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Dealing with Troubled Loans in Troubled Times

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Dealing With Troubled Loans In Troubled Times

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DEALING WITH TROUBLED LOANS IN TROUBLED TIMES

Perfection Issues Regarding Specialized Collateral

Overview of Various Issues Regarding Security Interests

- **Security interest: an interest in personal property or fixtures which secures payment or performance of an obligation (Cal. Com. Code § 1201 (35))**

Security Agreement

- Security agreement: an agreement that creates or provides for a security interest
  (Cal. Com. Code § 9102 (73))
- Description of collateral
  - Reasonably identify what is being described
    (Cal. Com. Code § 9108(a))
  - Sufficient: description by type or category
    (Cal. Com. Code § 9108(b))
  - Insufficient: "all the debtor's assets" or "all the debtor's personal property"
    (Cal. Com. Code § 9108(c))
- To be sufficient for attachment, must be in writing and be authenticated
  (Cal. Com. Code § 9203(b))
  - Authenticate means (i) to sign or (ii) to execute
    (Cal. Com. Code § 9102(7))

Attachment

- A security interest attaches when it becomes enforceable against the debtor

  (Cal. Com. Code § 9203(a))
- Pre-requisites:
  - Value must be given
  - The debtor must have rights in the collateral
  - One of
    - A written and authenticated security agreement describing the collateral
    - The collateral is in the possession of the secured party by agreement of the debtor
    - The secured party has control of the collateral

      (Cal. Com. Code § 9203(b))

Perfection

- Perfection: establishes priority among competing secured creditors with a security interest in the same collateral
- Methods:
  - By filing a financing statement
  - By possession
  - By control

Financing Statement

- Financing statement: a record or records composed of an initial financing statement and any filed record relating to the initial financing statement
  (Cal. Com. Code § 9102(39))
- Requirements for filing:
  - Provide name of debtor
  - Provide name of secured party or representative
  - Indicate the collateral covered
    (Cal. Com. Code § 9502(a))
- Debtor's name
  - Registered organization: name indicated on the public record of the debtor's jurisdiction of organization
    (Cal. Com. Code § 9503(a)(1))
  - Other debtors: the individual or organizational name
    (Cal. Com. Code § 9503(a)(4)(A)))
- Indication of collateral
  - By category or type
  - "All the debtor's assets" or "all the debtor's personal property"
    (Cal. Com. Code § 9504)

Appointment of an Agent for Multiple Secured Parties

- If there are multiple secured parties with the same priority, the lien should be granted to an agent to hold for the benefit of the secured parties
- The agent will have the right to enforce remedies with respect to the collateral for the benefit of the secured parties

How to Obtain a Enforceable Security Interest in Commercial Tort Claims

- Commercial tort claim: a claim arising in tort with respect to which
  - The claimant is an organization; or
  - The claimant is an individual and the claim:
    - Arose in the course of the claimant's business or profession and
    - It does not include a claim for damages arising out of personal injury or death of an individual

    (Cal. Com. Code § 9102(13))
- Greater specificity
  - Description of collateral by type or category is insufficient
  - Insufficient description: "all commercial tort claims"
  - Sufficient description: "all tort claims arising out of the explosion at debtor's factory"

    (Cal. Com. Code § 9108(e)(1))

How to Perfect a Security Interest in Copyrights

- Included in the scope of the Uniform Commercial Code (Cal. Com. Code § 9109(a); § 9-102(42))
- Federal pre-emption
  - Supremacy Clause: invalidates state laws that "interfere with, or are contrary to," federal law (U.S. Const. art. VI, cl. 2)
- Uniform Commercial Code Step-Back Provisions
  - Not apply to the extent that a statute, regulation, or treaty of the U.S. preempts (Cal. Com. Code § 9109(c)(1))
  - Filing of financing statement: not necessary or effective to perfect a security interest in property subject to…a statute, regulation, or treaty of the U.S. whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt Section 9310(a) (Cal. Com. Code § 9311(a)(1))

Copyright Act

- Permissive recordation in the U.S. Copyright Office
  (17 U.S.C. § 205(a))
- Such recording perfects a security interest if it gives constructive notice
  (17 U.S.C. § 205(d))
- Constructive notice:
  - Revealed by a reasonable search under the title or registration number of the work
  - Registration has been made for the work
    (17 U.S.C. § 205(c))

Registered Copyrights

- **Since a search under the title or registration of a registered copyright number would reveal the recorded financing statement, constructive notice would be given and the creditor's priority preserved**

  (*See Aerocon Eng'g, Inc. v. Silicon Valley Bank*, 303 F.3d 1120, 1126 (9th Cir. 2002))

- **Recording in the U.S. Copyright Office is the only proper method for perfecting a security interest in a registered copyright**

  (*Nat'l Peregrine, Inc. v. Capitol Fed. Sav. & Loan Ass'n*, 116 B.R. 194, 204 (Bankr. C.D. Cal. 1990); *Aerocon Eng'g, Inc. v. Silicon Valley Bank*, 303 F.3d 1120, 1128 (9th Cir. 2002))

Unregistered Copyrights

- An unregistered work does not have a title or registration number under which to conduct a reasonable search
- Since a reasonable search would not reveal a recorded financing statement, recording a security interest in an unregistered copyright would not give constructive notice and the creditor's priority would not be preserved

