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10 Things Every Commercial Banker Should Know About Bankruptcy

by Kelly W. McNulty

As most commercial bankers know, borrower bankruptcy has become more and more prevalent in the banking world. Bankruptcy law is constantly changing and a basic knowledge of the bankruptcy process is required to fully protect your bank's interests. Missing a deadline or failing to file the necessary paperwork can lead to disastrous results. This article is a brief overview of the basics of the bankruptcy system and a condensed guide on how to handle the most common bankruptcy issues that arise from a commercial banking prospective. If you would like to learn more and receive a full explanation of these concepts, please contact me for more information.

NUMBER ONE: Types of Bankruptcy. For those unfamiliar with bankruptcy, the first step is to understand the types of bankruptcy. While there are many, the three most common types are Chapter 7 (liquidation), Chapter 11 (reorganization) and Chapter 13 (debt adjustment). Chapter 7 is the most intimidating type of bankruptcy for bankers because in Chapter 7 the debtor's main purpose is to discharge all their debt. Chapter 7's can be filed by almost any type of debtor, and a guarantor on a loan who files Chapter 7 will most likely receive a discharge of that obligation. This means that the bank will likely lose one or more collection options. Chapter 11 debtors are often companies that are seeking to reorganize their debt while continuing operation of the business. Chapter 13 bankruptcies are called "wage earners" bankruptcy because it is often used by consumer debtors who need assistance and time in making the payments, but who seek to retain their homes, cars, and other goods. A lender is more likely to recover some of its debt under a Chapter 11 or 13 bankruptcy.

NUMBER TWO: The Bankruptcy Court System. Another important part of understanding bankruptcy is to be familiar with how bankruptcy court operates. Each judicial district in the United States has its own bankruptcy court. Arkansas contains the Eastern and Western Judicial Districts. The rule governing bankruptcy proceedings are Title 11 of the United States Code (the "Bankruptcy Code") and the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"). Additionally, each individual court has its own "local rules." The Bankruptcy Rules contain a set

of official forms for use in bankruptcy cases. Chief Judge Ben T. Barry, Judge Richard D. Taylor and Judge Phyllis M. Jones are the judges who handle all of the bankruptcy matters in Arkansas.

NUMBER THREE: Basic Pre-Bankruptcy Strategies. There are a few simple actions a lender can take to better secure its position prior to a borrower bankruptcy. First is to cure the perfection of the security interest if it is vulnerable. This can be done by filing a UCC-1 or recording a mortgage. Second is to seek more collateral if the creditor is under-secured. If the creditor has neither of these concerns, insist that the debtor strictly adhere to the security agreement. If possible, another safeguard is to initiate a collection lawsuit or to foreclose immediately. Note, however, that some of these actions (especially obtaining additional collateral) could be set aside by a bankruptcy court as a preferential transfer.

NUMBER FOUR: The Bankruptcy Petition. A bankruptcy petition is a document that a debtor files with the bankruptcy clerk's office and its filing signals the beginning of a bankruptcy case. The petition will denote the type of bankruptcy being filed and should list all of the debtor's assets and debts. Importantly, the filing of the bankruptcy petition invokes the automatic stay. As explained below, the automatic stay prevents almost all types of collection actions, and the creditor can be fined for any violation of the stay.

NUMBER FIVE: Proof of Claim. After the filing of the bankruptcy petition, a creditor should get notice that the debtor has filed for bankruptcy. Upon receipt of that notice, the creditor should immediately determine whether it needs to file a Proof of Claim (the form is normally provided along with the notice) in the debtor's case to preserve its rights to receive payments from the debtor's estate. In Chapter 7 and 13 bankruptcy cases, the creditor will not receive any distribution of funds from the bankruptcy estate unless it has timely filed a Proof of Claim. In a Chapter 11 case, it is not necessary (although advised) to file a claim if the creditor agrees with how the debtor has listed the claim on the debtor's schedules. A proof of claim is not difficult to complete and file properly. In most instances, it must be filed within 90 days after the first date set for the meeting of creditors.

