Undersecured loans: Protecting your rights in Chapter 11 bankruptcies

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By John D. Stiner

Commercial lenders know the story. They made loans prior to 2008 when asset values were high. The economy soured. Asset values declined. A tepid recovery has, at best, led to stagnation of those values. Now, balloon notes are maturing and refinancing is difficult. Borrowers are stressed. As a result of all this, commercial lenders are often undersecured when a loan default occurs with the collateral worth far less than the amount owed. For example, in the recent mortgage foreclosure of Crossroads Mall in Oklahoma City, the lender was owed more than $60 million. During the foreclosure proceedings the mall appraised at slightly less than $17 million. Only the lender bid at the sheriff's sale, credit bidding its judgment and taking title to the property for just over $11 million.

When a default is imminent or has already occurred, the lender may find itself on the receiving end of a Chapter 11 bankruptcy petition if the parties are unable to structure a workout. As a result of the Bankruptcy Code's so-called "automatic stay," absent permission by the bankruptcy court, the lender cannot pursue foreclosure proceedings, liquidate the collateral, and move on. Rather, the lender must attempt to enforce its rights during the often lengthy pendency of the bankruptcy case. However, the filing of a bankruptcy petition is not always a bad thing.

The Bankruptcy Code affords the lender some protection during the case. For example, secured lenders with the right security have a say in the debtor's use of cash generated from the operation of the asset and, in some cases, may be entitled to receive "adequate protection" payments or additional collateral. In addition, in so-called "single-asset real estate" cases, the debtor must begin making interest payments to the lender 90 days after it files its bankruptcy petition. Under the right circumstances, the lender may also "lift" the bankruptcy stay and foreclose. In most cases, the lender may also pursue any guarantors of the loan outside of bankruptcy.

Understandably, these protections are small comfort to a lender accustomed to receiving timely payments of principal and interest without having to litigate. First and foremost, the lender's goal in a commercial borrower's bankruptcy is to be repaid as much as possible as quickly as possible. On the other hand, the debtor often seeks to extend payment terms, modify interest rates, and reduce the principal amount of the debt as much as possible so that it may reorganize and continue operating. Nevertheless, working with the debtor to craft a plan of reorganization may offer the lender better prospects of recovery than would foreclosing on the property, especially in a down market. Leverage in the battle over how much the debtor will pay and the lender will accept without objection often centers around the value of the asset.

If an appraisal shows that the lender is undersecured, then, as one might suspect, this has significant consequences in bankruptcy. A bit of history is in order. Prior to 1978, when the Bankruptcy Code was enacted, undersecured non-recourse lenders were at a serious disadvantage. This was displayed most clearly in *Great National Life Insurance Co. v. Pine Gate Associates, Ltd.*, 2 B.R. 1478 (Bankr. N.D. Ga. 1976) often referred to as the "Pine Gate" case. In that case, the lender held a non-recourse mortgage on the debtor's apartment complex. The bankruptcy court confirmed a plan that repaid the lender only the court-determined value of the real estate, which was far less than the loan balance. The deficiency was not paid at all because, as non-recourse debt, it was not an obligation of the borrower. Once payment of the greatly reduced debt had occurred, the debtor would own the real estate free and clear of the lender's mortgage. However, to the extent any appreciation in value occurred during that time period, the debtor would enjoy a windfall and could, for example, then sell the real estate for a profit with the lender left holding the bag.

This result did not sit well with lenders and, had *Pine Gate* remained the law, in an era of undersecured loans borrowers could simply throw their company in bankruptcy, reduce their debt, and profit from any subsequent increase in the secured asset's value. Congress reacted to the unfairness of the *Pine Gate* case by enacting Section 1111(b) of the Bankruptcy Code. In short, Section 1111(b)(1) converts a secured lender's non-recourse claim to a recourse claim, even if the loan documentation makes clear the debt is non-recourse. In short, this provision of the Bankruptcy Code makes all secured debt recourse for purposes of bankruptcy distribution, whether or not this is the case under the loan documents.

This is important to a non-recourse lender because of another provision of the Bankruptcy Code: Section 506(a). Under that section, the secured creditor's total claim is "bifurcated." In other words, it is granted a secured claim for the value of the secured asset *and* an unsecured deficiency claim for the remainder of the debt. Without Section 1111(b)(1)'s protection, like the lender in the *Pine Gate* case, the non-recourse lender would have no right to an unsecured claim against the debtor for the deficiency.

Lenders who already have recourse rights against the borrower or who have seen their unsecured claims reap pennies on the dollar in bankruptcy may think the conferral of an unsecured claim for the deficiency is unimportant. However, having this unsecured deficiency claim can be critical because it confers upon the lender the right as a member of the unsecured class of creditors to vote to accept or reject any plan of reorganization proposed by the debtor. Often, the lender's unsecured deficiency claim is large enough to dwarf ordinary trade creditors and allows it to effectively control the vote of the unsecured class. Because Section 1129(a)(10) of the Bankruptcy Code requires that at least one impaired class vote in favor of the plan even in "cramdown" situations, this gives undersecured lenders the ability to have a significant say both as a secured claimant and a member of the class of unsecured creditors as to whether a plan may be confirmed. Moreover, because of the triggering of the so-called "absolute priority" rule, in "cramdown" situations current equity holders in the debtor will not be entitled to receive any interest in the reorganized debtor unless the lender's deficiency claim is paid, or the equity owners are willing to inject "new value" into the company.

However, there is more to the statute than a conversion of all secured debt into recourse debt, which would, standing alone, only be relevant to lenders with non-recourse loans. Section 1111(b)(2) provides the lender an important option. It may forego its unsecured deficiency claim, and thus its right to vote on a plan of reorganization and invocation of the absolute priority rule. But, in exchange, it may elect to have its *entire claim treated as secured*. As a result, under Section 1129(b)(2)(A)(i)(II) of the Bankruptcy Code, in order to be confirmed, a cramdown plan will have to make deferred payments to the lender totaling the full value of its claim. This can be of great importance to an undersecured lender that believes the asset will appreciate in value and wants to take full advantage of the asset's potential.

In sum, an undersecured lender may do one of two things under Section 1129(b) to influence treatment of its debt under a plan of reorganization. First, it may sit back and maintain a secured claim for the value of the collateral and an unsecured claim for the deficiency. In this case, it will be entitled to vote on the plan and maintain, through its unsecured deficiency claim, a right to participate in a distribution to unsecured claimants. This may be substantial as a result of the "absolute priority" rule.

On the other hand, if it believes that the asset will likely increase in value and the debtor can actually make such payments with a reasonable period of time, it may make the “Section 1111(b) Election,” waive its deficiency claim, but have its entire claim treated as secured and eventually paid.

The decision whether to make the Section 1111(b) Election is not an easy one, and should only be made after significant analysis of the collateral’s prospects for increased value and consultation with experienced bankruptcy counsel. For example, if the lender makes the Section 1111(b) Election but the debtor’s cash flow cannot support such payments, or would have to do so over an unreasonably long period of time, the plan may not be confirmed and, ultimately, the assets may be liquidated in one form or another, either under a plan or a so-called “Section 363 sale” in which case the lender will not be entitled to make the election. Nevertheless, Section 1111(b) provides an important form of leverage for the undersecured creditor and may, through careful decision-making, allow it to achieve a greater recovery on the asset than it might otherwise realize.

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