  (*Aerocon Eng'g, Inc. v. Silicon Valley Bank*, 303 F.3d 1120, 1126 (9th Cir. 2002))
- Priority in an unregistered work cannot be preserved by recording in the U.S. Copyright Office

  (*Aerocon Eng'g, Inc. v. Silicon Valley Bank*, 303 F.3d 1120, 1126 (9th Cir. 2002))

Deposit Accounts – Perfection by Control

- Deposit account: a demand, time, savings, passbook, or similar account maintained with a bank

  (Cal. Com. Code § 9102(29))
- Method of Perfection
  - Control is the exclusive method for perfection

    (Cal. Com. Code § 9312(b)(1))
- Three Ways to Control
  - Secured party is the bank with which the deposit account is maintained
  - Debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with the secured party's directing disposition of the funds in the deposit account without further consent by the debtor
  - The secured party becomes the bank's customer with respect to the deposit account

    (Cal. Com. Code § 9104(a))

Guaranties and Suretyship Waivers

- **Surety or guarantor: one who promises to answer for the debt, default, or miscarriage of another, or hypothecates property as security therefor (Cal. Civ. Code § 2787)**

Guaranties and Suretyship Waivers

- Rights and Entitlements
  - Entitled to the benefit of every security for the performance of the principal obligation
    (Cal. Civ. Code § 2849)
  - Entitled to have the property of the principal applied first applied to discharge the obligation
    (Cal. Civ. Code § 2850)
  - Right to require the creditor to proceed against the principal or to pursue any other remedy
    (Cal. Civ. Code § 2845)
  - Right to compel the principal to perform the obligation when due
    (Cal. Civ. Code § 2846)
  - Right to reimbursement from the principal and contribution by co-sureties
    (Cal. Civ. Code §§ 2847, 2848)
  - Right to enforce the creditor's remedies against principal
    (Cal. Civ. Code § 2848)
- Any one may waive the advantage of a law intended solely for his benefit
  (Cal. Civ. Code § 3513)

Waiver of Rights and Entitlements

- Common for the guarantor to waive defenses
- Allow creditors to seek recourse from the guarantor as though the principal
- Included if there are multiple borrowers or if there is a lien on collateral being granted by an entity that is not a borrower
- No particular language is required to waive the guarantor's defenses, but the waivers should be knowing and informed (Cal. Civ. Code § 2856(b))
  - For safe harbor language see Cal. Civ. Code § 2856(c) and (d)

Special Issues Regarding a Pledge of Membership Interests in a Limited Liability Company

- Delaware law
  - Assignees of a membership interest are not automatically admitted as members unless the limited liability agreement so provides or all members consent

    (Del. Code Ann. tit. 6, § 18-702(b))
- Language to this end should be included in the limited liability agreement
  - Example: "Any assignee shall be automatically admitted as a Member and shall have the rights to exercise all of the rights of the Member who has assigned the interest"

Special Issues Regarding a Pledge of Partnership Interests in a Limited Partnership

- **Delaware law**
  - **Assignees of a membership interest in a limited partnership are not automatically admitted as members unless the limited partnership agreement so provides**

    (Del. Code Ann. tit. 6, § 17-702(a))
- **Language should be included in the limited partnership agreement providing for the automatic admission of the assignee**

Forbearance Agreements

- Forbearance agreement: an agreement pursuant to which the lender agrees to forbear from exercising certain or any rights and remedies available to it as a result of an event of default until a specified time or the occurrence of a specified event
- Difference between a “waiver” and “forbearance”
  - A waiver cuts off any rights and remedies that a lender has regarding the events of default
  - A forbearance only prevents the lender from exercising its rights and remedies for a period of time

Forbearance Agreements

- Forbearance period: the period for which the lender agrees to not exercise its rights and remedies
  - Explicit language should be used to show that the lender only intends to forbears its rights and remedies, not to waive them
- Provide a limited period of time to explore alternatives
  - Identify a buyer or investor
  - Refinance the senior debt
  - Restructure the credit facility
- Many times this agreement will include a set of milestones that must be achieved to make sure that the Borrower is making progress in achieving the goals

Forbearance Agreements

- Lender will want to review the loan documents and take any steps that are necessary to shore up its collateral and the related loan documents
- Forbearance typically only applies to listed events
  - The lender will want the description of such events to be narrow
  - The borrower will want the protection granted by a broader description

Critical Review of Loan Documents

1. Are loan documents executed, full and complete?
2. Are there perfection issues?
3. Examine covenants and recourse provisions;
4. Conduct a lien search; are there issues of subordination?
5. Are there conditions to declaring a default in loan documents? – examine notice provisions

Critical Review of Collateral

1. Are there issues concerning location and/or condition of collateral?

2. Issues regarding repair, replacement or obsolescence?

3. Are there mixed collateral issues concerning real property collateral?

Critical Review of Loan Files, including Correspondence

1. California Commercial Code 1103(b) – The Uniform Commercial Code does not displace the principles of law and equity.

2. Review entire correspondence file – Are there issues of fraud, estoppel and/or waiver?

3. What are all possible defaults of borrower? If Lender wishes to enforce default “at will” or when it “deems itself insecure”, is there satisfactory evidence to support a good faith belief that the prospect of payment or performance is impaired? See California Commercial Code 1309.

