Common Bankruptcy Concerns for Lenders

Types of Bankruptcy, and Eligibility

The U.S. Bankruptcy Code is divided into several different chapters. Some chapters are applicable to all types of bankruptcy cases, and other chapters are only applicable to limited classes of debtors seeking relief under that particular chapter. So, for example, when someone "files a Chapter 12" he has sought relief under Chapter 12 of the Bankruptcy Code. There are four chapters under which the vast majority of bankruptcy cases are filed:

Chapter 7

Chapter 7 is intended for debtors seeking to simply liquidate their assets. Either individuals or entities can seek relief under Chapter 7, and there is no maximum debt amount. Chapter 7 relief is available to almost all debtors, but there are certain provisions that allow a court to convert the bankruptcy case to either a Chapter 11 or 13 case if it appears the debtor has sufficient income to pay much of its debts and is simply abusing the bankruptcy system in order to walk away from debt that could likely be repaid.

Chapter 11

Chapter 11 is intended for debtors seeking to reorganize. For the most part, the debtor gets to retain possession and substantial control over its assets and (if applicable) business operation while seeking to modify and restructure its pre-bankruptcy debts. Either individuals or entities can seek relief under Chapter 11, and there is no maximum debt limit. As the filing and administrative fees for a Chapter 11 are comparatively high, and as the legal costs to the debtor are often very high, Chapter 11 is used by those who are ineligible for either Chapter 12 or Chapter 13.

Chapter 12

Chapter 12 is intended for "family farmers" seeking to reorganize. Either individuals or entities can seek relief under Chapter 12, but there are substantial limitations for eligibility. Because Chapter 12 relief is usually cheaper and simpler than Chapter 11 relief, debtors almost universally choose Chapter 12 instead of Chapter 11 where available.

The tests for eligibility vary slightly based upon whether the debtor is an individual or an entity. For an individual, each of the following must be met:

1. the debtor must be engaged in a farming operation;
2. the debtor must have aggregate debts of not more than $4,031,575;
3. at least 50 percent of the debtor's debts (excluding debts related to the personal residence) must arise out of a farming operation owned by the debtor, or the debtor and spouse; and
4. the debtor must have received at least 50 percent of his gross income from the farming operation in either the tax year before the bankruptcy filing, or both the second and third tax years before the filing.

In order for a corporation or partnership to be eligible for Chapter 12 relief, each of the following must be met:

1. more than 50 percent of the outstanding stock or equity in the entity must be held by one family and its relatives, and the family or relatives must conduct the entity's farming operation;

2. at least 80 percent of the value of the entity's assets must relate to the farming operation;

3. the entity must have aggregate debts of not more than $4,031,575; and

4. at least 50 percent of the entity's debts must arise out of the farming operation owned or operated by the entity.

If the debtor is ineligible under the applicable standard set forth above, it may seek relief either under Chapter 11 or Chapter 13 as appropriate.

Chapter 13

Chapter 13 is intended for individuals with relatively modest debts and regular income who intend to reorganize while retaining most or all of their assets. Chapter 13 relief is only available to individuals; entities such as corporations and limited liability companies are not eligible to file under Chapter 13. Moreover, there are maximum debt limitations that prevent many debtors (especially farmers and other business operators) from being eligible for Chapter 13 relief. More specifically, in order for a debtor to be eligible for Chapter 13 relief, all of the following requirements must be met:

1. the debtor must be an individual;

2. the debtor must have regular income (which need not be from wages, but may include government benefits or similar sources of funds);

3. the debtor must have noncontingent, liquidated unsecured debts of less than $383,175; and

4. the debtor must have noncontingent, liquidated secured debts of less than $1,149,525.

For farmers (and other business persons) who routinely rely on unsecured account-type credit in their operations, the relatively modest limitation on unsecured debt will often make Chapter 13 relief unavailable.

For those who can meet the test of eligibility for Chapter 12, there may be little concern that Chapter 13 relief is unavailable. However, a debtor who has substantial farm-related debt but has ceased farming will usually be put in a difficult situation. The low debt limitation of Chapter 13 will prevent relief under that chapter, and the active farming operation requirement of Chapter 12 will prevent relief under that chapter. The debtor is left to choose between liquidation in Chapter 7, or the much costlier (and often prohibitively costly) Chapter 11.

Ineligibility Due to Dismissal of Previous Bankruptcy Case

It is not uncommon for a debtor to file several bankruptcy cases throughout his lifetime, and sometimes one bankruptcy case may quickly follow dismissal of another. The Bankruptcy Code is quite tolerant of repeat filers, but there is a modest limitation on eligibility due to a previous dismissal.

