Are Secured Creditors Protected in Bankruptcy?
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Many creditors, including private lenders and purchase money lenders believe that loans secured by real estate are protected even if the borrower files for bankruptcy. While this is generally true, the devil is in the details. The standard remedy for the secured creditor is to seek relief from the automatic stay that becomes effective when the debtor files for bankruptcy. This article discusses what happens when a borrower files for bankruptcy and the secured creditor, tries to collect on the property.

For purposes of this article, we will assume that "Borrower, LLC", which owns a commercial building, a hotel, and two undeveloped lots, has filed for bankruptcy protection. We will assume that Borrower, LLC has four parcels of Land, parcel A-small office building (valued at $8.0 million), parcel B-hotel (valued at $10.0 million), parcel C-undeveloped land (valued at $1.0 million), and parcel D-undeveloped land (valued at $2.5 million). Let us assume that parcel A has three creditors, Bank One, Two, and Seller Lender, who subordinated to Bank One and Bank Two, who recorded their deeds of trust in that order, respectively. Bank One has a promissory note for $5.0 million. Bank Two has a promissory note for $1 million. Seller Lender has a promissory note for $1.7 million. Let us assume that parcel B has one creditor, Bank Four, with a promissory note of $6.0 million.

The bankruptcy filing automatically stays all proceedings, including foreclosures already in process. The automatic stay will even invalidate sales that occurred without notice of the bankruptcy filing. The automatic stay is one of the defining features of bankruptcy, intended to provide the debtor (Borrower, LLC) sufficient time to either submit a plan of reorganization or conduct an orderly liquidation.

What does the secured creditor do to obtain repayment? Usually, they will need to to file a motion for relief from the automatic stay, thereby enabling the secured creditor to move forward with any foreclosure and sale of the property.

Under Section 362 of the Bankruptcy Code, the court will have to evaluate the value of the property in light of the encumbering liens. Under 11 USC 362 (d)(1), the court will determine if the secured creditor has "adequate protection", usually meaning that the value of the property exceeds the value of the moving creditors lien plus the value of all senior liens. "Equity cushion" is the term used to determine whether there is equity exceeding the amount owed to those creditors. Under subsection (d)(1) if the equity cushion is more exceeds 20%, then the moving creditor's motion will likely be denied. If the equity cushion is between 11-20%, then the court is less likely to grant the relief from stay but has the judicial authority to do so. If the equity cushion is less than 10%, then generally the court will grant the moving creditor relief from the automatic stay.

With respect to Seller Lender's interest in Parcel A, to determine if adequate protection exists, we aggregate his lien with Bank One and Bank Two. There are $7.7 million in

loans and a value of $8 million. The equity cushion is $300,000, which equals 3.75% of the value of Parcel A. The result is that court should grant Seller Lender's motion for relief from the automatic stay.

With respect to Bank Four's interest in Parcel B, there are $6 million in relevant loans and the value is $10 million; the equity cushion of 40% equity means that the motion for relief from the automatic stay would be denied.

Under 11 USC 362 (d)(2), the Court must determine 1) whether the debtor has any equity in the property; and 2) whether the property is not necessary to an "effective" reorganization. The court will consider <u>all</u> liens against the property in determining if any equity exists. With respect to whether the property is necessary for a reorganization, the court will also consider whether there is a feasible reorganization plan enabling Borrower, LLC to reorganize while paying off its creditors. Thus, under 11 USC 362 (d)(2), any creditor relying solely on subsection (d)(2) is much more likely to have the request for relief from stay denied.

It is possible that a secured lender could get relief under 11 U.S.C. 362 (d)(3), but that would depend on whether the debtor's bankruptcy case falls within the definition of "single asset real estate" meaning that Borrower, LLC is simply collecting rent and not operating as a business. Relief from the stay on this basis will not occur until ninety days after the bankruptcy filing.

Other methods of seeking relief from the automatic stay exist but they are beyond the scope of this article.

The lesson is that secured creditors need to conduct their due diligence before extending credit because the bankruptcy rules may defeat your perceived rights.