Review of All Related Parties

1. Is the borrower's name spelled correctly in the loan documents or is error "seriously misleading"? See California Commercial Code 9506

2. Obtain organizational documents of borrower and any guarantor.

3. Check to see if there are guarantors and junior lienholders.

Remedies That Can Be Exercised Short of a Public or Private Sale:

1. Rights Under Control Agreements (Deposit Accounts, Securities Account) 9607

2. Collection of Accounts, Payment Intangibles and Other Obligations 9607

3. Acceptance of Collateral In Full or Partial Satisfaction 9620, 9621

Before any exercise of remedies, carefully review secured creditor's rights and obligations under the security agreement: If security agreement imposes additional requirements or limitations on the exercise of remedies, terms of security agreement will govern secured parties' exercise of remedies.

UCC Does Not Prescribe the Order in Which Secured Party Exercise Remedies

Two caveats:

1. 9604 deals with exercise of remedies where collateral includes both real property and personal property.

2. Obligation to proceed in commercially reasonable manner may impose duty with respect to the order in which collateral is realized (i.e., collected or disposed) (commercially reasonable manner standard in 9607 and 9610(b))

   But generally secured party will seek to realize on most liquid assets first and will generally seek to exercise remedies in the following order:

   1. Deposit accounts and securities accounts (control agreements)
   2. Account receivables and payment intangibles
   3. Inventory, equipment, general intangibles

Enforcement of Rights Against Deposit Accounts

Relevant California Commercial Code Provisions:

9607 (b)(4)
9607 (b)(5)
9340
9341
9342

9607 (b)(4): Governs where secured party is the bank where deposit account is maintained.

Bank can apply balance of deposit account to the secured obligation.

9607 (b)(5): Governs where secured party has a control agreement with the bank concerning the deposit account or secured party becomes the customer with respect to the account.

Secured party instructs the bank to pay balance of deposit account to or for benefit of secured party.

Limitations on Enforcement of Rights Against Deposit Accounts

9340: Bank's right of set off against account is not superior to rights of secured party who becomes the bank's customer with respect to deposit account, but is superior to the rights of a secured creditor under a control agreement (unless the bank agrees otherwise).

9342: Bank is not required to enter into a control agreement, even if debtor requests it to do so. Nor must bank disclose existence of such a control agreement unless debtor requests.

Collection of Accounts and Enforcement of Obligations of "Person Obligated on Collateral"

Relevant California Commercial Code Provisions:

9209
9607
9401
9403
9409

9607 (a)(1) & (3): Instruction to Make Payment/Render Performance

(a)(1): Secured party can notify "account debtor" or "other person obligated on the collateral" to make payment or render performance to or for benefit of secured party.

NOTE: "account debtor" is a person obligated on an account, chattel paper or general intangible. Does not include a person obligated on a negotiable instrument. See California Commercial Code 9102(a)(3)

Collection of Accounts and Enforcement of Obligations of "Person Obligated on Collateral" (Continued)

9607(a)(3): Secured party may enforce those same obligations. "Other person obligated on collateral" will include enforcement of "supporting obligations" but is broader even than that. For example, where collateral is equipment or inventory that has a defect, other person obligated or "collateral" will include manufacturer on its warranty claim.

Comment 3 indicates that "person obligated on collateral" would extend so far as a secured party's action for injunction against infringement of a patent that is collateral.

Collection of Accounts and Enforcement of Obligations of "Person Obligated on Collateral" (Continued)

9406: To be effective, notice must state:

1. Amount or obligation due or to become due has been assigned
2. Payment/performance is to be made to the assignee; and
3. Notification must be authenticated by assignor or assignee.
4. Notification must reasonably identify the rights assigned (9406(b)(1))

Practice Note: Keep notice simple and short but advisable to recite:

- Security agreement granting security interest in account/payment intangible
- Principal debtor has defaulted
- Secured creditor entitled to recover payment
- Consequence of failure to follow payment instructions
- The payments/performance to be rendered to secured party

Collection of Accounts and Enforcement of Obligations of "Person Obligated on Collateral" (Continued)

9607(c): Secured Party must proceed in commercially reasonable manner if:

(1) it undertakes to collect or enforce obligation account debtor or person obligated on collateral; and

(2) has a right of recourse (full or partial) against debtor or secondary obligor.

Rights of Account Debtors and Other Persons Obligated on Collateral

9401 & 9406 (b)(2)

Whether debtor's rights in collateral may be voluntarily or involuntarily transferred is governed by law other than Div. 9: a person obligated on collateral may under applicable law have right to refuse to render performance to a party other than the debtor.

9403:

- Section covers only account debtors
- Generally validates agreements under which account debtor agrees not to assert defenses against assignee (e.g., the secured party), provided that the assignment is for value, in good faith and without notice of a property or possessory right in the property assigned.
- Special rules for consumer transactions

9406 (a):

General rule: Account debtor (account, chattel paper or payment intangible) pays assignor (debtor) prior to notification, but must pay assignee (secured party) after notification.

Account Debtor is At Risk of Paying Twice If It Pays Debtor After Receipt of Notification

Unless exception applies, payment to debtor after notification does not discharge obligation.