NUMBER SIX: The Automatic Stay. The automatic stay is a "blanket injunction" against any action that may directly or indirectly interfere with the administration of the bankruptcy estate. The stay comes into effect the exact moment the petition is filed. This is often of significance when a debtor files immediately prior to a foreclosure sale in an effort to halt the foreclosure. Note that no actual notice of the filing is required for the creditor to be bound by the stay. Once the automatic stay goes into effect, the creditor should immediately cease all collection effects, or be subject to damages for any willful violations of the stay. There are few and narrow exceptions, although one is consensual negotiations between the creditor and the debtor. An automatic stay might not protect property fraudulently transferred by the debtor. This is an area, however, in which creditors should tread lightly. The automatic stay remains in effect until the case is closed or dismissed, when the debtor receives a discharge, or when the court orders relief from the stay.

NUMBER SEVEN: Relief from the Automatic Stay. A secured creditor may seek relief from the automatic stay in some circumstances, such as in order to pursue its state law rights against

the collateral or as a way to force the debtor to make interim payments to the secured creditor as a condition to the stay remaining in effect. Although relief from a stay is a complicated issue that cannot be adequately covered in this article, all commercial bankers should know that relief is available if "cause" exists. The "cause" is most typically lack of "adequate protection" of the creditor's interest in the property of the estate. In certain situations cause may be constituted by the lack of any equity in the property or the property being unnecessary for an effective reorganization. Ultimately, you should consult with your bankruptcy counsel immediately upon the filing of the bankruptcy petition to see if relief from the automatic stay is available.

NUMBER EIGHT: Adequate Protection. Adequate protection refers to relief created to protect the value of a secured creditor's interest so that it does not diminish during the bankruptcy proceeding. To establish lack of adequate protection, a creditor must provide evidence of the declining or threatened value of the collateralized property caused by the automatic stay. The Bankruptcy Code does not specify what constitutes adequate protection. Rather, it provides the following three examples of what may provide adequate protection of a party's interest in property: 1) a cash payment or periodic cash payments to the extent that the party's interest declines in value as a result of the debtor's actions; 2) an additional or replacement lien to the extent that the party's interest declines in value as a result of the debtor's actions; or 3) such other relief, as will result in the realization of the "indubitable equivalent" of an entity's interest in property. In addition, depending upon the specific factual circumstances at issue, myriad other forms of relief also may constitute adequate protection.

NUMBER NINE: Things To Do To Improve Your Claim. Most people believe that once a borrower files bankruptcy the chances of recovery are non-existent. While that may be true in some instances, by taking an active role in the administration of the bankruptcy case a creditor can increase its ability to recover. Every lender should make sure its proof of claim is properly filed and the debt is properly listed on the bankruptcy schedules. Attending the meeting of creditors or otherwise contacting the trustee can also be beneficial to ensure that the trustee is personally aware of your claim and shares your view as to the value of the collateral and any problems with the debtor's case. The most persistent creditors are often the ones that receive the best result in bankruptcy.

NUMBER TEN: Advantages and Disadvantages of Bankruptcy. Most creditors consider bankruptcy to be a negative thing, and in some cases they are right. Bankruptcy can delay a foreclosure or wipe out a guaranty. But bankruptcy can also be beneficial to the lender. It allows for an orderly disposition of the debtor's assets and prevents other creditors from impairing your collateral or claim. For instance, without bankruptcy, the first creditor with a judgment could collect most if not all of a debtor's assets. While bankruptcy may be seen as a negative to most bankers, a basic knowledge of the bankruptcy system and an understanding of when and how to protect your claim can greatly increase your chances of recovery.

Mr. McNulty is a shareholder and director with GILL RAGON OWEN, P.A. Mr. McNulty's practice focuses on general litigation; corporate litigation, including large commercial foreclosures; collections; representation of creditors in bankruptcy and non-bankruptcy, and providing general corporate representation. He regularly speaks and writes on the issues facing lenders and other creditors in bankruptcy and foreclosure. To contact Mr. McNulty, please call (501) 376-3800 or email him at mcnulty@gill-law.com.