



*Creditors Rights, Loan
Enforcement and
Creditor Bankruptcy
Representation*



www.polsinelli.com

The Automatic Stay in Chapter 11
Bankruptcy and Actions Against
Co-Obligors: When is Stay-Relief
Necessary?

Page 2

Impacting the (Off) Balance Sheet:
Participating Interests
and FAS 166

Page 5



May 2010

Lender's EDGE

Ideas and Insights for Dealing with Distressed Assets

The Creditors Rights, Loan Enforcement and Creditor Bankruptcy Representation practice group provides these e-communications periodically to keep you updated on recently adopted legislation, important issues dealing with distressed assets and key changes in the law.

To learn more about the Creditors Rights, Loan Enforcement and Creditor Bankruptcy Representation practice group, click [here](#) or visit our Web site at www.polsinelli.com.

The Automatic Stay in Chapter 11 Bankruptcy and Actions Against Co-Obligors: When is Stay-Relief Necessary?

The automatic stay in bankruptcy stays all actions by a creditor to collect a debt against a debtor that arose before the filing of the bankruptcy case. But, does the automatic stay prohibit lenders who had the foresight to require guarantors or co-makers on a loan from proceeding against them after the borrower company files Chapter 11 bankruptcy? The answer is generally “no”, except in unusual circumstances.

An example helps illustrate the point. Lender makes a commercial loan to Borrower LLC. Borrower LLC is owned by two brothers, Barry and Bryce Borrower, each of whom own a 50 percent membership interest in Borrower LLC. Times are tough economically, and Borrower LLC defaults on its \$2 million loan obligation owed to Lender. Discussions for a workout of the loan ultimately fail, and Lender files for foreclosure of Borrower LLC's assets. A sale is pending.

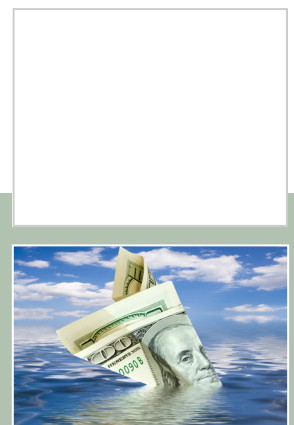
Lender has another source of collateral securing the loan as well. In this particular transaction, Lender received a pledge from each of Barry and Bryce of their membership interests in Borrower LLC. Pursuant to the pledge agreements, Lender has scheduled a foreclosure sale, under Article Nine of the Uniform Commercial Code, of Barry's and Bryce's membership interests in Borrower LLC.

On the eve of the foreclosure sales, Borrower LLC files Chapter 11. The automatic stay of the United States Bankruptcy Code applies, and the foreclosure sale of Borrower LLC's assets is stayed.

Barry and Bryce, however, do not file personal bankruptcies. Therefore, their membership interests in Borrower LLC are not property of any bankruptcy estate. The issue before Lender is whether it can, without violating the stay in the Borrower LLC bankruptcy, proceed with foreclosure of Barry's and Bryce's membership interests.

It is generally recognized that the correct answer is as follows: Barry's and Bryce's membership interests are not property of the estate in the Borrower LLC bankruptcy; the bankruptcy court in the Borrower LLC bankruptcy does not have jurisdiction over Barry's and Bryce's property, including the membership interests; and, even though the protections of the automatic stay, set forth in Section 362 of the United States Bankruptcy Code, are designed to be very broad, the automatic stay in the Borrower LLC bankruptcy does not stay Lender's foreclosure of Barry's and Bryce's membership interests. None of this is to say, however, that Barry and Bryce will not try to make use of the Borrower LLC bankruptcy to obtain a stay of foreclosure of their membership interests, so that they can retain control of Borrower LLC.