Exceptions:

9406(b):

- Notification does not reasonably identify rights assigned
- Payment intangibles: where other applicable law limits duty to pay another party
- At option of account holder, if notification states to make less than full amount of installment or other periodic payment to assignee

9406(c):

- If account debtor requests evidence of the assignment, assignee must "reasonably" do so. If assignee does not comply, account debtor can discharge debt by payment to debtor rather than secured creditor.

Account Debtor's Defenses to Obligation to Pay Secured Creditor

9404

- Basic Rule is that account can assert any defense accruing before receipt of notification of the assignment (setoff) but can only defenses accruing after assignment if it arises from the same transaction (recoupment)
- Does not apply to health care insurance receivable and special rules for consumer transactions

9405

- Modification of Assigned Contract

  NOTE: an account is a right to payment whether or not earned by performance. What 9405 addresses is what a rights of secured creditor/assignee where debtor and account debtor change the performance and specifically the right to payment. In short, what happens where debtor and account debtor agree that amount due is reduced.

Account Debtor's Defenses to Obligation to Pay Secured Creditor (Continued)

General Rule: the modification to the right to payment is effective if made in good faith and one of the following applies:

1. The right to payment or part thereof has not been fully earned by performance; or
2. The right to payment is earned but the account debtor has not received notification of assignment.

Result: Modification is not effective against secured party/assignee where payment is earned and account debtor has received notification of assignment.

Note: General rule does not apply to health care receivables or consumer account to extent other applicable establishes a different rule.

Account Debtor's Defenses to Obligation to Pay Secured Creditor (Continued)

9403 An agreement of account debtor can be valid if assignment is for value and taken in good faith without notice of claim.

- Different rules for consumer transactions

9209 Security Party's Obligation to Release Assignment

Where there is no outstanding secured obligation and secured party has no commitment to give further value, secured party must send the account debtor an authenticated record releasing the account debtor from further obligation to secured debtor within ten (10) days of debtor's demand.

Acceptance of Collateral In Full or Partial Satisfaction

Relevant California Commercial Code Sections:

9620,
9621,
9622,
9617

The secured creditor can avoid the time, expense and uncertainty of proceeding by private or public sale under 9610 through an acceptance of collateral.

Acceptance of Collateral In Full or Partial Satisfaction (Continued)

9622 The effect of the acceptance of collateral has same consequences as a disposition under 9617:

1. Obligations discharged to extent of the debtor's consent
2. All debtor's rights in collateral transferred
3. Discharges subordinate liens and terminates subordinate interests

Note that 9617 provides that only a transferee that acts in good faith takes clear of subordinate liens and interest: a transferee that does not act in good faith takes subject to debtor's rights and other liens.

Presumably because the debtor is consenting to acceptance of collateral – this is in essence a voluntary, consensual transfer -- 9622 has no "good faith transferee" qualification on the effect of the disposition.

Thus, it can be argued that the title transferred by a 9620 acceptance of collateral is "cleaner" than the title of a disposition under 9610

Acceptance of Collateral In Full or Partial Satisfaction (Continued)

9620 Requirements For Acceptance in Full or Partial Satisfaction

1. The debtor "consents"
2. The secured party consents to acceptance (if debtor proposes the acceptance) in an authenticated record or security party sends the proposal.

   NOTE: No "acceptance" merely by continued possession of collateral.

3. No timely notification of objection from a party required to be sent the proposal under 9621 or other party holding a subordinate interest.

   NOTE: Special rules for consumer goods collateral for example, the collateral cannot be in debtor's possession.

Acceptance of Collateral In Full or Partial Satisfaction (Continued)

9620(c) What constitutes debtor's consent:

- Consent to acceptance in partial satisfaction only if debtor consents in an authenticated writing after default
- Consent to acceptance in full satisfaction can be by

  I. Consent in authenticated record after default;

  II. Failure to object within 20 days after proposal is sent.

Notification of Proposal and Opportunity to Object:

9621 Secured creditor that seeks to accept collateral must send its proposal to:

1. The debtor (9621);
2. Secondary obligors (9621 (b));
3. A secured party that ten (10) days before the debtor's consent held a lien perfected by a properly filed UCC-1 Financing Statement or otherwise perfected by compliance with a statute that creates an alternative request as described in 9311. (e.g., aircraft, motor vehicles); and
4. Any party from whom secured party receives notification of a claim or interest in collateral before debtor consents.

Any party entitled to receive notice under 9621 has twenty (20) days to give notification of an objection.

Acceptance can only occur after all twenty (20) day notice periods have expired.

Notification of Proposal and Opportunity to Object: (Continued)

Circumstances where acceptance of collateral is more efficient, speedy and effective than private or public sale:

1. No secondary obligors or other liens or security interests or parties who give notification of an interest.
2. Have debtor sign proposal regarding acceptance to create the authenticated record of consent.
3. Acceptance and transfer of rights is effective on authentication and ability of other parties to give notice of a claim and objection are cut off.
4. Secured party immediately gets title that may be “cleaner” than a disposition under 9617.

PRIVATE AND PUBLIC SALES

Relevant California Commercial Code Provisions:

- 9610
- 9611
- 9612
- 9615
- 9627

9610(b)

The secured creditor may elect to sell the collateral at public (auction) or private (negotiated) sale.