An individual or "family farmer" entity (an entity that meets the test of eligibility for Chapter 12 as discussed above) is ineligible for bankruptcy relief in a subsequent case if a prior bankruptcy case of the debtor was dismissed within 180 days of the subsequent case filing, and either:

1. the prior case was dismissed because the debtor failed to abide by the orders of the court, or failed to put forth sufficient effort to prosecute the prior case; or

2. the debtor voluntarily dismissed the prior case after a creditor requested relief from the automatic stay.

These are obviously narrow circumstances. The limitation on eligibility is designed to prevent two common situations of abuse of the bankruptcy process:

1. A debtor files a bankruptcy case to stall his creditors, and then refuses to make any effort to properly pursue and complete the case. He realizes that the judge will eventually dismiss the case because of the lack of debtor's effort and failure to comply with bankruptcy requirements and deadlines. However, debtor figures he will at that point just file another bankruptcy case for the cost of a few hundred dollars, and continue in that fashion (dismissal and refiling) for as long as he wishes.

2. A creditor is in the process of foreclosing on some asset of the debtor, and the debtor files bankruptcy to stall the foreclosure. The creditor then asks the court for relief from the automatic stay (or even succeeds in obtaining court relief from the automatic stay), so that the creditor can continue foreclosing. At that point, the debtor voluntarily dismisses his bankruptcy case and promptly files a second case—which gives rise to a completely "new" automatic stay from which the creditor must again seek court relief. The debtor continues in this fashion (dismissal and refiling) for as long as he wishes, and the creditor never gets a sufficient window of relief from the stay in order to complete the foreclosure.

In either scenario, the statutory limitation on eligibility requires the debtor to wait at least 180 days after dismissal before being eligible to refile.

Most situations of repeat filing are not quite so egregious, although they seem abusive to most creditors. There are other minimal protections from repeat filing abuse, but they apply in limited situations and have a more limited effect on the debtor—such as restricting the effective period of the automatic stay. Although revisions to the Bankruptcy Code over the last several years have made some inroads in preventing blatant abuse, the Code remains quite tolerant of repeat filings.

The Effect of Ineligibility

Unfortunately, the fact that a debtor is *ineligible* to file a bankruptcy case, or to file a bankruptcy case under a particular chapter, does not prevent the debtor from filing anyway. The clerk is required to accept a bankruptcy petition filed by a debtor, and the act of filing the petition (in most cases) immediately gives rise to the automatic stay and other various benefits to the debtor. The clerk cannot simply refuse to accept a bankruptcy filing because the debtor appears ineligible. Likewise, the fact that the debtor is ineligible does not mean that the case he has filed is ineffective against creditors or others. The case will be effective, just like any other bankruptcy case, for as long as it remains pending.

It is usually necessary for a creditor or a bankruptcy trustee to take affirmative steps to bring the issue of the debtor's ineligibility before the court. This may come in the form of a written filing asking that the court dismiss the case, or perhaps convert the case into one under another chapter of the

Bankruptcy Code. Or it may come in the form of a written objection to some sort of relief the debtor has requested, on the basis that the debtor is ineligible for any relief. Once before the court, the case may be dismissed outright or "converted" into a case under a different chapter depending on the circumstances. Alternatively, the debtor may himself ask for the case to be dismissed or converted when someone has pointed out the debtor's ineligibility for relief.

The Automatic Stay

One of the most important features of a bankruptcy case is the "automatic stay." Basically speaking, the *automatic stay* is a legal stay that arises automatically when the bankruptcy case is filed to prevent creditors from taking any further action to collect from the debtor, or collect against property owned by the debtor. More specifically, it prohibits a creditor from, among other things, (a) filing or continuing to pursue a court action against the debtor; (b) taking any action to enforce a judgment it has already obtained against the debtor; (c) repossessing or selling assets of the debtor; or (d) imposing or enforcing a lien against property of the debtor.

The automatic stay should not be ignored or taken lightly. For one, acts taken in violation of the automatic stay are usually invalid as a matter of law. For example, if a creditor ignores the automatic stay and forecloses on some asset of the debtor anyway, the foreclosure will be invalid and won't affect the debtor's rights in the property. The creditor will have gained nothing. Second, the court can impose monetary sanctions against anyone violating the automatic stay. Where it appears the creditor knew about the bankruptcy case but decided to continue collecting anyway, a bankruptcy court will not hesitate to punish the creditor.

