# COMMUIATE BANKER

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Welcome to the latest issue of the COMMUNITY BANKER.

The Community Banker is prepared by attorneys at Olson & Burns P.C. to provide information pertaining to legal developments affecting the field of banking. In order to accomplish this objective, we welcome any comments our readers have regarding the content and format of this publication. Please address your comments to:

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The attorneys at Olson & Burns represent a wide range of clients in the financial and commercial areas. Our attorneys represent more than 30 banks throughout North Dakota.

# **Understanding Bankruptcy Matters**

Some days, it seems like the bad old days are here again. North Dakota's oil and ag economy was doing so well, or well enough, for at least a decade that many lenders have not had to deal with a customer bankruptcy. Those days are over for many banks, and lenders are getting a crash course in a fairly complex area of law. When reviewing a bankruptcy file or a potential bankruptcy file, it's crucial for the lender to consider different issues that could affect the lender's claim and may arise while your customer is in bankruptcy. Those issues may include, in no particular order of importance, preferences, equitable subordination, and the automatic stay.



# **Understanding Preferences**

A purpose of the Bankruptcy Code is to somehow equally distribute assets of the bankruptcy estate among the debtor's creditors. To aid in this policy, 11 U.S.C. § 547 gives the bankruptcy trustee or the debtor-in-possession the power to avoid or "claw back" transfers of interests in the debtor's property to a creditor that has the effect of favoring that creditor over other similarly-situated creditors. In plain English, the trustee has the right to take back property or money that the debtor improperly gave away before filing. The trustee has the ability to regain assets that should have been part of the debtor's bankruptcy estate, but were removed or hidden from the trustee by the debtor by means of preferential or fraudulent transfers. For example, a debtor may repay a debt to a friend or family member, paying that person in full instead of keeping the money to be put into the pot for division among all of the debtor's creditors; or, a debtor may wish to repay a debt to his doctor to make sure the doctor will keep seeing him. The problem with preferential transfers or preferences is that it benefits one creditor at the expense of the rest. Rather than having their debts tossed into the bankruptcy hopper and receiving pennies on the dollar from the bankruptcy trustee, creditors who receive preference payments are paid in full. This leaves that much less money to be distributed to other creditors.

To show that a transfer was preferential, the trustee or debtor-in-possession must establish the following seven features: (1) a transfer; (2) of an interest of the debtor in property; (3) to or for the benefit of a creditor; (4) for or on account of an antecedent or earlier debt; (5) while the debtor was insolvent; (6) within 90 days before bankruptcy (or within 1 year where the transfer was to or for the benefit of an insider); (7) that enables the creditor to receive more than it would have received in a hypothetical chapter 7 liquidation. 11 U.S.C. § 547(b).

Avoidable preferences received by a lender might include a lender perfecting its security interest within 90 days of the bankruptcy or the debtor making payments of principal or interest on the loan within 90 days of the bankruptcy. Note that the relevant date of the "transfer" to the lender for preference purposes cannot occur until the debtor acquires its interest in the property. So, a secured lender with a perfected lien on after-acquired property of the debtor risks receiving an avoidable preference where the debtor does not receive an ownership interest in the after-acquired property until sometime during the 90-day preference period. 11 U.S.C. § 547(e)(3).

Fortunately, the preference statute provides for a number of exceptions. First, the trustee may not avoid a transfer to the extent that it was intended by the parties as a contemporaneous exchange for new value given to the debtor, and the exchange was in fact substantially contemporaneous. What? It just means that the debtor simultaneously paid money in exchange for something of value—say Jack delivered four bushels of potatoes to the debtor and the debtor immediately paid Jack. That transaction would be a contemporaneous exchange for new value. If a trustee pursued a preference action against Jack for that transaction, Jack would likely be successful arguing that this falls under the "contemporaneous exchange exception." As always, though, the devil is in the details and the facts of a particular situation are the key. Timing is an important component. If Jack delivered the potatoes and the debtor didn't pay him until a month later, Jack has a weaker argument for the "contemporaneous exchange" exception because the exchange was not actually "contemporaneous."

This exception and a few of others are relevant to lenders:

- (1) If a lender perfects its security interest in the debtor's assets within days of making a secured loan to the debtor, that act of perfecting may not be an avoidable preference, depending on the facts and circumstances. 11 U.S.C. § 547(c)(1).
- Payments made by the debtor in the ordinary course of its business or according to ordinary business terms (such as paying principal, interest, fees and expenses when due per the terms of its credit documents) may not be avoidable preferences under 11 U.S.C. § 547(c)(2).
- (3) Valid purchase money security interests perfected within 30 days after the debtor receives possession of the property might not be avoidable preferences under 11 U.S.C. § 547(c)(3).
- (4) A transfer is not preferential to the extent that the lender subsequently gave new value to or for the benefit of the debtor (i.e., the lender may be able to retain \$400,000 of the debtor's repayment of \$600,000 in unsecured revolving loans where the lender subsequently extended the debtor \$400,000 in new, unsecured loans). 11 U.S.C. § 547(c)(4).
- A floating lien security interest (such as one on inventory or receivables) is not a preference, provided that it does not improve the lender's position as it existed 90 days prior to bankruptcy. Our handy-dandy chart below gives an example of an "improvement in a lender's position" due to its floating lien and showing a \$100,000 avoidable preference):

Time	Amount of Debt Owed to Lender	Value of Collateral - Inventory and Receivables
90 Days Before Bankruptcy Filing	\$400,000	\$200,000
45 Days Before Bankruptcy Filing	\$400,000	\$250,000
Date of Filing	\$400,000	\$300,000 (Because the collateral is worth \$100,000 more on the filing date than it was 90 days ago, the trustee can grab \$100,000 in collateral).