Section 362(a) of the Bankruptcy Code lists eight types of actions that are stayed by the filing of a bankruptcy petition. Those actions may be summarized as follows:



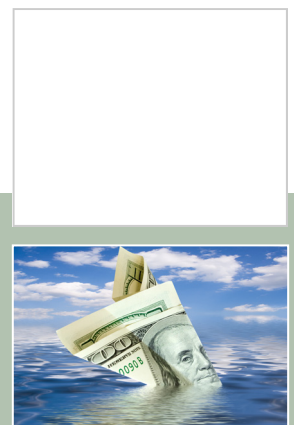
- (1) the commencement or continuation of any process (including judicial process) against the debtor in bankruptcy or to recover a claim against the debtor in bankruptcy;
- (2) the enforcement against the debtor or against property of the estate of a judgment obtained before the bankruptcy case commenced;
- (3) any action to obtain possession of property of the estate or to exercise control over property of the estate;
- (4) any action to create, perfect or enforce a lien against property of the estate;
- (5) any action to create, perfect or enforce a lien against any property of the debtor to the extent such lien secures a prepetition claim;
- (6) any action to collect a claim against the debtor that arose before the bankruptcy case commenced;
- (7) any action to offset any debt owed to the debtor that arose before the bankruptcy case commenced; and
- (8) the commencement or continuation of an action before the United States Tax Court concerning a corporate debtor's tax liability that may be determined by the Bankruptcy Court, or concerning an individual debtor's tax liability for a tax period that ended before the bankruptcy case commenced.

Lender's foreclosure of Barry's and Bryce's membership interests is not stayed by Section 362(a)(1), because foreclosure of their interests is not an action against the debtor in bankruptcy. Borrower LLC is the debtor; Barry and Bryce are not. In addition, foreclosure of the membership interests is not an action to recover on a claim against the debtor; it is an action to recover on a claim against Barry and Bryce, in their capacity as pledgors of their ownership interests.

Section 362(a)(2) clearly does not apply to stay the foreclosure, which is not an action against either the debtor (Borrower LLC) or property of the estate.

Section 362(a)(4) does not stay the foreclosure of the membership interests. Section 362(a)(4) stays the enforcement of a lien, but only stays enforcement of a lien against property of the estate. However, in this case, the lien being enforced is a lien on Barry's and Bryce's membership interests, which are not property of the estate in the Borrower LLC bankruptcy. The same rationale applies to Section 362(a)(5), which only stays enforcement of liens against property of the debtor, Borrower LLC.

Section 362(a)(6) does not stay the foreclosure. The foreclosure is an action to collect a claim against Barry and Bryce, in their capacity as pledgors of their membership interests. It is not an action to collect a claim against the debtor, Borrower LLC.



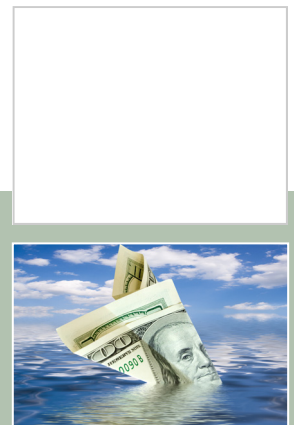
Section 362(a)(7) and (a)(8) are clearly not applicable, as the foreclosure sale does not involve an offset or a tax court proceeding.

Some have argued that subsections (a)(1) and (a)(6) should be held to apply because, even though Lender would be foreclosing against property of Barry and Bryce, such an action is designed to recover on a claim against Borrower LLC. However, Lender does have a "claim" against Barry and Bryce by virtue of having a right against Barry's and Bryce's property, and the Code does not preclude Lender from enforcing its claims against Barry and Bryce. Further, resort to collateral pledged by persons or entities outside of bankruptcy merely reduces the obligations of the debtor in bankruptcy, Borrower LLC, and therefore does not harm or diminish the estate in any manner. Most tellingly, however, certain chapters of the Code, such as Chapters 12 and 13, have specific sections that impose the stay for the benefit of co-obligors. Chapter 11 has no such specific section, indicating that the legislators designed the Code such that a Chapter 11 filing by Borrower LLC would not result in imposition of a stay for the benefit of co-obligors Barry and Bryce. Last, under Section 524 (e) of the Code, a discharge in favor of a bankrupt debtor (like Borrower LLC) does not affect the liability of any other person or entity (such as Barry and Bryce) who is liable on the same debt.

This leaves Section 362(a)(3) of the Code. This section prohibits acts to obtain possession of property of the estate or to exercise control over property of the estate. Most owners of entity debtors in bankruptcy have argued that the foreclosure of ownership interests is an action designed to obtain possession of property or the estate or to exercise control over property of the estate. This argument, too, normally fails, but lenders should proceed carefully taking into account this specific subsection.

