

## INSIGHTS + NEWS

### Client Alert: Getting Paid in Bankruptcy – Part I, Lender Claims

BY CESIRA NEWCOMB • AUGUST 20, 2020

In this series, we look at how various payment rights are treated in bankruptcy. A summary like this could not possibly address every right that might arise in any given bankruptcy case. We have omitted several of the Bankruptcy Code's more esoteric legal protections and exceptions that arise in specific kinds of bankruptcy cases. When bankruptcy strikes, creditors should always consult a bankruptcy lawyer to understand what actions they need to take to preserve their rights and maximize their recovery.

#### THE BASIC CONCEPT OF A "CLAIM"

The Bankruptcy Code defines a "claim" to include any right to payment against the bankrupt entity (called the "Debtor"), regardless of whether the claim is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured. It's a broad definition.

Claims break down into four basic categories: (1) secured claims; (2) administrative expense claims; (3) priority claims; and (4) general unsecured claims.

It is no surprise that in bankruptcy there is seldom enough money to pay every creditor in full. Order of priority, therefore, is critical. Imagine the creditors forming a line in order of priority: secured claims, followed by administrative expense claims, priority claims, and general unsecured claims. Equity claims – the owners' stake in the Debtor – are technically at the end of this line, but since the estate is usually insolvent, they typically do not receive any payment at all.

Outside of bankruptcy, the creditor probably thinks about the money that the Debtor owes as a single debt. As we shall see, however, the Bankruptcy Code's payment hierarchy can slice and dice this "debt" into several tranches according to what portions of the debt qualify as administrative expense, priority, or general unsecured claims. Creditors should think about the money they are owed in terms of these claim categories, which can differ in value significantly. A \$100,000 administrative expense claim could be worth pursuing, while a \$100,000 general unsecured claim might not.

Secured claims are secured by a lien on the Debtor's real or personal property (called "collateral"), and the creditor may, under certain conditions, levy and sell collateral in satisfaction of its claim. The perfection and priority of liens is determined by non-bankruptcy law (usually Article 9 of the Uniform Commercial Code and real property law). A secured claim is really just one of the other kinds of claims *plus* collateral. Once the collateral is liquidated and applied to the debt, any remaining debt will be treated as an administrative expense, priority, or general unsecured claim.

Creditors assert priority and general unsecured claims by filing a short and simple form with the bankruptcy court called a proof of claim. This can be done for little cost. If no one objects to the proof of claim, the claim is deemed

allowed. Administrative expense claims require a more extensive application filed through counsel. The bankruptcy court must approve the application before an administrative expense claim is deemed allowed.

In a successful reorganization, allowed administrative expense claims and priority claims are paid in full, while general unsecured claims can receive as little as nothing or as much as 100% plus accrued interest if the estate ends up being solvent. In most cases, the dividend on general unsecured claims is very small.

Finally, if the creditor owes the Debtor property (including money), it cannot receive payment until it has turned such property over to the Debtor. This allows the Debtor to net out liabilities with its creditors as part of the claim administration process.

## LENDER CLAIMS

### 1. Secured Lender Claims

If the Debtor gave you an interest in property to secure repayment of your loan, then congratulations: you are a secured creditor with a secured claim and lots of rights including:

- cash payments or replacement liens to offset any diminution in the value of your collateral during the bankruptcy; reinstatement of the loan under a plan of reorganization, and permission to foreclose in a liquidation scenario;
- if your collateral is sold during the bankruptcy, the sale proceeds will attach to your lien. And if the Debtor proposes to sell your collateral for a price you believe to be inadequate, you have the right to “credit bid” your debt if you want to own the asset;
- if your security agreement allows it, your lien will attach to property that the Debtor acquires after the commencement of the bankruptcy case;
- if you have an interest in the Debtor’s cash (i.e., cash collateral), the Debtor cannot spend that money without your consent or a court order that adequately protects your collateral position;
- if the collateral securing your loan consists of a single piece of real estate providing substantially all of the Debtor’s income, then the Debtor must either resume paying the interest on your loan or it must achieve confirmation of a reorganization plan in a reasonable period of time, otherwise the bankruptcy court must grant you relief from the automatic stay to foreclose on your mortgage on the property; and
- if the collateral securing your loan consists of aircraft equipment or a vessel, you are entitled to take possession of such property unless the Debtor obtains court approval to cure any defaults under the loan or lease agreement and continue performing all obligations under your loan/lease agreement or sale contract.

Notwithstanding these rights, there is no “free lunch” for secured claims. The bankruptcy estate is also allowed to surcharge against the collateral the costs and expenses of preserving or disposing of the collateral during the case. This will necessarily reduce the amount of cash available to satisfy your claim.

As discussed in the introduction, a secured claim is just an administrative expense, priority, or general unsecured claim plus collateral. This means that your right to payment is *secured* only to the extent of the value of your interest in the collateral. If you are under-secured (i.e., the collateral is worth less than the total debt), the Debtor might be able to bifurcate the claim into secured and unsecured components. The Debtor will then issue you a new note for the portion of the debt that remains secured. The unsecured portion (called the deficiency claim) is treated as a general unsecured claim, relegated to the back of the payments line where it will likely receive less than full payment.

