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FINANCING

Bankruptcy of a Co-Lender Or Subordinate Lender

Over the past year, in this column, we have examined several different issues related to troubled real estate loans, primarily in connection with borrower defaults and lender remedies. The credit crisis, however, has affected mortgagees as well as mortgagors. If, in the context of a participated, syndicated, tranching or senior/junior loan structure, one of the lenders were to file a petition for relief under the Bankruptcy Code,¹ the automatic stay afforded such lender could have material consequences to the other lenders, especially in a circumstance where the loan or underlying collateral was itself troubled. As banks and other financial institutions fail, the issue of lender bankruptcy has become more prevalent in the finance industry.

One of the most fundamental protections afforded entities that file for bankruptcy is the imposition of the automatic stay, which prohibits creditors from commencing or continuing nearly all efforts to enforce debts or perfect security interests in property of the debtor.² The automatic stay is designed to give a debtor “breathing room” in order to focus on either reorganizing its business or conducting an orderly liquidation of its assets in bankruptcy. In situations where the automatic stay applies, a creditor must move for relief from the automatic stay prior to engaging in activities designed to enforce its debt.

Failure to seek relief from the stay may result in a bankruptcy court awarding a debtor actual damages, including costs and attorney’s fees, as well as punitive damages, in appropriate circumstances.³ Actions taken in violation of the automatic stay are generally void; however, courts may grant retroactive relief from the stay in limited circumstances.⁴

If the automatic stay is applicable, a creditor must seek relief from the stay based on certain grounds enumerated in Bankruptcy Code §362(d). The two grounds that may apply to a senior lender seeking relief in order to foreclose a bankrupt junior lender’s lien are: (1) “for cause”⁵ or (2) if the debtor has



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no equity in the subject property and the subject property is not necessary for the bankrupt junior lender’s effective reorganization.⁶ Aside from “lack of adequate protection,”⁷ the phrase “for cause” is not defined in the Bankruptcy Code.⁸



CREDIT: PHOTOS

There is a split in authority as to whether the automatic stay is applicable in a circumstance where a senior lender is attempting to foreclose on a property subject to a junior mortgage after the junior lender has filed for bankruptcy. Inasmuch as the subject junior mortgage still has value (in the most basic sense, if the market value of the underlying property exceeds the outstanding principal balance of the first mortgage loan) and is an asset of the bankruptcy estate, the automatic stay could prevent the first mortgagee from exercising its remedies and

completing a foreclosure against the underlying borrower. The majority of relevant decisions appear to hold that the automatic stay does indeed apply⁹ and that a senior lender must petition the court for relief from the stay before it can foreclose out the junior lender’s mortgage. Bankruptcy has long been an issue for lenders structuring complex transactions, but such concerns have typically been focused on the borrower, not another lender in the stack.

In *In re Three Strokes Limited Partnership*¹⁰ a senior lender was prevented from completing a non-judicial foreclosure that was commenced before the junior lender voluntarily filed its Chapter 11 case. The court held that the bankrupt junior lender’s second lien was a “cognizable property interest” protected by the automatic stay and that an intercreditor and subordination agreement entered into by the lenders did not extinguish said property interest. As such, the senior lender was required to seek relief from the stay before continuing with its foreclosure.

Certain courts, however, have found that the automatic stay does not apply to a senior lender foreclosing a bankrupt junior lender’s lien. In *Farmers Bank v. March*¹¹ the court found that the automatic stay was intended to protect “debtors” and although under the protection of the bankruptcy court, the junior mortgagee was a “lender” in respect to the collateral property, not a “debtor” (and the senior lender was not its “creditor”), and, therefore, its second mortgage interest was not subject to the automatic stay.

In another situation, where a senior lender commenced foreclosure against its borrower, but did not name or serve a necessary bankrupt party, thereby leaving its security interest undisturbed, the court found that as the debtor would remain in the same position, no interest of the bankrupt estate was affected and therefore the automatic stay did not apply.¹² However, the case law is not well developed on whether such a foreclosure would constitute a violation of the automatic stay and a cautious lender may want to seek relief from the stay.

