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BANKRUPTCY LAW

A Secured Creditor's Chapter 11 Chess Match

Should he seek to dismiss, exit or participate in the reorganization?

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The bargain between a secured lender and its borrower is basic: failure to repay a secured loan by its terms allows the lender to take possession of the collateral securing the debt, sell it, and satisfy all or part of the loan. Pretty simple, conceptually.

Then, as is true in life generally, the unexpected happens. Another bubble bursts. Another Hurricane Sandy hits and borrowers have inadequate insurance coverage. Cash flow or credit dries up. Equity in the collateral erodes or evaporates altogether, introducing new concepts to the bargain: the upside down and underwater loans. Shareholders demand different results. The possibilities are real and endless.

This article analyzes the various options for a secured creditor, one that has exhausted loan modification leading to a consensual, acceptable "new bargain," and must consider litigation. These options are but two sides of the same coin. They are at once defenses invoked by a distressed borrower and, simultaneously, the means for a lender to enforce its original bargain. Often the choices derive from a stayed foreclosure action by the owner of real property having filed a petition for relief under Chapter 11 of Title 11 of the United States Code (11 U.S.C. § 101 et seq.), also known as the Bankruptcy Code.

Depending on the facts and circumstances of the foreclosure and the timing and merits of the bankruptcy filing, a secured creditor will typically seek either to: (i) dismiss the Chapter 11 in its entirety, as a bad-faith filing under §1112(b) of the Bankruptcy Code; (ii) obtain relief from the automatic stay, under § 362(d) of the Bankruptcy Code, to continue prosecuting the foreclosure in state court and liquidate its security interest at a sheriff's sale; or (iii) actively participate—and enforce its rights as a secured creditor—in the Chapter 11 reorganization. Regardless of the option a secured creditor elects, the goal is the same: enforce the original bargain to maximize and expedite a recovery.

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Dismissal as a Bad-Faith Filing

Bankruptcy Code §1112(b) governs the dismissal of a Chapter 11 petition:

> [O]n request of a party in interest, and after notice and a hearing,…the court shall…dismiss a case under this chapter…for cause.

See 11 U.S.C. § 1112(b)(1). In the Third Circuit, a bankruptcy petition filed in bad faith establishes "cause" to dismiss the petition. *In re 15375 Memorial Corp*., 589 F.3d 605, 618 (3d Cir. 2009). The debtor bears the burden to establish that its petition has been filed in good faith, which rests on two interrelated issues: (1) whether the petition serves a valid bankruptcy purpose, e.g., by preserving a going concern or maximizing the value of the debtor's estate; and (2) whether the petition is filed merely to obtain a tactical litigation advantage. See also *In re Integrated Telecom Express*, 384 F.3d 108, 118-20 (3d Cir. 2004).

Typically, a desperate borrower uses bankruptcy as a last-ditch effort to further delay the inevitable loss of its real property. Often, the Chapter 11 filing will occur on the eve of a sheriff's sale, by a limited liability company whose only asset is the real property. Indeed, a "single asset real estate" debtor (SARE) is defined by the Bankruptcy Code as:

> real property constituting a single property or project…which generates substantially all of the gross income of a debtor… on which no substantial business is being conducted by a debtor other than the business of operating the real property

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and activities incidental thereto.

See 11 U.S.C. § 101(51B). SARE debtors are notorious bad-faith filers. Bankruptcy will be the only option available to the SARE debtor once a sheriff's sale is imminent.

Prepetition wrongdoing by a debtor (e.g., refusal to turn over collected rents to the lender-mortgagee, failure to pay taxes on the property, or inability to maintain the value of real property as a prudent owner) mitigates in favor of a dismissal as a bad-faith filing, especially if it becomes clear the postpetition debtor has: (i) only one asset, the mortgaged property; (ii) few legitimate creditors with relatively small claims; (iii) few or no employees except for principals; (iv) no income-producing assets from which cash flow can be paid to the secured creditor as adequate protection; and (v) no demonstrable ability to promptly sell its only asset as part of a confirmable plan.