The bifurcation of the claim into secured and unsecured components is called “cram down.” If the Debtor crams you

down, you might come out of the bankruptcy with a considerably smaller loan. In consumer bankruptcy cases, the Debtor cannot cram down a mortgage on their principal residence. In business reorganization cases, the creditor can avoid cram down by electing to have its entire debt treated as a secured claim, and in this scenario, the Debtor will still be able to reduce the monthly payments on the debt *as if* it had bifurcated the creditor's claim, but the deficiency claim hangs around like a giant balloon payment that is payable to the creditor if the Debtor sells or refinances. You might choose this treatment if you believe that the collateral is likely to increase in value post-bankruptcy.

Finally, you will have a secured claim only to the extent that your security interest attached to an interest of the Debtor in property and is *perfected* under applicable non-bankruptcy law as of the petition date. Interested parties can and will challenge your liens in bankruptcy and if they prevail, the secured claim you thought you had will be a general unsecured claim.

## 2. Unsecured Lender Claims

If you lack a perfected interest in collateral to secure repayment of the loan, you hold a general unsecured claim. Creditors who make unsecured loans have rather dismal prospects of a full recovery unless they can call on a third-party guarantor. While the Bankruptcy Code does not prioritize payment for general unsecured claims, it does make some debts non-dischargeable, which means that the lender is free to continue pursuing the Debtor for payment after bankruptcy. Creditors can have debts incurred by a consumer debtor for "luxury goods or services" in excess of \$725 within 90 days and cash advances in excess of \$1,000 within 70 days of the bankruptcy declared non-dischargeable. This protection prevents debtors from running up excessive credit card debt on nonessential items on the eve of bankruptcy. Certain education loans are also non-dischargeable unless the Debtor obtains a ruling from the bankruptcy court determining that repayment of the loan would constitute an "undue hardship."

If you are an owner or insider of the business who advanced cash to your business prior to the bankruptcy and treat the advance as a loan on the company's books, be sure that your "loan" is appropriately documented. Bankruptcy trustees are not shy about commencing litigation to attempt to recharacterize any such cash advance as a capital contribution (with a lower priority of payment) when the terms of repayment are more favorable than those offered by an arm-length third-party lender.

## 3. Automobile and Equipment Loans

If you provided financing to allow the Debtor to purchase an automobile or other equipment, you will usually have a purchase money security interest in the collateral. This gives your secured claim in the collateral priority over a secured creditor with a "blanket lien" on all the Debtor's assets. To perfect a lien on an automobile, for example, the creditor must hold the title to the vehicle. A bank that provided a working capital loan to the Debtor will usually not have this document. An automobile lender will.

Consumer debtors who wish to retain their vehicle are prohibited from "cramming down" an automobile loan (i.e., reducing the secured claim to the present value of the vehicle and treating the deficiency as a general unsecured claim) if the loan was made within two and a half years before the bankruptcy filing. The Debtor might be successful in modifying the interest rate, however.

Finally, because equipment financing is typically structured like an installment contract, much ink has been spilled over whether the transaction should be legally characterized as a secured sale where the Debtor owns the property, or a "true lease" where the Debtor is just leasing the property from the creditor. The distinction can have serious consequences for a creditor because of the Debtor's ability to "cram down" a secured claim on collateral. If the transaction was a sale and the equipment has depreciated, the Debtor can issue a "new note" for the present value of

the property and discharge the deficiency (unsecured) claim without full payment. If, on the other hand, the creditor has a lease, the Debtor cannot rewrite its terms: if it wants to keep using the equipment, the Debtor must cure any payment default and maintain the lease payments. The bankruptcy court will look to state law (usually the Uniform Commercial Code) to determine whether the creditor's agreement with the Debtor should be treated as a secured sale or a true lease. The court will consider the economics of the transaction: if the "lease" covers the entire economic life of the property and if the Debtor has the option to become the owner of the property at the end of the lease for little or no additional consideration, the court might characterize the transaction as a sale leaving the creditor with a secured claim subject to cram down.

#### 4. **Accounts Receivable Factoring**

If you purchased the Debtor's accounts receivable (known as factoring), you might face recharacterization issues similar to those discussed above concerning equipment financing. The Debtor might argue to the bankruptcy court that your factoring arrangement is not a "true sale" of its accounts receivable, but a loan secured by the accounts. If the Debtor prevails, the accounts (and the cash proceeds therefrom) are property of the bankruptcy estate, which can be used to fund the case. Moreover, the Debtor's first-lien lender will take the position that your security interest is subordinate to its interest in the same accounts. On the other hand, if the bankruptcy court agrees that you purchased the accounts, then they are outside the court's jurisdiction.

In deciding whether a factoring arrangement is a true sale of accounts, the court will look at the allocation of risk for non-collection between the factor and the Debtor (i.e., whether the factor has recourse against the Debtor), whether the Debtor continues to service the accounts and commingles receipts with its operating funds, and whether the Debtor can repurchase the accounts, among other factors.

Regardless of whether your arrangement is a true sale or secured financing, you must file a UCC-1 financing statement to perfect your interest in the accounts. If you fail to do so prior to the bankruptcy filing, you will have a general unsecured claim for any money you lent to the Debtor. You should also be sure to give notice to the account debtor as required by the Uniform Commercial Code (or the federal Assignment of Claims Act if the account debtor is the U.S. government) so that it knows to pay you and not the Debtor in order to discharge its liability on the account.

[Read Part 2: Goods and Services](#), [Part 3: Landlords, Leases, and Licenses](#), and [Part 4: Employees](#).