Paul H. Zumbro

Conducting Review of the Collateral from a Secured Lender's Perspective

by Paul H. Zumbro, Christopher J. Kelly, and Stephanie A. Marshak, Cravath, Swaine & Moore LLP

Secured creditors enjoy several advantages in bankruptcy cases over unsecured creditors. First, secured creditors are at the top of the waterfall in a bankruptcy case vis-à-vis general unsecured creditors. Specifically, a secured claim is entitled to be paid in full out of the proceeds of the collateral that secures it before any of those proceeds may be used to pay unsecured claims. See 11 U.S.C. §§ 725, 726 and 1129; Monarch Air Serv., Inc. v. Solow (In re Midway Airlines, Inc.), 383 F.3d 663, 669 (7th Cir. 2004) ("Secured claims are paid (or the collateral returned) before any distribution is made to priority claimants or to unsecured general creditors"); Old West Annuity & Life Ins. Co. v. Apollo Group, 605 F.3d 856, 865 (11th Cir. 2010). Second, if a claim is oversecured (meaning that the value of the collateral exceeds the face amount of the claim on the date that the bankruptcy petition is filed), then despite the general rule that interest that accrued after the petition date is not allowable, the allowed secured claim includes interest accrued after the petition date, plus reasonable costs and attorneys' fees as provided for in the contract, up to the value of the collateral. 11 U.S.C. § 506(b). Finally, in a chapter 11 case, a chapter 11 plan cannot be "crammed down" on a class of secured creditors that did not accept the chapter 11 plan, unless the plan proponent can show that the secured creditor is receiving a combination of cash or secured debt equal to the value of its collateral. See 11 U.S.C. § 1129(b)(2)(A). In such "cram down" circumstances, the secured creditor cannot be compelled to receive a distribution of new equity interests in the reorganized debtor without its consent. Cf. 11 U.S.C. § 1129(b)(2)(A) (which requires that holders of secured claims retain liens on their collateral, receive liens on the proceeds of the sale of their collateral or otherwise receive the "indubitable equivalent" of their secured claims) with 11 U.S.C. § 1129(b)(2)(B*)* (which generally provides that no holder of any claim or interest junior to the general unsecured creditor class may receive any property unless the general unsecured creditor class receives the full value of its claims, but does not otherwise specify the nature of the property that may be distributed in satisfaction of the general unsecured claims).

Accordingly, it is very important that a creditor that has been granted a security interest in a borrower's assets confirm that its security interest is properly perfected before a bankruptcy case is commenced. Unperfected security interests are avoidable under the so-called strong-arm powers set forth in section 544 of the Bankruptcy Code, and security interests that become perfected more than 30 days after the loan is made and within 90 days before bankruptcy are avoidable under the preference provision of section 547 of the Bankruptcy Code. See 11 U.S.C. §§ 544(a)(1) and (a)(3) (granting the trustee the powers of a hypothetical judgment lien creditor or a bona fide real property purchaser as of the filing date); 11 U.S.C. § 547(b)(4)(A) (allowing a trustee to avoid certain transfers of an interest of the debtor in property made on or within 90 days before the date of filing of the petition); 11 U.S.C. § 547(e)(2)(A) (defining the time of a transfer for preference purposes as "the time such transfer takes effect . . . if such transfer is perfected at, or within 30 days after, such time").

Below is a list of questions that a creditor who has been granted a security interest should ask after the transaction has closed and from time to time thereafter to confirm that its security interest has been properly perfected under applicable law:

1. For collateral on which a security interest can be perfected by the filing of a UCC financing statement, have lien searches been conducted in the appropriate jurisdictions to confirm that the UCC financing statements have been filed?
2. When were the UCC financing statements originally filed? UCC financing statements are effective for five years, and UCC-3 continuations should be filed within the six-month period prior to the lapse date (timely UCC-3 continuations do not re-start the 90-day preference period). If the financing statements have lapsed, new financing statements will need to be filed (this would re-start the 90-day preference period).

