

Chapman Client Alert

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Current Issues Relevant to Our Clients

Are You an Over-Secured Lender in Your Borrower's Bankruptcy? Beware: You May Still Not Be Entitled to Receive Post-Petition Interest

It is a basic principle in bankruptcy that a secured lender is entitled to receive interest, attorneys' fees and other charges arising post-petition to the extent the lender is over-secured (*i.e.*, the value of the collateral exceeds the secured claim as of the bankruptcy filing date). A recent decision issued by a federal district court in North Carolina challenges this principle in cases where the value of an over-secured lender's collateral diminishes during the course of the bankruptcy case, and raises questions for secured lenders about how to avoid the result suffered by the secured lender in this case.

Legal Background

Section 506(a) of the Bankruptcy Code provides that a lender's claim will be treated as secured to the extent of the value of such lender's collateral, and unsecured as to any deficiency. Section 506(b) of the Bankruptcy Code provides that a secured lender is entitled to receive interest, attorneys' fees and other charges arising post-petition to the extent that the lender's claim is over-secured.

Together, these two sections of the Bankruptcy Code establish that a secured lender's recoveries in the bankruptcy case will be driven by the value of its collateral, and that an over-secured creditor should expect repayment not only of pre-bankruptcy principal, interest and other charges, but also post-bankruptcy amounts — at least to the extent that such post-bankruptcy amounts, when added to pre-bankruptcy amounts, do not exceed the total value of the lender's collateral.

But what if the debtor intends to continue to use the lender's collateral, specifically, its cash collateral, during the pendency of its case? In that event, section 362 of the Bankruptcy Code protects the lender by conditioning the debtor's use of cash collateral upon its provision of "adequate protection" to the lender — a term which means that the borrower must ensure that the total value of the lender's collateral does not diminish as a result of the borrower's use of the collateral during the bankruptcy. Borrowers who are debtors in bankruptcy routinely seek to provide this adequate protection against collateral value diminution by granting replacement liens and also by making payments during the bankruptcy case to their lenders.¹

The Bankruptcy Code recognizes that in some cases the adequate protection provided by a borrower to its secured lender during the bankruptcy case will come up short. Section 507(b) of the Code therefore provides that if the borrower provides adequate protection and the secured lender still suffers a loss then such creditor's claim for the loss shall have priority over most every other type of unsecured claim.

In re Construction Supervision

These principles were very much in play in an appeal recently decided by the District Court in North Carolina in the bankruptcy case of Construction Supervision Services, Inc. (Construction Supervision).² In that case, Branch Banking and Trust Company (BB&T) made loans to Construction Supervision secured by (among other assets) the borrower's accounts receivable. When Construction Supervision filed its chapter 11 petition, BB&T held claims of \$1,265,868.55 in principal and matured interest, while the debtor's accounts receivable were valued at \$5,514,574.50. On their face, these values would seem to suggest that BB&T was comfortably over-secured, and could expect to recover interest, attorneys' fees and other charges arising post-petition.

The facts were more complicated than that, however. Construction Supervision requested permission from the bankruptcy court to use BB&T's collateral — that is, the proceeds of accounts receivable — during the bankruptcy case, asserting that BB&T's claim was secured by property "valued far in excess of the [debtor's] obligations." BB&T objected, arguing that it was not adequately protected because "a substantial portion of the Debtor's accounts receivable [were] aged beyond 60 days or consist[ed] of retainage." In the alternative, BB&T argued that it was entitled to monthly adequate protection payments to preserve the value of its interest in Construction Supervision's accounts receivable.

The bankruptcy court granted Construction Supervision's request to use the proceeds of accounts receivable during the bankruptcy case, but also ruled that BB&T's interests in the accounts receivable were not adequately protected. To compensate BB&T for the possible diminution in the value of its collateral, the bankruptcy court required Construction Supervision to make monthly payments to BB&T. During the course of the case, the bankruptcy court ordered Construction Supervision to pay BB&T adequate protection payments totaling \$62,900 by the end of the case.

