

Insights

Preparing for the (Likely) Coming Wave of Bankruptcies

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As the economic fallout from the COVID-19 pandemic continues to rise – for example, J. Crew recently filed bankruptcy, and the financial press is predicting that Neiman Marcus may also file for relief this week – it seems prudent for secured lenders to consider what steps they can take to prepare for what may prove to be a tidal wave of bankruptcy filings this year.

First, a brief review. The United States Bankruptcy Code, 11 U.S.C. §§ 101, *et seq.* (“Bankruptcy Code”), governs most forms of insolvency-related restructurings in the U.S. (restructurings of insurance companies are governed by state law). The four types of bankruptcy filings that most secured lenders will encounter are chapter 7 – liquidation, chapter 11 – reorganization (but also can cover liquidations), chapter 12 – adjustment of debts of a family farmer or fisherman with regular annual income, and chapter 13 – adjustment of debts of an individual with regular income.

Corporate debtors most often seek relief under chapters 7 or 11 of the Bankruptcy Code. Late last year, Congress enacted the Small Business Reorganization Act of 2019 (“SBRA”), which became effective February 19, 2020, and as further amended on March 27, 2020, by the Coronavirus Aid, Relief and Economic Security Act (“CARES Act”), creates more simplified and expedited alternative procedures that small business debtors (defined as a person in commercial or business activity with aggregate or noncontingent liquidated secured and unsecured debts as of its bankruptcy filing date of not more than \$7.5 million^[1], and excluding a person whose primary business is the owning or operating of real property) may use to reorganize under chapter 11.

Given that bankruptcies unfortunately appear imminent for many corporate borrowers, some immediate steps that secured lenders should be taking include the following:

- Mortgages: make sure these are properly recorded

- UCC Financing Statements: make sure these are current, complete and filed in the correct place

- Monitor floating liens on accounts receivable and inventory to see if IRS liens have been filed (note that an IRS lien may trump a pre-existing UCC security interest in accounts receivable and/or inventory on the 46th day after the IRS lien's filing)

Where such a review discloses “holes” in the secured lender’s collateral position, secured lenders should consider seeking the borrower’s cooperation in consenting to fix these problems, including getting additional collateral. Note that effecting such fixes may run the risk that the borrower later may seek to avoid them as either preferential transfers and/or voidable transactions (formerly known as fraudulent transfers). However, since the secured lender cannot know when its borrower may seek bankruptcy relief, and because secured creditors enjoy greater protections in bankruptcy than do unsecured creditors, most secured lenders usually determine that pursuing such fixes are worth the risk.

If a borrower files a bankruptcy petition for relief, note that the Bankruptcy Code contains many tight deadlines that can trap the unwary – thus, timeliness is key to protecting a secured lender’s rights. Common deadlines include:

- Attending a first meeting of creditors

- Filing a proof of claim

- Objecting to confirmation of the debtor’s proposed chapter 11 plan of reorganization or liquidation (or chapter 12 or 13 plan, as the case may be)

- In bankruptcy cases involving individuals, filing a complaint to determine dischargeability of certain debts, an objection to discharge, and/or objecting to exemptions

Additional steps that a secured lender may need to address include protecting cash collateral (meaning the liquid proceeds (cash and equivalents) of collateral subject to a security interest); the Bankruptcy Code strictly limits a debtor’s use of cash collateral, so that a debtor cannot use cash collateral without the consent of secured creditor and/or the bankruptcy court.

Finally, remember the “ABCD’s of Bankruptcy”, namely:

Automatic Stay

- A statutory injunction that ***automatically*** stops lawsuits, foreclosures, garnishments, and all collection activity against the debtor ***the moment a bankruptcy petition is filed***.
- A creditor may seek relief from the automatic stay under proper circumstances.

Bankruptcy Estate

- All legal or equitable interests of the debtor in property at the time of the bankruptcy petition filing.
- Subject to exemptions defined by state law, to which creditors may object.

Claim

- A creditor’s assertion of a right to payment from the debtor or the debtor’s property.
- Assertion of a claim often requires that a creditor file a proof of claim, which is subject to strict deadlines.

Discharge

- A release of a debtor from personal liability for certain dischargeable debts set forth in the Bankruptcy Code, which prevents creditors from taking any action against the debtor to collect such debts.
- Not all debts are dischargeable – in certain circumstances, a creditor may wish to file a complaint to determine the dischargeability of a debt.

Takeaway: A borrower's bankruptcy filing – or the prospect of a potential filing – dramatically changes the equation for a secured lender.

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[1] This increased amount sunsets after one year and then reverts to \$2,725,625.