Although the automatic stay arises automatically and immediately in almost all bankruptcy cases, creditors can seek relief from the stay. This will require the creditor to, through its attorney, file a motion with the court showing some legal basis that the stay should not continue as to certain property of the debtor, or as to certain actions of the creditor. Common bases for relief from the automatic stay include:

1. that the creditor has a security interest or similar interest in an asset of the debtor, and the asset is at substantial risk of loss (for example, it is uninsured) or markable depreciation, to the creditor's detriment (in bankruptcy parlance, this is referred to as a "lack of adequate protection");

2. that the creditor has a security interest in an asset of the debtor, the debtor has no equity in the asset above the amount of the debt secured, and the asset is not needed for the debtor to reorganize through bankruptcy; or

3. that the debtor has filed his bankruptcy case in bad faith, or is ineligible for relief in bankruptcy.

The process of obtaining relief from the stay (assuming it is successful) can take several weeks once it is commenced, and the court is usually very hesitant to grant stay relief in the early stages of the bankruptcy case. Courts usually prefer to give the parties and trustee time to investigate the assets and debts of the debtor before allowing creditors to take action against those assets.

However, if there is a real risk of loss to the creditor's collateral (for example, it is an uninsured vehicle or home) the court may be willing to grant relief on an emergency basis in a very short period of time. The creditor should take prompt action if it believes its collateral is in substantial jeopardy. The end result may not be that the creditor gets to immediately foreclose on the collateral, but bringing the matter to the attention of the court may prompt the debtor or others to arrange for appropriate protection of the property.

Cash Collateral: Protecting the Creditor's Interest

Cash collateral, as the term is used in bankruptcy proceedings, is defined by the Bankruptcy Code to include all cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents in which the bankruptcy estate and any other entity have an interest. In most situations, the "interest" held by the entity other than the bankruptcy estate will be a security interest or lien held by a creditor of the debtor.

Cash collateral issues arise most often in reorganization cases (Chapters 11, 12, and 13) where the debtor seeks to continue operating its business but a creditor holds a security interest in rents, profits, accounts, or proceeds of collateral that is property of the bankruptcy estate.

An obvious example presenting cash collateral issues would involve a debtor operating a hotel or rental properties, and a creditor who has a security interest in rents arising from the properties. However, the cash collateral concept is much broader than just rents. Any time a creditor's collateral is sold, producing cash or cash-equivalent proceeds, the Bankruptcy Code's cash collateral provisions are likely to be applicable.

Cash collateral issues commonly arise in farm reorganization cases where a creditor holds a security interest in the debtor's crops. The crops themselves are not cash collateral (they are not "cash equivalents"), but when the crops are sold the *proceeds* they generate are cash collateral. The creditor's security interest has essentially been transferred from the crops to the cash collateral (proceeds). And because, absent an order from the court, the creditor's security interest will not attach to crops planted after the bankruptcy has been filed, protecting the creditor's cash collateral in the form of proceeds of pre-bankruptcy crops is key to protecting the value of the creditor's security interest.

The Bankruptcy Code does offer potential protection for a creditor's cash collateral. Although the debtor in a reorganization case is generally authorized to operate its business while in bankruptcy, the Bankruptcy Code prohibits the debtor from any use of cash collateral unless either (a) each entity holding an interest in the cash collateral consents to its use; or (b) the court specifically authorizes use of the cash collateral after notice and a hearing for interested parties.

Despite the legal prohibition on using cash collateral, many debtors will simply continue to use cash collateral in their operations until the secured lender takes affirmative steps to limit or stop the use. Usually, the appropriate action will be to file a written motion with the court, asking that the judge order the debtor to stop using the creditor's cash collateral, or to use it only subject to restrictions that will adequately protect the lender's security interest.

Courts may use many different types of requirements and restrictions to assure that the creditor's security interest in cash collateral is adequately protected. Commonly, the court will require that the debtor routinely report its receipt and use of cash collateral, and segregate a creditor's cash collateral into a separate account. In addition, a court may provide the lender with "replacement liens" on other property of the debtor to compensate for the value of the cash collateral used by the debtor; or require that the debtor make periodic cash payments to the creditor in order to prevent the value of the creditor's collateral from dropping too rapidly in comparison to the amount of the debt owed to the creditor.

In a case where cash collateral is involved, the affected creditor should not rely upon the debtor to protect the creditor's interest in cash collateral. Likewise, without some affirmative request from the creditor, the court is not itself likely to take protective action on the creditor's behalf. The creditor must promptly obtain counsel to seek protection on terms favorable to the creditor. Otherwise, the creditor

may see its security position devalue quickly as the debtor continues to operate or otherwise use the proceeds of the creditor's collateral.

