattern involves a lender who exercised an unreasonable level of control over the debtor and its business. Sometimes there is a fine line, as a secured lender, between trying to assure that the debtor operates in a way that maximizes the prospects for repayment and the sort of “undue control” that can lead to equitable subordination.

#### **6. Can the Debtor Sell a Secured Creditor’s Collateral During the Case, and if So, What Does That Secured Creditor Get?**

A debtor may sell assets in the ordinary course of business without court approval. Thus, for example, a retail debtor may sell inventory to its retail customers without the need for court approval. If the sale is outside the ordinary-course-of-business, however, court approval is necessary.

As a baseline rule, the sale of encumbered assets will result in the lien following the asset; if a debtor sells an office building that is encumbered by a mortgage, the mortgage would continue to encumber the building. Debtors, however, often want to sell assets “free and clear” of liens. This is possible, under §363(f), if one of the five criteria set forth in that section are satisfied. The most common of these are that the secured creditor consents, or where the sale price is greater than the amount of debt encumbering the asset to be sold. In these situations, a lien will attach to the proceeds of the sale (which are often promptly used in turn to pay off the lien).

Finally, if a secured creditor’s collateral is sold, the creditor has the right to “credit bid” (bid debt rather than cash) at the sale, pursuant to §363(k) of the Bankruptcy Code.

#### **7. What Happens if the Chapter 11 Case Gets Converted to Chapter 7?**

The primary goal of a chapter 7 trustee is to distribute assets to unsecured creditors (although this goal is rarely achieved; in the overwhelming majority of chapter 7 cases, there’s nothing to distribute). Thus, if a secured creditor’s collateral is worth more than the liens encumbering it plus the costs of a sale, a chapter 7 trustee is likely to sell the collateral, pay the costs of sale and the liens, take his commission (subject to court approval) and distribute the remainder to other creditors. But if the collateral is worth less than the liens encumbering it (plus the costs of a sale), then the trustee is likely to

abandon the collateral (or consent to relief from the stay so that a lienholder can foreclose). The bottom line is that in chapter 7, a secured creditor is likely to get either (1) repayment of its debt or (2) title to its collateral. Often, a secured creditor's collateral is worth much more if it can be liquidated on a "going-concern" basis rather than in a "fire sale." Usually, going-concern sales can be achieved only in chapter 11 cases, but even in chapter 7, the bankruptcy court may (and occasionally does) authorize the business to be operated in order to achieve going-concern value.

## 8. What Is the Impact of Post-petition Financing on the Secured Creditor?

Many debtors will need new post-petition financing in order to be able to operate during bankruptcy. Section 364 of the Bankruptcy Code provides a series of inducements to the post-petition lender, who otherwise might not be inclined to lend money to a bankrupt company. We will devote a future column to the issue of post-petition financing (also referred to as "DIP lending"). For now, we mention only a few issues that are of particular relevance to the pre-petition secured creditor.

DIP lenders often insist on a lien on estate assets in order to make a debtor-in-possession (DIP) loan. Courts typically will approve this if the debtor can show that post-petition financing on an unsecured basis is not available.

If there are unencumbered assets, the debtor may pledge these to the DIP lender to secure the post-petition loan. This will typically not be of particular concern to the pre-petition secured creditor. But often there are not unencumbered assets, or at least not sufficient unencumbered assets to make the DIP lender comfortable. In these situations, the court may grant to the DIP lender a lien on already encumbered assets—a pre-petition lender's collateral. This lien may be subordinate to existing liens on such collateral, on an equal priority with existing liens (sometimes called "*pari passu*" with existing liens), or even senior in priority to existing liens (a so-called "priming lien").

In order to grant a *pari passu* lien or a priming lien, the debtor must offer adequate protection to the existing secured creditor. It is particularly difficult to get permission to do a priming lien over the objection of a pre-petition secured creditor, since doing so typically imposes significant risk on the pre-petition lender. The case law imposes a heavy burden on a debtor who seeks to grant a priming lien over the objection of an existing secured lender. But it is done in

some cases, such as where the existing secured lender is substantially oversecured.

Sometimes, a pre-petition secured lender will consent to the *pari passu* or priming lien. For example, such a lender may realize that the debtor needs new financing in order to be able to continue to operate (and preserve the value of its collateral), but may not want itself to put in new money. So it may agree to subordinate its pre-petition lien in favor of a new lender. In our experience, most priming liens are done on a consensual basis.

Sometimes the pre-petition secured lender will also be the DIP lender. The existing lender is a natural candidate, since it knows the debtor and has an incentive to protect its pre-petition investment. In that case, the lender may "prime" its pre-petition loan with a new post-petition loan. Not surprisingly, this is less controversial than a new lender doing a priming loan.

## 9. How Will a Secured Creditor Be Treated in the Event that the Debtor Confirms a Reorganization Plan?

In most cases where a plan is confirmed, the secured creditor, debtor and possibly unsecured creditors make a deal of some sort, and that deal is reflected in the terms of the plan. The deal may take many different forms—a sale of collateral, conveyance of collateral to the secured creditor, restructuring the loan, partial pay-down, third-party lender refinance, granting additional collateral, giving equity to the creditor, changing the loan terms, etc. The possibilities are (almost) endless.

In those cases where no deal is made, the debtor may resort to the "cramdown" provisions of the Bankruptcy Code. These provisions allow a debtor that has the support of at least one impaired class of creditors (a class of creditors whose rights are modified by the plan) to modify the terms of a secured obligation—even over the objection of the secured creditor. The debtor who wants to "cram down" a secured creditor has three basic options, which are described in §1129(b)(2)(A).

First, the debtor can give the secured creditor a note secured by its existing collateral, with a principal amount equal to the value of the collateral, and a market interest rate. For example, if the creditor is owed \$1.8 million but has collateral with a value of \$1.3 million, the debtor must give the creditor a \$1.3 million note with a term that is adjudged to be fair by the bankruptcy court, as well as a "market" interest rate. This rate will depend, among many other

factors, on the length of the term involved. Generally, the longer the term, the higher the risk and therefore the higher the interest rate. A creditor may choose to make the "fully-secured" election under §1111(b), which triggers the application of an additional requirement. In this event, not only will the debtor have to give a note with a principal amount equal to the collateral value and a market interest rate, but the total payments of principal and interest over the life of the plan must equal at least the total amount of the secured creditor's debt. This election is not often made (but when representing an undersecured creditor, you ought to at least consider it).

The second option is that the debtor can sell the creditor's collateral, giving the creditor a lien on the sale proceeds. The debtor can then either pay off the loan using the sale proceeds or give the creditor a note secured by the cash proceeds.

The third option is referred to as "indubitable equivalent." This is one of the most cryptic phrases in the Bankruptcy Code, and nobody really knows what it means. But most often it is invoked when a debtor wants to convey a secured creditor's collateral back to the secured creditor, in satisfaction of the secured debt. (In real estate cases, this is sometimes referred to as "dirt for debt"). Sometimes, when the creditor is oversecured, the debtor will seek to convey to the secured creditor only a part of the collateral to extinguish the debt, arguing that only part of the collateral is necessary to satisfy the whole debt. This might occasionally work, but the debtor should be prepared to make a very clear and very compelling case that the secured creditor is being made whole. ■

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