

Don't underestimate the risks of being a secured creditor in a bankruptcy case

By Howard N. Madris

As Donald Trump once said, “[R]eal estate is always good.” Indeed, less experienced purchasers of distressed, real estate secured loans might agree. Purchasers often assume that if they buy promissory notes from banks and other lenders for perhaps 50 to 60 percent of the outstanding loan balances, and if the value of their collateral is sufficiently high, they will quickly make substantial profits through either foreclosure of the realty or perhaps from repayment of the loans.

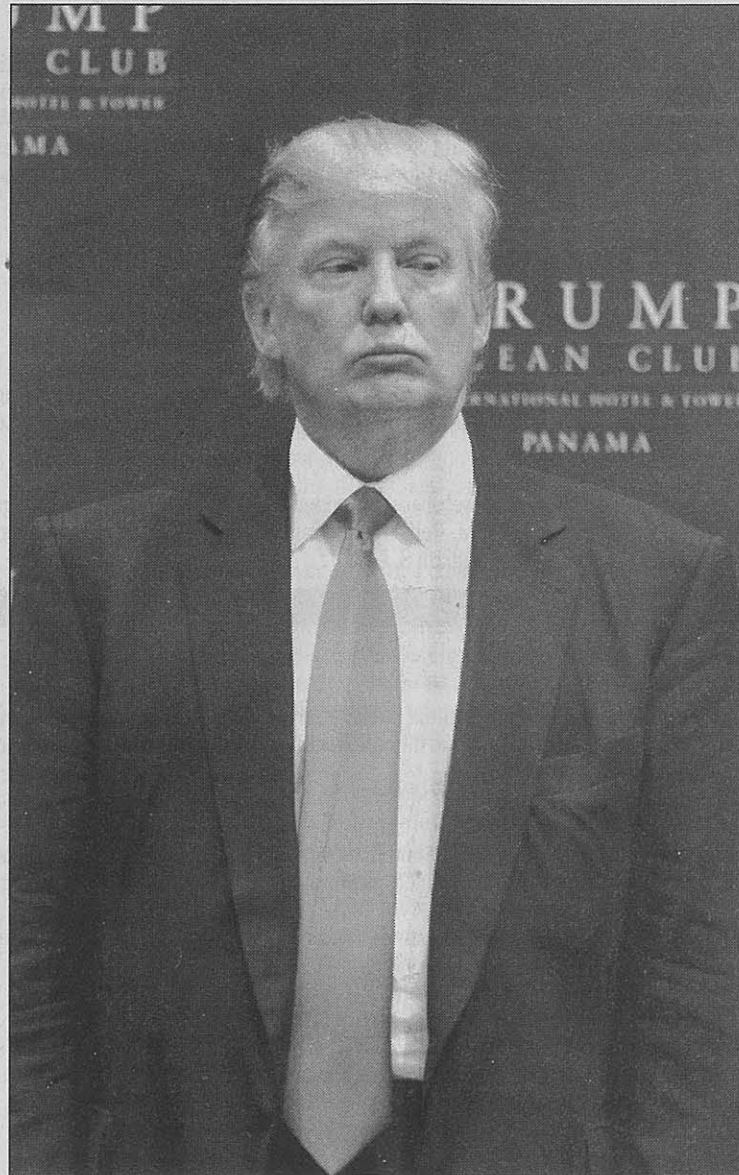
However, while note purchasers may anticipate that their non-performing borrowers will file for Chapter 11 protection in order to stay foreclosure, purchasers often underestimate the risks associated with being a secured creditor in a bankruptcy case. They may also overestimate the likelihood of quickly obtaining relief from stay to foreclose. To maximize profits, prudent purchasers should have a good general understanding of the bankruptcy process before even acquiring the notes. Indeed, it is important for purchasers to understand whether the impact of bankruptcy laws on the types of notes they contemplate acquiring is compatible with their business models.

The value of the collateral is crucial in a bankruptcy case. One of the requirements for a debtor to confirm a Chapter 11 plan over a secured creditor's objection is that the plan provides for the full payment of the secured claim, plus a market rate of interest, over the life of the plan, which is typically around five years. However, the amount of a secured claim in bankruptcy is the lesser of the amount owed or the value of the property.

Therefore, in a hypothetical case where a buyer acquires a note with a \$10 million unpaid balance, secured by a first deed of trust against a \$15 million property, and is thus “oversecured,” the debtor would be obligated to pay the buyer \$10 million plus a market rate of interest during the plan. However, if the note buyer is “undersecured” because the property is worth less than the loan balance (i.e. the collateral is only worth \$7 million) the buyer, on account of the secured portion of its claim, would only be entitled to receive \$7 million plus a market rate of interest over the life of the plan. While the buyer would also have an unsecured deficiency claim for \$3 million, the debtor's plan might only pay the holders of unsecured claims a few cents on the dollar.

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While it is thus advantageous for note purchasers to be oversecured, there is a disadvantage if the collateral value substantially exceeds the note balance, such that the buyer has what is known as a huge “equity cushion.” As realty is a depreciating asset, oversecured creditors may



U.S. tycoon Donald Trump.

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be entitled to monthly “adequate protection” mortgage payments during the period between the bankruptcy filing and plan confirmation, to protect against the realty depreciating in value below the outstanding loan balances.

However, bankruptcy courts hold that if the value of collateral exceeds a secured creditor's claim by more than about 11 to 20 percent, the secured creditor has a sufficient equity cushion that monthly adequate pro-

tection payments are not required before a plan is confirmed. The debtor could thus repay the missed payments over the life of the plan. This would be quite detrimental to a note purchaser that is expecting to receive monthly payments during the bankruptcy case prior to plan confirmation: a period that could be months or even years.

Another significant bankruptcy consideration is whether there are junior liens encumbering the collateral. On the one hand, purchasers of notes secured by first deeds of trust might believe that junior liens against the collateral enhance their prospects for obtaining relief from stay to foreclose. One factor as to whether a secured creditor is entitled to relief from stay is whether the debtor lacks equity in the property. If the total of all encumbrances exceeds the value of the collateral, the debtor lacks equity in it. A junior lien might make the difference in this calculation.

However, to obtain relief from stay, the note purchaser must also show that the debtor does not have prospects to reorganize the property. Junior lienholders typically fear that first deed of trust holders will obtain relief from stay and “wipe out” their junior liens in foreclosure. Therefore, junior lienholders often collaborate with debtors in formulating Chapter 11 plans, to the detriment of the first trust deed holders. Unsecured creditors might align with debtors as well, in arguing that the debtors can reorganize the property and pay debt service not only to the secured creditors, but also to the unsecureds.

A further bankruptcy consideration is the location of the debtor and collateral. There are approximately 21 bankruptcy judges hearing cases in the Central District of California. However, in more remote locations around the state and nation, there may be only one bankruptcy judge hearing matters. Perhaps the judge has a reputation for being “debtor friendly”; exhibited for instance by a reluctance to grant relief from stay in other cases, or from having previously determined that a rate of interest that other judges might find to be too low is in fact the market rate that can be paid to secured creditors. Note purchasers should take this into account before making their acquisitions in these jurisdictions, even if it does not deter them from ultimately making the purchases.

This just scratches the surface of the many bankruptcy issues that may arise from the acquisition of real estate secured promissory notes. Concerned purchasers should consult with experienced bankruptcy counsel before they make their acquisitions.



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