(6) Any payment on an oversecured loan is not a preference.

# **Understanding Equitable Subordination**

The remedy of equitable subordination is available under 11 U.S.C. § 510(c), authorizing the bankruptcy court to subordinate the claim of any creditor who has acted wrongfully. In general, the equitable subordination doctrine is limited to re-ranking priorities and does not permit a court to totally disallow a claim. Generally, three elements must be satisfied:

- (1) the "bad" creditor must have engaged in some type of inequitable or unfair conduct;
- (2) the misconduct must have resulted in financial injury to the other creditors of the debtor or gave an unfair advantage to the bad creditor; and

(3) equitable subordination of the claim must be consistent with other provisions of the Bankruptcy Code.

Equitable subordination is meant to correct rather than punish; if the three factors are met, the court should subordinate the claim only as necessary to disgorge profit or to offset harm caused to other creditors as a result of the unfair conduct.

Creditors sometimes seek to equitably subordinate a lender's claim when the lender has tried to enhance its financial position and exert control over the debtor during a pre-bankruptcy, out-of-court workout. In these circumstances, a lender might try to amend credit documents, to add financial covenants to control the borrower's use of cash, to increase interest rates and fees, to add collateral and lessen its credit risk, to require the debtor to report to the lender, or to put someone from the lender's bank on the debtor's board of directors. When participating in a workout or otherwise negotiating with a distressed borrower, lenders should be aware of the risk that the borrower may file for bankruptcy. In that case, a court will examine the parties' conduct for fairness.

While typical lender activity in distressed debt situations is generally permissible, actions that can be viewed by the bankruptcy court as fraud, breach of fiduciary duty, mismanagement, or overreaching might result in equitable subordination of the lender's claim and a resulting decrease in the lender's recovery.

# **Understanding the Automatic Stay**

One of the biggest benefits for debtors filing for bankruptcy is the automatic stay. The automatic stay gives the debtor rest and breathing room from the collection efforts of creditors, including and especially foreclosures and repossessions; it also gives the debtor time and protection to plan for rehabilitation. Additionally, the stay allows for the orderly administration of estate assets and levels the playing field among the various creditors to work toward an equal distribution.

Filing a petition for bankruptcy operates as an automatic stay of beginning or continuing any judicial or administrative proceeding against the debtor that was, or could have been, brought before the bankruptcy was filed. 11 U.S.C. § 362(a)(1). Additionally, the stay prevents activity to obtain possession of, or to exercise control over, property of the estate (recall that the estate includes all of the debtor's legal or equitable interests in property as of the petition date). 11 U.S.C. § 362(a)(3); 11 U.S.C. § 541. The stay also prohibits any act to create, perfect, or enforce a lien against property of the estate. 11 U.S.C. § 362(a)(4) and (5). (Recall our discussion above on preferences and perfecting liens prior to the filing.)

Although the automatic stay is broad and covers most collection activities, there are a few narrow exceptions to the automatic stay in the Bankruptcy Code. For example, the automatic stay is not applicable to post-petition transactions, bringing or continuing a criminal proceeding against the debtor, collecting alimony, maintenance, or support from property that isn't property of the estate (such as post-petition wages or income of the debtor), and bringing or continuing an action by a governmental unit to enforce that unit's police or regulatory power. See 11 U.S.C. § 362(a) and (b). An exception also permits stockbrokers, commodity brokers, financial institutions, and other participants in financial and derivatives markets to exercise rights under repurchase agreements and other specifically defined financial contracts. 11 U.S.C. § 362(b)(6).

At any time after the borrower's bankruptcy filing, a lender can seek relief from the stay by filing with the court a motion "to lift" or "for relief from" the automatic stay. The court must grant relief from the stay, such as by terminating, annulling, modifying, or conditioning the stay (1) "for cause," including the lack of adequate protection of the lender's interest in property; or (2) where (i) the debtor lacks equity in the subject property and (ii) the property is not necessary to an effective reorganization. 11 U.S.C. §§ 362(d)(1) and (2). Under the first basis, a court might find a lack of adequate protection where the lender's collateral is exposed to physical or economic depreciation or unreasonable risk of loss due to inadequate insurance coverage. Under the second basis, a lack of equity is shown if the property's value is less than not only the debt owed to the lender, but also the sum of all encumbering liens and charges. Under either basis, the bankruptcy court has discretion to create appropriate relief, which might include permitting the lender to record a notice of default, accelerate a debt, commence a lawsuit, or enforce a judgment against the debtor.

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