Meanwhile, during the course of the bankruptcy proceeding, various subcontractors and material providers surfaced and asserted security interests in the accounts receivable which were (under state law) senior in priority to the interests of BB&T. This, of course, reduced the value of BB&T's interest in the accounts receivable. Finally, after eight months of attempting to reorganize under chapter 11, Construction Supervision converted the case to a chapter 7 liquidation proceeding which resulted in the cessation of its business and the appointment of a chapter 7 trustee. The trustee proceeded to liquidate Construction Supervision's assets, and when all was said and done BB&T received a total of \$1,300,736.79, inclusive of the adequate protection payments of \$62,900. This amount exceeded BB&T's pre-bankruptcy claim by \$34,868.24, and BB&T applied this amount to its post-petition interest, costs and fees. The amount, however, was not enough to pay all of the interest, attorneys' fees and other charges which BB&T incurred during the bankruptcy case.

BB&T filed a motion in the bankruptcy court requesting a super-priority unsecured claim under section 507(b) for the amount of its post-petition interest, costs and fees which it did not receive from the proceeds of its collateral. BB&T argued that it was substantially over-secured when the bankruptcy case was filed, but that the value of its collateral was diminished by the debtor's use of its accounts receivable collateral during the case — leaving BB&T unable to recover its post-petition expenses from its collateral under section 506(b). The bankruptcy court denied BB&T's motion and the appeal before the District Court ensued.

The District Court affirmed, holding that section 507(b) only applies when the "value" of a secured lender's "interest" in its collateral is impaired, and that the only "interest" protected is the "value" of the secured lender's *claim* — principal, matured interest and other charges compensable under the loan documents — *as of the date the bankruptcy case is filed*. The District Court held that section 507(b) does not protect the value of the secured lender's *collateral* as of the petition date, and thus cannot be invoked to recover post-petition interest, fees and other charges which are unable to be paid when the

collateral value declines during the bankruptcy case. Because BB&T received repayment in full of its pre-bankruptcy *claim*, the District Court found that the adequate protection payments made to BB&T had served their purpose — ensuring that BB&T's pre-petition claim was paid in full — and that the value of BB&T's interest in its collateral was not impaired for purposes of section 507(b).³ Interestingly, therefore, it emerges that the allowed amount of a secured claim under section 506(b) (*i.e.*, inclusive of post-petition fees) is *not* identical to the amount of secured claim that is entitled to protection under section 507(b) of the Bankruptcy Code. This likely was not the governing assumption prior to the issuance of this decision.

The Construction Supervision case may yet be appealed to the Court of Appeals for the Fourth Circuit. In any event, bankruptcy courts in cases outside the district will not be required to follow the ruling (although they may be influenced by its reasoning). That said, the decision provides a cautionary tale to over-secured creditors in bankruptcy cases: make every effort to obtain regular payment of post-bankruptcy interest, attorneys' fees and other charges as they are incurred.⁴ This can be accomplished (the debtor's cash flow permitting) by negotiating provisions for such payment in the cash collateral orders by which the debtor is permitted to use the lender's collateral during the case, and by insisting that regular payment of such expenses be included in the debtor's post-bankruptcy budget. The lesson from Construction Supervision is that accruing such expenses for payment at a later point in the case may result in non-payment and no remedy.

For More Information

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- 1 Borrowers also routinely argue that the lender is “adequately protected” because the value of its collateral significantly exceeds the amount of the lender’s claim (the differential often is referred to as an “equity cushion”) — such that even if the collateral does diminish it will still be sufficient in value to repay the lender in full.
- 2 *In re Construction Supervision Services, Inc. (Branch Banking and Trust Company v. Stephen L. Beaman)*, Case No. 15-CV-434, United States District Court for the Eastern District of North Carolina (May 9, 2016).
- 3 The District Court also affirmed the ruling of the bankruptcy court that BB&T had failed to prove that the diminution of the value of its collateral during the bankruptcy case was due solely to Construction Supervision’s use of the accounts receivable proceeds. The District Court agreed that BB&T had failed to rule out that the diminution was, instead, caused by the subcontractors’ intervening senior liens.
- 4 Even though the amount of the secured lender’s claim is fixed as of the petition date, the value of its collateral is not. Whether the secured lender is indeed over-secured is a determination that in some Circuits will be made towards the end of the case. Thus, the debtor may agree to pay post-petition amounts only on a provisional basis, subject to the determination later that the lender was entitled to payment thereof under Section 506(b).



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