Foreclosure, in and of itself, of Barry's and Bryce's ownership interests does not result in Lender obtaining possession of Borrower LLC's property. Similarly, foreclosure, in and of itself, does not result in Lender exercising control over Borrower LLC's property. However, *after* such foreclosure, if Lender, as the new owner of 100 percent of the membership interests in Borrower LLC, desires to take possession (which is not likely) of any of Borrower LLC's property, Lender should consider seeking stay relief before doing so. Likewise, if Lender, as the new owner of 100 percent of the membership interests in Borrower LLC, desires to exercise control over (more likely) property of the estate, Lender should consider seeking stay relief before doing so.

Thus, bankruptcy courts generally (absent "extraordinary circumstances") will not interfere with lenders' foreclosures of membership interests (or other ownership interests, such as stock or partnership interests) if the owners of those interests are not themselves in bankruptcy. However, following foreclosure, lenders should take care before acting further without obtaining stay relief. For instance, Lender, following foreclosure, may naturally desire to appoint a new managing member of Borrower LLC, who will then be the point person in the reorganization process, who may formulate the plan for dealing with other creditors, etc. This action could be considered to be an action to exercise control over the debtor's property, necessitating stay relief, and some courts will consider it to be such. (Others may not, the reason being that, if any person owning or in control of a debtor needs stay relief in order to "exercise control" in this manner, then even the *original owners*, Barry and Bryce, would need stay relief before acting in such a manner).



Impacting the (Off) Balance Sheet: Participating Interests and FAS 166

Introduction

In June 2009, the Financial Accounting Standards Board issued Financial Accounting Standard (FAS) 166. This new Standard, along with FAS 167, changes the way that banks account for securitized assets that are currently excluded from their balance sheets. The Standard effectively places new rules on the terms of loan participation agreements that every institution should carefully observe. As a result, it significantly limits what qualifies as a “participating interest” for purposes of derecognizing transferred assets.

The new Standard is effective for an entity's first annual reporting period beginning after November 15, 2009. For calendar year filers, this Standard became effective on January 1, 2010. The Standard amends its predecessor, FAS 140, and imposes requirements on terms of loan participation agreements that are executed or modified after that date. The Standard applies to transfers that occur on or after the effective date.

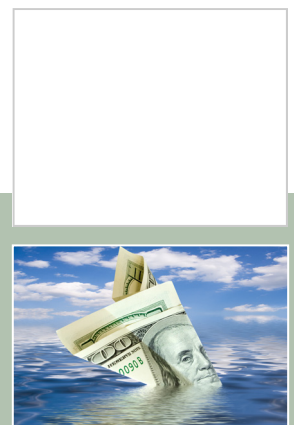
If your institution enters into participation agreements, is involved in guaranteed mortgage securitizations, or has an entity that is defined as a QSPE (qualifying special-purpose entity) under FAS 140, this Rule could impact you in various ways. In addition to eliminating the QSPE (Qualified Special Purpose Entity) concept and making other changes, the Standard now provides some guidance as to what qualifies as a “participating interest” for purposes of derecognizing transferred assets. Under the new Standard, institutions may derecognize a portion of a transferred asset only if it qualifies as a participating interest. Additionally, the transfer must meet the conditions for surrender of control of this interest, further narrowing opportunities to derecognize transferred assets. This article explores the new conditions on participating interests and their transfers.

Participating Interests

Under the predecessor FAS 140, the Board provided no prescriptive guidance as to what qualifies as a participating interest. However, the new Standard requires the transfer to meet certain conditions for a participating interest.

FAS 166 defines a participating interest as a portion of a financial asset that meets the following conditions:

- (1) *Conveys proportionate ownership rights with equal priority to each participating interest holder.*
- (2) *Involves no recourse (other than standard representations and warranties) to, or subordination by, any participating interest holder.*
- (3) *Does not entitle any participating interest holder to receive cash before any other participating interest holder.*



See FASB, Statement of Financial Accounting Standards No. 166, Accounting for Transfers of Financial Assets, June 2009, p.2. See also FAS 166, ¶ 8B. It is also important to note that a participating interest will not allow a party to pledge or exchange the entire financial asset, “*unless all participating interest holders agree to pledge or exchange the entire financial set.*” See FAS 166, ¶ 8B(d).