3. Does the description of collateral in the UCC financing statement conform with the assets that were pledged as collateral to the creditor?
4. Has the borrower or any guarantor changed its name or jurisdiction of organization? If so, it may be necessary to file a UCC-3 amendment to reflect the name change, or a new financing statement if the entity has changed its state of organization (timely UCC-3 amendments for name changes do not re-start the 90-day preference period; filing a new financing statement does re-start the 90-day preference period). Note that a secured creditor generally remains perfected for four months following a name or jurisdiction change. U.C.C. § 9-507(c)(2) (2010); U.C.C. § 9-316(a)(2) (2010).
5. Has the borrower or any guarantor acquired any new subsidiaries or other businesses? If so, supplements to the collateral documents may need to be executed.
6. Did the borrower grant a security interest in real estate? If so, was the mortgage or deed of trust recorded in the local recording office where the property is located? Furthermore, were UCC fixture filings recorded at the county level (if not already covered by the applicable mortgage or deed of trust)?
7. Did the borrower grant a security interest in intellectual property? If so, was a security agreement (or a short-form thereof) recorded with the U.S. Patent and Trademark Office and/or the U.S. Copyright Office?
8. Did the borrower grant a security interest in deposit, security or commodities accounts? If so, is there a control agreement in place or did the creditor secure possession or control over the deposit, security or commodities account in another manner? Alternatively, for security accounts, did the creditor become the entitlement holder or the borrower's securities intermediary?
9. Did the borrower grant a security interest in a commercial tort claim in which the borrower is the plaintiff? If so, is such a commercial tort claim appropriately identified and included in the collateral description of the financing statement?
10. Did the borrower grant a security interest in motor vehicles that are not inventory of the borrower? If so, is the creditor's name identified on the certificate of title?
11. Did the borrower grant a security interest in certificated securities? If so, has the creditor taken control of such certificated securities through possession and delivery of a stock power? Are the names indicated on pledged stock certificates accurate and up-to-date to reflect any corporate name changes?
12. Did the borrower grant a security interest over instruments, tangible chattel paper, goods, equipment, money or negotiable documents? If so, has the creditor taken possession of these assets?
13. Did the borrower grant a security interest in electronic chattel paper? If so, has the creditor taken control over the electronic chattel paper?
14. Did the borrower grant a security interest in uncertificated securities? If so, is there an agreement in place, signed by the issuer and acknowledged by the owner, where the issuer agrees to comply with the instructions of the creditor without further consent of the owner?
15. Did the borrower grant a security interest in letter of credit rights? If so, did the issuer of the letter of credit consent to an assignment of proceeds of the letter of credit?
16. Did the borrower grant a security interest in goods held by a bailee that are not represented by negotiable documents? If the goods are not represented by any documents, did the bailee acknowledge in writing that the goods are being held for the creditor? If the goods are represented by a non-negotiable document, was there either (a) issuance of the non-negotiable document in the name of the secured party (as cosignee of a straight bill of lading or the person to whom delivery would be made under a non-negotiable warehouse receipt) or (b) the bailee's receipt of notification of the secured party's interest?
17. Did the borrower grant a security interest in insurance? If so, was notice given to and acknowledged by the insurer and was the creditor named as an additional insured or a loss payee?
18. Did the borrower grant a security interest in any foreign collateral? Have the local foreign laws governing perfection been satisfied?

It is critically important from the secured creditor's perspective to ask these questions and to implement any necessary corrective measures before any bankruptcy filing as the automatic stay that is triggered upon a bankruptcy filing will generally prevent the creditor from taking any steps to perfect liens post-petition. See 11 U.S.C. § 362. If, as a result of this collateral review, the creditor identifies any defects in the collateral package, the creditor should act to remedy those defects as soon as possible, keeping in mind that the bankruptcy trustee or debtor-in-possession may be able to avoid as a preferential transfer any security interest that has been perfected within 90 days (or one year, if the creditor is an insider) of the borrower's filing of a bankruptcy case. 11 U.S.C. §547(b). The unsecured creditors' committee, appointed once a bankruptcy filing has been made, is tasked with investigating

potential untapped recoveries for unsecured creditors. See generally 11 U.S.C. § 1103(c). Thus, counsel for the unsecured creditors' committee will scrutinize the collateral package for any defects in perfection. Minimizing such defects is the key to ensuring the secured creditor in fact enjoys the advantages the Bankruptcy Code and other applicable law provide for secured creditors relative to unsecured creditors.