WHEN A BORROWER FILES A CHAPTER 11 BANKRUPTCY: WHAT LENDERS SHOULD KNOW

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As the effects of COVID-19 and its related government restrictions continue to be felt across the United States and Canada, businesses are evaluating how to recover from the economic slowdown. For many creditors, this involves recovering money or collateral from a business which has filed for bankruptcy protection. In a previous alert, we discussed sales under Article 9 of the Uniform Commercial Code and the potential for judicial foreclosure in the event a borrower defaults on its obligations. However, if a borrower will not consent to a cooperative liquidation by its lender and seeks to attempt to pursue a sale on its own terms or restructure, a bankruptcy filing may ensue. Often, this is done under Chapter 11 of the United States Bankruptcy Code. This alert discusses several key issues lenders should be aware of at the outset of a Chapter 11 filing.

The Borrower's Right to the "Automatic Stay"

Because a lender can use its rights to self-help and demand payment from the borrower's account debtors or set-off the balances in the borrower's operating and deposit accounts, if they are maintained by the lender without the need for court intervention, the Lender can very quickly cut off the borrower's access to cash and, therefore, its ability to operate. If a lender were to exercise this remedy, the borrower may file for relief under Chapter 11 to obtain the benefit of the "automatic stay." The automatic stay, imposed pursuant to section 362(a) of the Bankruptcy Code, bars any attempt by the lender to enforce its rights and collect indebtedness owed by the borrower by prohibiting any commencement or continuation of any process to recover a claim against the debtor that arose prior to the bankruptcy filing. This includes any attempt to obtain possession of the debtor's property, to perfect or enforce liens against the debtor's property. A lender's right of setoff is also stayed. There are exceptions to the stay for settlement payments for securities contracts, commodity contracts, forward contracts, repurchase agreements, swaps and other derivatives which we will not address here. Generally speaking, the stay enables the borrower more flexibility to attempt to refinance or self-liquidate. However, the stay is *not* indefinite.

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The Lender's Right to "Adequate Protection"

During the Chapter 11 case, a lender who has a lien on the debtor's assets is entitled to "adequate protection." Adequate protection is defined in Section 361 of the Bankruptcy Code and provides for a debtor to: (1) make a cash payment or payments to the extent the stay results in a decrease in the value of its collateral; (2) provide the creditor an additional or replacement lien; or (3) granting other relief that will result in the "realization" of the "indubitable equivalent" of the creditor's interest in its collateral. However, creditors that lack collateral ("*unsecured creditors*") are not entitled to adequate protection payments. Creditors who are *undersecured* (their collateral is worth less than the amount of the debt) will only be entitled to "adequate protection" on the secured portion of their claim to the extent they can demonstrate the value of their collateral is decreasing. Only *fully secured creditors* will be entitled to post-petition interest. Obviously, valuation of a lender's collateral is the key to this analysis and a lender may need to provide evidence to the Court, possibly through the use of expert testimony, in a dispute regarding valuation of collateral/adequate protection.

The Lender's Access to the Borrower's "Cash Collateral"

Often a lender's security interest will include the debtor's cash ("cash collateral"). A Chapter 11 debtor needs court approval to use cash collateral following the bankruptcy filing. Typically, the debtor will file a motion seeking authority to use cash collateral at the outset of the case. The lender is entitled to adequate protection of its interest in the cash collateral, which usually includes the granting of a lien in the cash collateral generated following the bankruptcy filing. A lender will often use the debtor's request to use cash collateral as an opportunity to negotiate for certain rights and concessions from the debtor. If the debtor and lender cannot agree on adequate protection, then the Court may hold a hearing and accept evidence from the parties as to the lender's interest in the cash collateral and the appropriate adequate protection for the lender. For example, if a lender has an interest in accounts receivable it may receive a replacement lien on post-petition receivables. The "replacement lien" is necessary because section 552 of the Bankruptcy Code cuts off a lender's security interest in property acquired by the debtor after the bankruptcy filing.

The Lender's Ability to Foreclose on Collateral

If a lender seeks to foreclose on its collateral during the Chapter 11 bankruptcy, it must obtain Court approval for terminating the automatic stay. A lender may make an application to the bankruptcy court to terminate the stay for "cause." Section 362(d) permits "any party in interest" to request the stay be terminated "for cause, including a lack of adequate protection of an interest in property of the party in interest." While "cause" is not defined in the Bankruptcy Code, it can be summarized as a balancing of the harms to both the creditor and the debtor based upon the debtor's continued use of the lender's collateral. Section 362(d)(2) provides more specific requirements for terminating the stay. The stay shall be terminated if: (A) the debtor does not have any equity in the property securing the debt; and (B) such property is not necessary for a reorganization of the debtor. Once again, the value of the collateral is a key component in the court's determination of whether to terminate the stay.

If you have questions about how a Chapter 11 filing may impact your business, please contact James Thoman (716.848.1361).

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