With these facts, the case is essentially viewed as a two-party dispute between debtor and a secured creditor that can be resolved in state court. See, e.g., *In re Ravick*, 106 B.R. 834, 850 (D.N.J. 1989) (the debtor's "true motives in filing its Chapter 11 petition were not rehabilitative but were to utilize the bankruptcy court as a means of renegotiating the terms of its [c] ontract"). The secured creditor should succeed in dismissing the Chapter 11 as a bad-faith filing, and the debtor will have few, if any, countermoves in its chess match.

Relief from the Stay

Alternatively, if dismissal is not a strong option, a mortgagee may seek relief from the automatic stay for "cause," under Bankruptcy Code § 362(d)(1), to continue its foreclosure and liquidate its security interest at a sheriff's sale. The automatic stay, which protects a debtor's legal and equitable interest in property, is subject to termination or modification under Section 362(d) of the Bankruptcy Code as follows:

> (d) On request of a party in interest and after notice and a hearing, *the court shall grant relief from the stay*…such as by terminating, annulling, modifying, or conditioning such stay—
>
> (1) *for cause, including the lack of adequate protection of an interest in property*…;
>
> (2) with respect to a stay of an act against property … if—
>
> (A) *the debtor does not have an equity in such property*; and
>
> (B) *such property is not necessary to an effective reorganization*[.]

11 U.S.C. § 362(d) (emphasis supplied).

Under § 362(d)(1), the lender has the burden of establishing a prima facie case of cause, such as a lack of adequate protection, whereupon the debtor then must show that the movant is adequately protected. The Bankruptcy Code does not define "cause," leaving courts to consider what constitutes cause based on the totality of the circumstances in each particular case. *Baldino v. Wilson (In re Wilson)*, 116 F.3d 87, 90 (3d Cir. 1997).

"Cause" may exist when the debtor fails (postpetition) to make monthly payments to the secured lender under the loan documents *and* the lender is undersecured. Those facts, coupled with the secured creditor's delay in liquidating its security interest as a result of the Chapter 11 filing, support a prima facie showing of cause to lift the stay. In addition, a Bankruptcy Court may be inclined to lift the stay for cause if the foreclosure was nearly complete at the time of the Chapter 11 filing and a successful reorganization appears speculative.

A Bankruptcy Court may be reluctant to lift the stay under §362(d)(2) if the debtor has significant equity in its real property, the property is necessary to an effective reorganization, and the foreclosure is in its infancy. A borrower armed with these facts will checkmate the secured creditor, rendering it captive to a long, sometimes tortured reorganization process.

Participation and Enforcement of Secured Creditor's Rights in the Chapter 11 Case

Whether a debtor sells assets, pursuant to Bankruptcy Code § 363, or files a reorganization plan, pursuant to Bankruptcy Code § 1129, either strategy affects a secured creditor's rights and requires active participation.

For example, a secured creditor will usually expedite and maximize its recovery in a Section 363 sale in bankruptcy compared to a sheriff's sale in state court. This is especially true if the foreclosure is in its infancy at the time of the bankruptcy filing. Even an uncontested foreclosure will take months to conclude. A 363 sale, by contrast, often occurs within days following the Chapter 11 filing. For this reason alone, a 363 sale may generate greater interest in, and thus competitive bidding for, the debtor's assets than would otherwise exist in a foreclosure. Furthermore, a successful bidder at a Bankruptcy Court-approved auction will take title "free and clear" of claims and interests, may avoid costly realty transfer taxes and the sheriff's commissions, and may otherwise limit its exposure to the quirky pitfalls of state law.

Unlike a 363 sale, where a lender typically gets paid in full, a Chapter 11 plan presents specific risks for a secured creditor. First, a loan in default may be reinstated and paid over time with market-rate, not contract, interest. Second, collateral may be swapped for, arguably, less attractive collateral. Third, a secured creditor may face the concept of "cramdown," where its secured claim equals the value of its collateral, and any deficiency is rendered unsecured. This treatment is codified. See 11 U.S.C. § 1129(b)(2)(A). A plan that proposes none of these options is patently unconfirmable.

In its Chapter 11 chess match, a secured creditor's strategy is dictated by the facts and a risk-benefit analysis of these three basic options: whether to seek to dismiss, exit or participate in the Chapter 11. ■