Given the potential negative consequences of failing to seek relief from the automatic stay, a prudent first mortgagee is well advised to seek relief from the stay “out of an abundance of caution” rather than risk wasting time and effort on a foreclosure that may be overturned. Additionally, a first mortgagee

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may choose to petition the court for relief from the stay rather than risk punitive damages for willfully continuing with a foreclosure of a bankrupt junior lender's lien. If, however, the market value of the underlying property has declined below the outstanding balance of the first mortgage, the second mortgage loan is essentially unsecured and may not be considered an asset of the bankrupt estate.

Generally, bankruptcy courts will lift the stay if the bankrupt junior lender has no equity in its lien. It will be difficult, if not impossible, for a bankrupt junior lender to prove to the court that its unsecured lien is "necessary for an effective reorganization." However, a bankrupt junior lender may argue that rather than conducting a hasty foreclosure sale of the underlying collateral that will result in no return to the junior lender, a properly marketed sale of the collateral will result in a higher sale price and, ultimately, provide some return on the junior lien. Obviously, this analysis would vary on a case-by-case basis.

Developments in the structure of modern commercial mortgage loans have attempted to mitigate the risk of borrower bankruptcy from the underwriting process. In standard non-recourse loans, carve-out guaranties, for example, typically include a provision triggering full recourse to a deep-pocket guarantor if the borrower goes into bankruptcy, whether voluntarily or not.

The concern is that, among other things, absent a methodology for limiting a borrower's ability to seek bankruptcy protection, it can use the threat of filing to obtain concessions from a lender. Although not as well developed, there are certain mitigants a lender may employ to deter co-lender bankruptcy. Frequently, intercreditor agreements contain language requiring that any assignee or acquirer of a lender's position be "qualified."

The requirements for qualification include, among other things, a net worth significant enough to make bankruptcy unlikely. Of course, such protections only go so far, and many of the recently failed banks and financial institutions would have "qualified" only months or even weeks before their collapse.

Another context in which issues involving the automatic stay and a lender's bankruptcy arise involves loan participations. In a participated loan, typically there is only one mortgage, with two or more lenders owning participation interests therein. The note and mortgage are usually in the name of the originating lender and each participant is issued a participation certificate (and not a separate lien or mortgage) and becomes party to a participation agreement (sometimes called a participation and servicing agreement).

A participation agreement assigns the position of "controlling holder" or "lead lender" to one of the participants and memorializes the relationship among the lenders, including what actions the controlling holder may take without consent of the other participants. As the mortgage and note in a participated loan is normally in the name of only one participant (the originating lender) and the controlling holder is generally entitled to make certain unilateral decisions, a bankruptcy of the named mortgagee or controlling holder could significantly affect the participant group's interest and the administration of the loan.

The Bankruptcy Code addresses certain concerns of a participant in a loan where the named mortgagee has filed for protection of the court. As a limitation on the definition of what is deemed to be property of the debtor estate (as set forth in Bankruptcy Code

§541(a)), Bankruptcy Code §541(d) states:

Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

The effect of Bankruptcy Code §541(d) is to prevent a bankruptcy trustee from challenging a loan participation and asserting that the entire mortgage loan is an asset of the debtor's estate (as it would be held in the name of the debtor).

The court in *In re Coronet Capital Co.*,¹³ however, distinguished between a true participation interest protected by Bankruptcy Code §541(d) and a mere loan to the originating lender, disguised as a participation, which would not benefit from such

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protection. The debtor in *In re Coronet* originated a mortgage loan secured by a multifamily building in Brooklyn and then sold a 90.91 percent "participation" interest to another real estate investor.

The terms of the supposed participation agreement required the debtor to pay interest to the participant whether or not the underlying borrower made its interest payment. Furthermore, the debtor continued to make interest payments to the participant after the underlying borrower defaulted and ceased paying the required debt service. The obligation of the debtor to pay the participant interest regardless of a default by the underlying borrower was a de facto guaranty by the debtor.

