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BANKRUPTCY AND CREDITORS' RIGHTS NEWS

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STRIPPING OF UNSECURED SECOND MORTGAGES IN CHAPTER 7 BANKRUPTCIES TO BE DECIDED BY THE UNITED STATES SUPREME COURT

On March 24, 2015, the U.S. Supreme Court heard oral arguments in two cases involving whether a Chapter 7 debtor may strip off a second (or any junior) mortgage that is not secured by the home's actual market value. The two underlying cases arose out of the Eleventh Circuit U.S. Court of Appeals which has approved stripping-off wholly unsecured second mortgages in Chapter 7 bankruptcies under Section 506(d) of the Bankruptcy Code. The Eleventh Circuit position conflicts with the holdings of the Fourth, Sixth, and Seventh Circuits (the only other federal Courts of Appeal to have addressed the issue).

YOUR BORROWER IS CONTEMPLATING BANKRUPTCY OR HAS JUST FILED CHAPTER 11—WHY WOULD YOU EVEN THINK ABOUT BECOMING THE DEBTOR-IN-POSSESSION ("DIP") LENDER?

Most debtors filing Chapter 11 have filed bankruptcy because they are, among other things, running out of cash, facing numerous creditor pressures and need to be able to fund their company while seeking to restructure during the Chapter 11 process. Most debtors turn to their existing lender(s) for debtor-in-possession ("DIP") financing. Advantages to DIP lending by the existing lender range from: obtaining concessions regarding the validity or enforcement of the prepetition loan and liens, as well as the amount of the prepetition debt; obtaining a superpriority administrative claim while avoiding getting primed by another lender; the inclusion of certain milestones and deadlines (a greater ability to control the debtor and the case); and the potential to convert prepetition debt into the DIP financing (through what is known as a "roll-up"). Every case is unique and will therefore involve some of these factors, as well as others.

WILL YOU BE ENTITLED TO COLLECT DEFAULT INTEREST IN A CHAPTER 11 BANKRUPTCY?

In the In re: SW Boston Hotel Venture, LLC case, the First Circuit Court of Appeals confirmed that an oversecured lender was entitled to collect default rate interest at 14.5%. The Court noted that it was the Debtor's burden to prove that a default rate of interest constitutes an unenforceable penalty and all reasonable doubts are resolved in favor of enforcement. However, by employing a flexible

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valuation approach, the Court found that the lender was not oversecured until a significant portion of its collateral, the hotel property, was actually sold, some fourteen months after the Chapter 11 filing. As a result, the lender was not entitled to any interest on its principal, whether at the default rate or contract rate, until after the hotel closing occurred. The Court held that as long as the sale price is fair and the result of an arm's length transaction, courts should use the sale price and not some earlier hypothetical valuation to determine whether a creditor is oversecured and thus entitled to post petition interest.

HOW CAN YOU PREVENT BEING CRAMMED DOWN IN A CHAPTER 11?

Pursuant to Section 1111(b) of the Bankruptcy Code, a lender can opt to have the full amount of its claim be paid based on the present value of its collateral. This strategy is particularly helpful to a lender where it anticipates there will be a substantial unsecured deficiency claim but there is a likelihood that the collateral will appreciate in value over time. The 1111(b) election allows the lender to preserve its lien for the full amount of its claim, thereby preventing the debtor from being able to reap the appreciation in value of the collateral through a subsequent sale or refinance of the property. Although the lender will only receive monthly payments based on the present value of the collateral, the lender is entitled to receive payments totaling the full amount of the outstanding balance due.

MONITORING QUALITY CONTROL OF YOUR LOAN DOCUMENTS IS MORE IMPORTANT THAN EVER BEFORE

An increasing number of lenders are having their mortgages and other liens avoided by bankruptcy trustees as a result of defective filings and documents. These problems include defective notarization of mortgages, incorrect property descriptions, and failure to file in the appropriate registry of deeds. Consequently, the bankruptcy trustee is able to step into the shoes of the lender and collect the value of the lender's position, with the lender being forced to call its title company and/or closing counsel. We are also discovering mistakes by lenders with the filing of UCC financing statements which leads to the same result with the bankruptcy trustee. Some lenders are filing UCCs in the state where the borrower is operating rather than the state of incorporation, which is often Delaware. Others are failing to file continuation statements prior to the five year expiration and yet some lenders never filed a UCC financing statement. The consequences for the lender are disastrous as failure to properly perfect will result in the lender losing its security interest in bankruptcy.

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