9610(c)

If it is a public sale, the secured creditor may buy; if it is a private sale, the secured creditor may buy only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.

9611(c) & 9611(d):

Notice of sale must be given to the debtor, other secured creditors, and guarantors unless the collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market.

NOTE: California Commercial Code section 9-613 (5) provides a form of notice.

9612(b)

If the notice is sent ten or more days before the disposition, it is presumptively reasonable.

If the notice is returned prior to sale, the secured creditor should make a second attempt to notify the debtor. See *Varela v. Wells Fargo Bank*,15 Cal.App.3d 741 (1971).

9610(b) Every aspect of the sale must be commercially reasonable.

NOTE:

The fact that a higher price might have been obtained may suggest a need for greater scrutiny, but does not in and of itself indicate a commercially unreasonable sale. See California Commercial Code sections 9-610, comment 10, and 9-615, comment 6, and 9-627 (a).

- California Commercial Code section 9-627 (b) recognizes several safe harbor sales including
  - A sale in the usual manner on any recognized market or at the price current in any recognized market at the time of disposition
  - A sale in conformity with reasonable commercial practices among dealers in the type of property that is the subject of the disposition.

- Many secured creditors provide for the mode of disposition in the initial security agreement. It is also a good practice to seek the debtor's advice about the disposition after default.

9615(a) Sales proceeds are allocated to:

1. the expenses of the secured creditor, including, to the extent there is a provision in the security agreement, the creditor's attorneys fees

2. the secured debt

3. junior secured debts.

9615(d)(1):

Any surplus must be returned to the debtor.

9615(d)(2)

The secured creditor can proceed against the debtor as an unsecured creditor for any deficiency.

REPOSSESSION AND CREDITOR MISBEHAVIOR

Relevant California Commercial Code Provisions –

9609(b)
9609
9615
9625
9626

The secured creditor may repossess the collateral without judicial process if this can be accomplished without a "breach of the peace".

Breach of the peace is not defined in the California Commercial Code, but case law generally prohibits repossession by force or threat of force. See *Henderson v. Security National Bank*, 72 Cal.App.3d 764 (1977).

NOTE:

If breach of the peace is likely, a secured creditor can judicially repossess pursuant to the claim and delivery statutes, California Code of Civil Procedure Sections 511.010 et seq. Generally, notice and a hearing are required.

- A secured creditor may be liable to the debtor on common law theories, for example, conversion for wrongful repossession. See *Varela v. Wells Fargo Bank*, 15 Cal.App.3d 741 (1971).

9625(b)

In addition, the secured creditor is liable to the debtor for compensatory damages.

9626(a)(4)

In the event of creditor misbehavior, the value of the collateral is presumed to be equal to the amount of the debt; hence, no deficiency judgment is allowed.

9626(a)(3)

The burden is on the secured creditor to establish the amount of proceeds that would have been realized by a proper disposition.

DEALING WITH TROUBLED LOANS IN TROUBLED TIMES – BANKRUPTCY ISSUES

I. Automatic Stay:

A. Scope of Stay – 11 U.S.C. §362(a)

> (a)Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section (a)(3) of the Securities Investor protection Act of 1970, operates as a stay, applicable to all entities, of –
>
> (4) any act to create, perfect, or enforce any lien against property of the estates;
>
> (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor;

In re Pettit, 217 F.3d 1072 (9th Cir. (Cal.) 2000) – no violation of automatic stay where creditor had obtain ownership.

B. Term of stay and exceptions – 11 U.S.C. §362(c)

> (c) Except as provided in subsections (d), (e), (f), and (h) of this section –
>
> (1) the stay of an act against property of the estate under subsection (a) of this section continues until such property is no longer property of the estate;
>
> (2) the stay of any other act under subsection (a) of this section continues until the earliest of –
>
> (A) the time the case is closed;
>
> (B) the time the case is dismissed; or
>
> (C) if the case is a case under chapter 7 of this title concerning an individual or a case under chapter 9, 11, 12 or 13 of this title, the time a discharge is granted or denied;

C. Grounds for relief from stay – 11 U.S.C. §362(d):

> (d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under

subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay –

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;

(2) with respect to a stay of an act against property under subsection (a) of this section, if –

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization;"

D. Procedure - §362(e)(1) and Bankruptcy Rule 4001 -

E. Adequate protection- §361; *United Savings Association of Texas v. Timbers of Inwood Forest Association Ltd.*, 484 US 365 (1988).

II. Use of Collateral and Cash Collateral

A Debtor-in-Possession is authorized to Operate its Business

- Read together, 11 U.S.C. **§§** 1107 & 1108 authorize a debtor-in-possession to operate its business after the filing of a bankruptcy petition.
    - 11 U.S.C. § 1107(a) specifies that a debtor-in-possession "shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties . . . of a trustee serving in case under this chapter." 11 U.S.C. § 1107(a).
    - 11 U.S.C. § 1108 provides that "[u]nless the court, on request of a party in interest and after notice and a hearing, orders otherwise, the trustee may operate the debtor's business." 11 U.S.C. § 1108.

Adequate Protection of Collateral

- A debtor-in possession operating its business under Chapter 11 is authorized to use, sell, or lease collateral, however, courts may condition such use, sale or lease on a demonstration that secured entities are adequately protected.
- 11 U.S.C. § 363(e) provides that "at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest."