Binding Effects of Bankruptcy Plans

In bankruptcy cases under Chapters 11, 12, or 13, the debtor proposes a "plan" of reorganization that sets forth how the debtor's creditors and debts will be treated in the process of reorganization. For instance, it might provide that certain collateral will be surrendered to a secured creditor in satisfaction of debt; that other collateral is to be retained by the debtor, with the secured creditor to receive periodic payments over time; and that unsecured creditors will receive over time some small percentage of the debt owed.

Once a plan is approved (in bankruptcy terminology, "confirmed") by court order it is essentially treated as a binding contract on the debtor and all creditors of the debtor, even if the creditor did not agree to the plan or the creditor did not receive any payment under the plan.

A Creditor Can Waive its Rights by Failing to Object to the Plan

The Bankruptcy Code does provide potential protection to creditors by imposing limitations on plan's treatment of claims. Two of the most important limitations are, summarily stated:

1. for unsecured claims, the plan must provide for payment of a greater amount (in present value terms as of the effective date of the plan) than the unsecured creditors would receive if the debtor's non-exempt assets were liquidated in bankruptcy as of the effective date of the plan (this is usually referred to as the "best interests of creditors test"); and

2. for secured claims, the plan must provide that either (a) the creditor retain its lien and receive payment, over the life of the plan, of an amount equal to the present value of its secured claim as of the effective date of the plan; or (b) that the collateral be surrendered to the creditor.

Even though these are considered two bedrock protections for creditors that have long been features of bankruptcy law, a creditor can accept lesser treatment under a plan. Acceptance will occur if either the creditor affirmatively agrees to the plan, or simply doesn't submit a formal objection. In other words, if the creditor does not take action to object, the creditor is considered to have voluntarily accepted whatever is proposed by the plan. Even if the plan violates one of the two principles discussed above, the court may still confirm the plan and the plan will still be binding on the creditors as written.

Because acceptance will be implied absent a formal objection, a creditor must act promptly to obtain counsel and object to any improper treatment under a plan. Moreover, if the creditor is dissatisfied with the proposed plan, there may be other potential grounds for objection even aside from the treatment of the creditor's claim. For example, the debtor may be ineligible for relief under that particular chapter (12 or 13), or the debtor may have filed his case or proposed his plan in bad faith. Counsel will be able to assess these opportunities for objection by reviewing the bankruptcy case and its factual background before the deadline for objection has passed.

Plans Releasing Non-Debtor Guarantors

One specific issue of which creditors should be aware is that debtors may propose plans whereunder a non-bankrupt guarantor of a debt owed by the debtor is released from liability. For example, the bankruptcy debtor may be a small corporation whose loan has been guarantied by its sole shareholder, who has not filed for bankruptcy protection; or, the bankruptcy debtor may be an individual

whose loan was guarantied by a parent, who has not filed for bankruptcy protection. The plan will provide for some treatment of the creditor's claim (perhaps partial payment, or surrender of collateral), and further state that the guarantor is released from all liability in relation to the debt owed to the creditor.

In these situations, the debtor has a goal of protecting the guarantor rather than treating its creditors fairly. These guarantors should not receive the benefit of a discharge of debt if they have not themselves filed for bankruptcy protection and submitted their own assets for administration. The Bankruptcy Code does not provide for a discharge of anyone other than the debtor itself.

Just as a creditor can accept treatment that would otherwise be unfair and impermissible, a creditor can accept a plan providing for the release of a non-bankrupt guarantor. If the debtor proposes such a plan, and the court confirms the plan without objection, then the plan will be binding on all creditors and the guarantor will be released as stated in the plan. If instead the creditor properly files an objection based on the proposed release, the court cannot confirm the plan until the release provision is removed or a different plan is proposed. Again, the burden is upon the creditor to affirmatively oppose the provisions of the plan. A failure to carefully monitor and promptly act can prove quite costly to the creditor.

Cram-Down and Collateral Valuation in Reorganization Cases

If a secured creditor objects to the debtor's proposed plan, the plan can only be confirmed despite the objection (a situation known as "cram-down") if it either (a) surrenders all of the creditor's collateral to the creditor, or (b) allows the creditor to retain its lien and provides for distribution to the creditor, over the life of the plan, the value of the creditor's secured claim as of the effective date of the plan. The latter option frequently leads to disputes in bankruptcy cases, as valuation of the collateral is key to determining whether the requirements for cram-down have been satisfied.