The court in *In re Coronet* established a four factor test to determine whether a sale of an interest in a loan was a participation, entitled to the protections of Bankruptcy Code §541(d), or a loan to the originating lender, subject to the automatic stay.

The factors denoting the intent to create a loan and not a proper participation were held to be (i) the existence of a guarantee of repayment by the lead lender to a participant, (ii) the participation that lasts for a shorter or longer period than the underlying obligation, (iii) different payment arrangements between borrower and lead lender and lead lender and participant, and (iv) a discrepancy between the interest rate due on the underlying note and interest rate specified in the participation. As the subject arrangement clearly violated the first factor, the court found that the "participation" was in fact a loan and denied the participant's motion for relief from the stay.

Even if a participant's interest is protected by

Bankruptcy Code §541(d), the administration of the loan may be jeopardized by the bankruptcy of a controlling lender. If the underlying mortgage loan requires decisions to be made by the controlling lender, such controlling lender's bankruptcy may adversely affect its ability to manage the loan, thereby endangering the investment of the other participants. A well drafted participation agreement should contemplate such an event and include the bankruptcy or insolvency of a controlling lender as a trigger to automatically assign the position of controlling lender to the next-in-line participant.

Given the increased complexity of financing arrangements in recent years, lenders who participate in multiparty lending agreements are well advised to carefully consider the potential impact of a bankruptcy of a co-lender. As the above cases indicate, there are risks for both senior and junior lenders should another co-lender file for bankruptcy. The automatic stay is a powerful protection for a debtor, and a lender must be aware of the financial strength of not only the borrower but the other participating lenders as well, lest that lender find itself unable to employ the remedies it had bargained for.

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1. 11 U.S.C. §101, et seq. (2006).

2. See 11 U.S.C. §362.

3. See 11 U.S.C. §§105(a), 362(k)(1); see also *In re Spookyworld Inc.*, 346 F.3d 1, 8 (1st Cir. 2003) (noting the split among courts as to whether punitive damages can be imposed on a creditor when the debtor is a corporation).

4. See Michael J. Lichtenstein, *Violations of the Automatic Stay: Void or Voidable?*, 23-May AM. BANKR. INST. J. 20 (May 2004) (discussing the consequences of actions taken in violation of the automatic stay and differing approaches that courts use in determining the validity of those actions).

5. See 11 U.S.C. §362(d)(1).

6. See 11 U.S.C. §362(d)(2). If the bankrupt junior lender has filed a chapter 7 bankruptcy case, then the senior creditor will only have to show that the bankrupt junior lender's lien is unsecured because the debtor's assets will be liquidated and there is no prospect of reorganization.

7. See 11 U.S.C. §361 (defining adequate protection).

8. See *In re Kerns*, 111 B.R. 777, 787 (S.D. Ind. 1990); see also *In re Robinson*, 169 B.R. 356 (E.D. Va. 1994) (setting forth a balancing test to determine whether cause exists to lift the automatic stay).

9. *In re Cardinal Indus. Inc.*, 105 B.R. 834 (Bankr. S.D. Ohio 1989); *In re Fidelity Mortgage Investors*, 550 F.2d 47 (2d Cir. 1976).

10. 397 B.R. 804, 808 (Bankr. N.D. Tex. 2008).

11. 140 B.R. 387 (E.D. Va. 1992), aff'd, 988 F.2d 498 (4th Cir. 1993).

12. *In re Comcoach Corp.*, 698 F.2d 571 (2d Cir. 1983); see also *In re Geris*, 973 F.2d 318, 320-21 (4th Cir. 1992) (allowing a noteholder to foreclose on a deed of trust while leaving the debtor/guarantor's obligation under a note securing the deed of trust in tact). But see *In re Bialac*, 712 F.2d 426 (9th Cir. 1983) (holding that a violation of the automatic stay occurred even though the debtor was not named in the foreclosure action because the foreclosure affected the debtor's equitable right to cure and redeem the foreclosed note).

13. *In re Coronet Capital Co.*, 142 B.R. 78 (Bankr. S.D.N.Y. 1992).a