- While the term "adequate protection" is not defined in the code, 11 U.S.C. §361 sets forth three non-exclusive examples of what may constitute adequate protection: (1) periodic cash payments equivalent to decrease in value of collateral; (2) an additional or replacement lien on the other property; or (3) other relief that provides the indubitable equivalent. *See* 11 U.S.C. §361.

- Courts within the Ninth Circuit have found that, in some circumstances, the collateral itself has sufficient value to constitute adequate protection of an entity's interest in the subject property - this approach is often referred to as the "equity cushion" approach. *See La Jolla Mortg. Fund v. Rancho El Cajon Assocs.*, 18 B.R. 283, 287 (Bankr. S.D. Cal. 1982) (The 'equity cushion' "has been defined as value in the property above the amount owed to the creditor with a secured claim, that will shield that interest from loss due to any decrease in the value of the property during the time the automatic stay remains in effect").

- When the value of collateral is not declining, nothing more than insurance, taxes and appropriate reporting may be needed to protect the value of the secured entity. *See* Collier on Bankruptcy § 361.03[2][b] (15th Edition).

Use of Cash Collateral

- The use of cash collateral by a debtor-in-possession is restricted to a greater extent than other forms of collateral.

- 11 U.S.C. § 363(a) defines cash collateral as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits or property and the fees, charges, accounts or other payments for the use of occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title."

- 11 U.S.C. § 363(c)(2) provides that a debtor-in-possession may not "use, sell or lease cash collateral . . . unless – (A) each entity that has an interest in such cash collateral consents; or (B) the court, after notice and a hearing, authorizes such use, sale or lease . . ."
- A creditor's consent under § 363(c)(2)(A) must be express. *See Freightliner Market Dev. Corp. v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 368-369 (9th Cir. 1987) (finding that due to unique nature of cash collateral, implied consent is insufficient to satisfy the requirements of § 363(c)(2)).

- Under § 363(c)(2)(B), the "primary concern of the court in determining whether cash collateral may be used is whether the secured creditors are adequately protected." *See In re Plaza Family P'ship*, 95 B.R. 166, 171 (E.D. Cal. 1989).

- Absent consent or court authorization, a debtor in possession has an affirmative duty to segregate and account for any cash collateral in its possession, custody or control. *See* 11 U.S.C. § 363(c)(4).

- In *Freightliner*, the Ninth Circuit held that a debtor had violated 11 U.S.C. § 363(c)(2) by using cash collateral derived from collection accounts receivable purportedly covered by the secured creditor's security interest without a court order or the secured creditor's consent. To remedy this violation the court upheld the granting of a security interest in all of the debtor's pre- and post-petition accounts receivable and shifted the burden of tracing the accounts receivable to the trustee (who succeeded the debtor in possession).

- In a recent decision, the 11th Circuit upheld a bankruptcy court's decision ordering the recovery of transfers of cash collateral from vendors which were not authorized pursuant to § 363(c). *See Marathon Petroleum Co., LLC v. Cohen (In re Delco Oil, Inc.)*, 599 F.3d 1255, 1263 (11th Cir. 2010).

III. Sale of Collateral Free and Clear of Liens

- Collateral may be sold pursuant to 11 U.S.C. §363(b)(1), which provides: "The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate . . ." 11 U.S.C. §363(b)(1).

- A debtor-in-possession is empowered to sell property *free and clear* of any interest in such property of an entity other than the estate only if: "(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." 11 U.S.C. § 363(f).

- The reversal or modification on appeal of an authorization to sell or lease property of the estate under 11 U.S.C. §§ 363(b) and (c) does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal. *See* 11 U.S.C. § 363(m).

- California courts have drawn a distinction under § 363(m) between relief related to transfer of title and relief related to the stripping of junior liens. In *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (B.A.P. 9th Cir. 2008), the bankruptcy court confirmed the credit bid sale of property to a first lien creditor free and clear of all claims and encumbrances, thus stripping a junior lien on the same property. On appeal, the United States Bankruptcy Appellate Panel for the Ninth Circuit determined that while the junior lien creditor's appeal of the validity of the sale was moot under § 363(m), the appeal of the lien-stripping was not moot under that section.

- A secured credit is allowed to "credit bid" at sale of collateral pursuant to 11 U.S.C. § 363(k) which provides: "At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." 11 U.S.C. § 363(k).

- However, a secured creditor's right to credit bid under § 363(k) is not absolute. Indeed, courts in some jurisdictions have held that a creditor is not guaranteed the right to credit bid in a plan of reorganization. *See In re Phila. Newspapers, LLC*, 599 F.3d 298, 317 (3d Cir. 2010) (holding a lender does not have an absolute right to credit bid when its collateral is being sold pursuant to a plan of reorganization); *Bank of New York Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pac. Lumber Co.)*, 584 F.3d 229, 247 (5th Cir. 2009)(holding that a plan or reorganization which deprived creditors the right to credit bid was proper).

IV. Trustee's Powers

F. "Strong Arm" power – The Bankruptcy Code and its relationship to Article 9:

Cal.Comm.Code §9317(a):

> (a) A security interest or agricultural lien is subordinate to the rights of both the following:
>
> …
>
> (2) Except as otherwise provide in subdivision (e), a person that becomes a lien creditor before the earlier of the time the security interest or agricultural lien is perfected, or one of the conditions specified in paragraph (3) of subdivision (b) of Section 9203 is met and a financing statement covering the collateral is filed.