It is important to understand the meaning of *secured claim* in the bankruptcy context. The fact that a lender is owed $1 million and there is some collateral for the debt does not mean that the lender has a secured claim for $1 million. The lender's *secured claim* is the amount that is the lesser of (a) the amount of the debt secured by the collateral, or (b) the value of the collateral. In other words, if the debt owed to lender is greater than the value of the collateral, the amount of the secured claim held by the lender is the amount of the value of the collateral. The rest of the debt is, for bankruptcy purposes, split into a separate unsecured claim and the lender is treated as an "unsecured creditor" for the purpose of that separate claim.

Example 1

> Bank makes a loan to Farmer in the amount of $2,500,000. The loan is secured by certain land owned by Farmer, and all of Farmer's equipment. Farmer subsequently files a Chapter 12 bankruptcy, owing $2,200,000 to Bank at the time.
>
> As determined by the court, Farmer's land has a value of $1,100,000, and his equipment has a total value of $400,000.
>
> Bank has a secured claim of $1,500,000 and an unsecured claim of $700,000.

Example 2

> Bank makes a loan to Farmer in the amount of $2,500,000. The loan is secured by certain land owned by Farmer, and all of Farmer's equipment. Farmer subsequently files a Chapter 12 bankruptcy, owing $2,200,000 to Bank at the time.
>
> As determined by the court, Farmer's land has a value of $2,100,000, and his equipment has a total value of $400,000.
>
> Bank has a secured claim of $2,200,000. Bank has no unsecured claim.

Again, for cram-down purposes, the plan must provide the creditor, in present value, the amount of the creditor's secured claim (meaning the actual amount of the secured claim plus interest to compensate for the time value of money). Because the amount of the secured claim is determined by the value of the collateral, collateral valuation is key to determining how much the creditor must be paid in the bankruptcy plan.

The examples used above simply assume a definite value for collateral, but in reality the parties usually have different opinions on collateral value. This is foreseeable, as the debtor and creditor have opposing interests: the debtor wants a low value, so he has to pay less to the creditor under the plan; and the creditor wants a high value, so the debtor has to pay more under the plan. Moreover, the question is not just what the debtor *wants* to pay the creditor under the plan. The question is often what the debtor can *afford* to pay the creditor, given likely future income, and still have a realistic chance of making all of the other payments required by the plan. So a better example might be something more like this:

> Bank makes a loan to Farmer in the amount of $2,500,000. The loan is secured by certain land owned by Farmer, and all of Farmer's equipment. Farmer subsequently files a Chapter 12 bankruptcy, owing $2,200,000 to Bank at the time.
>
> Farmer asserts in his bankruptcy schedules and plan that the land is worth $1,100,000, and the equipment is worth $300,000—meaning the plan has to pay Bank, in present value terms, $1,400,000 to satisfy the cram-down requirement.
>
> Bank believes Farmer has substantially undervalued the collateral. Bank asserts the land is worth $1,400,000 and the equipment is worth $600,000. Thus, the plan should pay the present value of $2 million.

In such a dispute, the court ultimately decides the value of the collateral. But if the creditor disagrees with the debtor's valuation, then the creditor bears the burden of proving to the court that a higher value should be used. As value is a matter of opinion, the evidence that the creditor must present to the court is an opinion as to the value of the collateral.

In deciding upon value, the court can consider the opinion of the creditor itself (more specifically, the opinion of an officer or employee of the creditor), but the court is not likely to find the opinion very reliable. Just as the debtor has strong motivation to under-value collateral, the creditor has strong motivation to over-value. Further, the court may have a hard time determining whether the bank officer does, or does not, have sufficient skill and experience to formulate a realistic value. The usual reaction from the court is to substantially discount the creditor's opinion of value.

Instead of relying on the valuation opinions of its own officers, the creditor should obtain an independent, professional appraisal whenever there is a substantial amount in dispute. The court is much more likely to view the professional appraiser's opinion as realistic and reliable. If the debtor itself obtains a professional appraisal to support the debtor's valuation (which is common in larger farm

bankruptcies), the creditor will definitely need to obtain its own independent appraisal—or otherwise run the risk of essentially being ignored by the court in determining value.

In our example dispute above, the Bank would need to obtain an independent appraisal of the land securing the loan and of the equipment securing the loan. There will be greater costs required as compared to using in-house appraisals, but the amounts in dispute—more than $600,000—plainly justify incurring the costs. As with other matters, the creditor needs to take substantial steps to protect its own interests, rather than relying upon the court or trustee to provide protection from mistreatment by the debtor.