

# Perspective



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This newsletter is designed to address legal issues that impact lending in Florida. Whether making loans or collecting bad loans, *The Lender's Perspective* will provide timely and valuable insight to the creditor.

## Your Borrower Is Bankrupt Now What?

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**I in 60.** That is the approximate number of Southwest Florida adults who have filed bankruptcy during the last three years. Most lenders today have already dealt with bankrupt borrowers or guarantors. Regardless, in today's economy, every lender should understand the ramifications of bankruptcy, the lender's rights and remedies, and the procedure to enforce these rights.

### New Ball Game

First and foremost in dealing with any bankruptcy is understanding that the relationship between the lender and borrower has changed. Many of the old rules governing the debtor/creditor relationship no longer apply. Let's review a few of the areas that directly impact the lender.

### I. The Automatic Stay

The filing of a bankruptcy case triggers what is known as the "automatic stay." Generally speaking, the automatic stay requires lenders cease all direct contact with a borrower once a bankruptcy is filed. Courts have repeatedly subjected lenders to contempt proceedings, imposed fines, and awarded borrowers attorney's fees as sanctions for violations of the automatic stay.

Due to the requirements of the automatic stay and the stiff penalties for a violation, the

lender should place the account in a "bankruptcy" status to avoid inadvertently violating the automatic stay. If you do not have a procedure in place to flag an account in bankruptcy, you should develop one immediately to ensure the lender has no direct contact with the borrower while the automatic stay is in place.

### 2. Secured or Unsecured, That's the Question

Having flagged the loan to ensure compliance with the requirements of the automatic stay, the first step in doing in determining the lender's rights and remedies is to confirm whether you hold a secured or unsecured claim against the debtor.

A secured claim is generally defined as a debt backed by a mortgage, pledge of collateral, or other lien. However, under bankruptcy law, a lender is only "secured" to the extent of the borrower's interest in the collateral. In other words, even though you loaned \$100.00 to purchase the collateral last year, if the collateral is only worth \$50.00 today, you are only secured in the amount of \$50.00. (In this example, the lender would hold an unsecured claim for the deficiency of \$50.00.) As a result, immediately upon receiving notice of a bankruptcy, a lender should inspect its collateral (you may find that the value on the books is substantially different from what is actually there) and/or have the collateral reappraised if your claim

is significant. The lender might also choose to have its documents reviewed to ensure the collateral position is perfected. You might also choose to do all of these things at the hint of a potential bankruptcy filing in the hopes of improving your collateral position.

In contrast, an unsecured claim is any claim or debt for which a creditor holds no special assurance of payment, such as a mortgage or lien. This typically includes personal loans or lines of credit which were extended solely based upon the borrower's ability to pay. Of course, under secured claims (as in the \$1,500,000 example, above) and previously secured claims where documentation deficiency caused the claim to be unsecured are also lumped in this category.

### Not All Bankruptcies Are Equal

The Bankruptcy Code includes different "chapters" (Chapters 7, 9, 11, 12 and 13) which provide different means to deal with a borrower's assets and liabilities. Chapters 9 and 12 relate to the rehabilitation of municipalities and family farmers, respectively, and, due to their rarity, are not addressed here.

### CHAPTER 13 - ADJUSTMENT OF DEBTS OF INDIVIDUAL WITH REGULAR INCOME.

Cases filed under Chapter 13 represent the largest portion of bankruptcy cases filed today. Under Chapter 13, a borrower proposes to the Court a plan

of repayment towards which the borrower is required to submit all of his or her disposable income. Chapter 13 allows borrowers significant benefits, including retaining the family home and most personal property. Similarly, Chapter 13 benefits creditors by generally insuring payment of secured claims in full (unless the value of the asset is less than the amount owed) and, at least some payment on unsecured claims.

**CHAPTER 7 - LIQUIDATION.** Chapter 7 is available to those borrowers unable to reorganize under Chapter 13. Under Chapter 7, a trustee is appointed to collect and liquidate all non-exempt property of the debtor for the benefit of unsecured creditors. In order to prevent the borrowers from being completely destitute after a bankruptcy, the law allows a borrower to exempt certain property from a Chapter 7 liquidation. This provision, together with the shift of most cases to Chapter 13, makes Chapter 7 a poor option for both borrowers and lenders. In most cases, unsecured creditors receive nothing on account of their claim.

**CHAPTER 11 - REORGANIZATION.** Chapter 11 cases are generally known as reorganization cases and are typically filed by large corporations seeking to restructure debt. However, Chapter 11 cases may also be

filed by individuals, in which case Chapter 11 bears many similarities to Chapter 13. In the case of a corporation, the Bankruptcy Code places the debtor, known as the "debtor-in-possession", in the position of a fiduciary with the rights and powers of a trustee. And the debtor continues to operate its business without much supervision from either the Court or the United States Trustee.

Chapter 11 reorganization plans are often quite drawn out in time and expense. This is so because, unlike in Chapter 13, the debtor, Court, and creditors must come to an agreement over the terms of the Chapter 11 Plan. However, there are circumstances in which the Court can approve a plan even over the objection of creditors (the infamous "cram down").

### **Proof of Claim**

Regardless of the chapter the case is filed under, or whether lender is secured or unsecured, the easiest way for lenders to protect their rights in bankruptcy is to file a proper proof of claim. Except in limited cases, lenders must timely file proof of claim in order to be paid a distribution in the bankruptcy case.

A proof of claim is a written statement setting forth the amount and basis of the

lender's claim. (The Bankruptcy Rules provide a form proof of claim - Official Form B10.) As a result, completing the claim is easy and may often be completed by the lender.

### **Role of Counsel**

As in most legal matters, it is essential a lender consult with counsel who specializes in creditor's rights in bankruptcy and can guide her through the bankruptcy process. In selecting counsel, a lender should also weigh the benefits of retaining local counsel who will be familiar with the judges, trustees, and other lawyers, which should lead to a more effective representation.

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*As always, thanks for reading and watch for the next issue of The Lender's Perspective.  
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