Bankruptcy Code §544(a)(1):

> (a) The trustee shall have, as of the commencement of the case, and without regarding to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by –
>
> (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

G. Preferences – Bankruptcy Code §547:

1. Elements: §547(b):

i. A preference is a transfer of an interest

1. to a lender

2. made while the borrower is insolvent,

3. either within 90 days of filing for bankruptcy or, if the lender was an insider of the borrower at the time the transfer was made, within 1 year of filing for bankruptcy,

4. that enables the lender to receive more than it would

a. Under a liquidation

b. If the transfer had not been made

c. Than it would under Chapter 11 of the Bankruptcy Code (11 U.S.C. §547(b))

ii. Voidable under the Bankruptcy Code

1. A preference is voidable under federal bankruptcy law, except to the extent that the transfer was

a. Intended to be a contemporaneous exchange for new value given to the debtor and

b. In fact a substantially contemporaneous exchange (11 U.S.C. §547(c)(1))

2. Specific Applications in secured creditor context:

i. Bankruptcy Code §547(c)(5):

> (5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of –

(A)(i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or before the date of the filing of the petition; or (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition ; or

(B) the date on which new value was first given under the security agreement creating such security interest;"

H. Turnover of property of the estate – 11 U.S.C. §542(a):

(a) Except as provided in subsection (c) or (d) of this section, an entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.

United States v. Whiting Pools, 462 US 198 (1983); (debtor entitled to turnover of property seized by IRS.)

I. Fraudulent Conveyances 11 U.S.C. §548:

i. Forbearance does not constitute consideration

ii. In the 9th circuit forbearance by a lender does not constitute "new value" such that is protected against voidance under the Bankruptcy Code (e.g., *In re Powerine Oil Co.*, 59 F.3d 969 (9th Cir. 1995))

V. Cure of Defaults under 11 U.S.C. §1124

- Under the Cal. Comm. Code, when a debtor defaults on an obligation, the secured party has no right to cure a default and reverse any acceleration of payments.

- A debtor's only recourse under state law after a default is to redeem the collateral. A debtor may redeem collateral upon tender of both: (1) fulfillment of all obligations secured by the collateral and (2) reasonable expenses and attorney's fees. *See* Cal. Comm. Code § 9623.

- However, in connection with confirmation of a plan of reorganization, the Bankruptcy Code empowers a debtor-in-possession to reverse acceleration and return to the original terms of a loan under if certain conditions specified in 11 U.S.C. § 1124(2) are met.

- 11 U.S.C. § 1124(2) provides:

  notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default –

  (A) cures any such default that occurred before or after the commencement of the case under this title, other than a default of a kind specified in section 365(b)(2) of this title or of a kind that section 365(b)(2) expressly does not require to be cured;

  (B) reinstates the maturity of such claim or interest as such maturity existed before such default;

  (C) compensates the holder of such claim or interest for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or such applicable law;

  (D) if such claim or such interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), compensates the holder of such claim or such interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of such failure; and

  (E) does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.

  11 U.S.C. § 1124(2).

- California courts have found that § 1124(2) authorizes a plan to nullify all consequences of default, including avoidance of default penalties such as higher interest. *See In re Southeast Co*., 868 F.2d 335, 338 (9th Cir. 1989). "Plans to cure defaults under section 1124(2) are not limited to those defaults resulting in acceleration. (internal citation omitted). Nor are such plans limited to nullifying only the acceleration component of a default." *Id*.

- Similarly, other courts within the Ninth Circuit have found that a debtor need not pay late charges in order to effectuate a cure under § 1124(2). *In re Phoenix Bus. Park Ltd. P'ship*., 257 B.R. 517, 522 (Bankr. D. Ariz. 2001). However, damages incurred as a result of actions taken in reliance upon the existence of an acceleration clause (such as legal fees, foreclosure notice fees, court costs, and the like) are compensable under § 1124(2)(C). *See id*. at 523.

- If defaults are cured under § 1124 the secured creditor is no longer impaired under the Chapter 11 reorganization plan. Only classes that are impaired can vote on a plan. As

such, an unimpaired class it is presumed to have accepted the plan. *See* 11 U.S.C. § 1129(a).

VI. Secured Claims

1. Secured claim defined – Bankruptcy Code §506(a)(1) :

   (a)(1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

2. Bifurcation into secured and unsecured claim

3. Determination of "value of such creditors' interest". *Associates Commercial Corp. v. Rash*, 520 US 953 (1997).

2. The purchase money security interest. Bankruptcy Code 1325(a)(*) "hanging paragraph" and In re Penrod, ____ F.3d __ 2010 WL 2794409 (9th Cir. (Cal.) 2010).

VII. Plan Issues

Consensual Plan Confirmation (11 U.S.C. § 1129(a))

- To obtain consensual confirmation of a plan of reorganization the debtor must demonstrate the following:

  (1) The plan complies with the applicable provisions of title 11;

  (2) The proponent of the plan complies with the applicable provisions of title 11;

  (3) The plan has been proposed in good faith and not by any means forbidden by law;

  (4) Any payment made or to be made by the proponent, by the debtor, or by a person issuing securities or acquiring property under the plan, for services or for costs and expenses in connection with the case, or in connection with the plan and incident to the case, has been approved by, or is subject to the approval of, the court as reasonable;

(5) (A) (i)The proponent of the plan has disclosed the identity and affiliations of any individual proposed to serve, after confirmation of the plan, as a director, officer, or voting trustee of the debtor, an affiliate of the debtor participating in a joint plan with the debtor, or a successor to the debtor under the plan and the appointment; (ii) the appointment to, or continuance in, such office of such individual, is consistent with the interests of creditors and equity security holders and with public policy; and (B) the proponent of the plan has disclosed the identity of any insider that will be employed or retained by the reorganized debtor, and the nature of any compensation for such insider.

(6) Any governmental or regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval.

(7) With respect to each impaired class of claims or interests-(A)each holder of a claim or interest of such class-(i) has accepted the plan; or (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under Chapter 7 of this title on such date; or (B) if secured claims make an election to waive a deficiency claim for the right to have a lien on the collateral equal to the fill amount of its allowed claim, then each holder of a claim of such class must receive or retain under the plan on account of such claim property of a value that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.

i. This is known as the "best interests of creditors" test.

ii. It requires that creditors receive better treatment under a plan than they would in a Chapter 7 case.

(8) With respect to each class of claims or interests-(A) such class has accepted the plan; or (B) such class is not impaired under the plan.

(9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that – (A) holders of administrative and gap claims will receive on account of such claim cash equal to the amount of such claim; (B) claims of an accepting class may be paid through deferred cash payments of a value equal to the allowed amount of such claim; (C) holders of unsecured priority tax claims will receive on account of such claim regular installment payments in cash of a total value equal to the allowed amount of such claim over a period not later than 5 years after the date of the order for relief and in a manner not less favorable than the most favored non-priority unsecured claim provided for by the plan; (D) secured tax claims are treated in the same manner as unsecured tax claims;

(10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.

(11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

i. This is known as the feasibility requirement.

(12) All fees payable United States Trustee System are paid.

(13) The plan provides for the payment of retiree benefits at either (1) the level originally provided by the debtor in possession without modification, or (2) at the modified level established pursuant to the requirements of section 1114 of the Bankruptcy Code by court order, or by agreement between the debtor in possession or trustee and the authorized representative of the persons entitled to receive retiree benefits.

(14) The debtor has made any required domestic support obligations.

(15) If the debtor is an individual and a holder of an allowed unsecured claim objects to the confirmation of the plan (A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or (B) the value of the property to be distributed under the plan is not less than the projected disposable income of the debtor to be received during the 5-year period beginning on the date that the first payment is due under the plan, or during the period for which the plan provides payments, whichever is longer.

(16) All transfers of property of the plan shall be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust.

See 11 U.S.C. § 1129(a).

Cramdown under 11 U.S.C. § 1129(b)

- To confirm a nonconsensual plan under §1129(b), a debtor must fulfill all of the requirements enumerated in § 1129(a) except subsection (a)(8).

- In addition, a debtor must demonstrate that the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interest that is impaired under, and has not accepted the plan.

- To be fair and equitable with respect to a class, a plan must meet the following requirements:

    - With respect to a *secured* class of claims, the plan provides:

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds; or (iii) for the realization by such holders of the indubitable equivalent of such claims.

- With respect to a class of *unsecured* claims, the plan provides:

  (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

  (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14).

- With respect to a class of interests:

  (i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or

  (ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

Examples of Cramdown over Negative Vote of Secured Creditors

- Hypothetical #1
  - Secured creditor is owed a debt of $1 million, secured by collateral worth $1 million.
  - To confirm a plan over negative vote of a secured class of claims this secured creditor must: (1) retain a $1 million lien on this collateral; (2) receive a new note with *actual* value (including interest) of $1 million; or (3) receive $ 1 million worth of the proceeds of the sale of the collateral.

- The United States Supreme Court has held that the appropriate interest rate to be applied to installment payments under a Chapter 13 plan is the national prime rate as adjusted to reflect the specific risks associated with a particular debtor. *See Till v. SCS Credit Corp*., 541 U.S. 465, 479 (2004).
- Similarly, the Ninth Circuit has adopted a case by case market approach for determining present value payments under § 1129(b)(2)(A)(i)(II). *See In re Villa Diablo Assocs*., 156 B.R. 650, 653 (Bankr. N.D. Cal. 1993); *In re Fowler*, 903 F.2d 694, 697 (9th Cir. 1990).

- Hypothetical # 2
  - Secured creditor is owed $ 2 million, secured by collateral worth $1 million.
  - Results in a claim split. $1 million of the claim is secured and is entitled to receive the same treatment as under hypothetical #1 and the remaining $1 million of the claim is unsecured and is treated as a general unsecured claim under the plan.
  - Note: A class of secured claims can make an election under 11 U.S.C. § 1111(b) to not split their claim, but instead have the entire claim remain secured by the collateral. Thus, the creditor in hypothetical #2 would receive a note with a *face* amount of $2 million and an *actual* value of $1 million. As such, an election under § 1111(b) allows a secured creditor to capture any increase in the value of the collateral in the future.

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