Institutions should heed the effect of these conditions on cash flows, particularly with respect to their priority and division to participating interest holders. Cash flow must be proportionately distributed to the participating interest holders, all of whom must have the same priority. Take the following example:

In the case of an individual loan in which the borrower is required to make a contractual payment that consists of a principal amount and interest amount on the loan, the transferor and transferee shall share in the principal and interest payments on the basis of their proportionate ownership interest in the loan. In contrast, if the transferor is entitled to receive an amount that represents the principal payments and the transferee is entitled to receive an amount that represents the interest payment on the loan, that arrangement would not be consistent with the participating interest definition because the transferor and transferee do not share proportionately in the cash flows received from the loan.

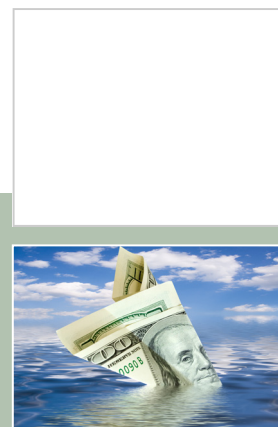
FAS 166, ¶ 26D. The Standard allows for some exceptions, such as cash flow paid for compensation for services or for cash flow allocated to third-party guarantors for guarantee fees. See FAS 166 ¶¶ 8B, 26D, 26H.

The Standard's condition prohibiting subordination may also be of interest. As stated, a participating interest involves no subordination by any participating interest holders. Thus, a provision requiring the transferor to reimburse premiums paid by the transferee if the asset is prepaid within a defined timeframe would fail to meet the definition of a participating interest. See FAS 166, ¶ 26G.

Institutions should also be concerned with the restrictions on recourse because these could result in characterizing the transfer as a secured borrowing, as opposed to a sale. See FAS Statement Q & A, p. 160. Under the new Standard, a participating interest holder can have no recourse “*other than standard representations and warranties[.]*” See FAS 166, ¶ 8B(b). The Board also excluded “*ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits received by any participating interest holder*” and independent third-party guarantees. See FAS 166, ¶ 8B, 26H. It is important to note that some recourse issues remain open. For example, the effect of a limited recourse provision may vary by jurisdiction. “*In some jurisdictions, transfers with full recourse may not place transferred financial assets beyond the reach of the transferor, but transfers with limited recourse may.*” See FAS 166, Appendix A, ¶ 113. An issue like this would affect the transferor's surrender of control under FAS 166 ¶9, explained below.

Surrender of Control

In addition to meeting the above conditions for a participating interest, an institution that transfers loan participations must also meet a second set of conditions before derecognizing an asset. Essentially, it must have surrendered control of the asset. Under FAS 166, a surrender of control



must meet the following conditions. First, the transferred financial assets must be isolated. Second, the transferee must have control. And, third, the transferor must have surrendered control. These criteria are rolled over from the predecessor FAS 140, but the new Standard expands them. For instance, the drafters set forth an isolation analysis to guide an institution's determination. That is, isolation means that the asset must be "*beyond the reach of the transferor or its creditors, even in bankruptcy.*" See FAS 166, ¶ 9.

Other Issues

Institutions should also note some other changes to the Standard. The concept of a qualifying special-purpose entity (QSPE) is eliminated for FAS 166 purposes. Therefore, former QSPEs "*should be evaluated for consolidation by reporting entities on and after the effective date in accordance with applicable consolidation guidance.*" FASB Statement, p. ii. Special provisions relating to guaranteed mortgage securitizations have also been removed. Now, some of those securitizations must be "*treated the same as any other transfer of financial assets*" within the scope of FAS 166. FASB Statement p. iii.

Conclusion

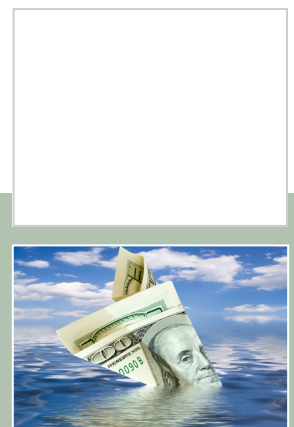
Institutions should be mindful of these conditions and their effect on participation agreements. Failure to meet these conditions will result in an accounting for the transfer as a secured borrowing. See FAS 166, ¶ 12. Additionally, an institution's legal lending limits may be impacted if a transaction is treated as a secured borrowing rather than a transfer of a participating interest. These narrower standards will ultimately result in less derecognizing of assets, and an impact on the capital-to-liability ratio of lending institutions.

For More Information:

If you have questions or would like additional information regarding creditors rights, loan enforcement or creditor bankruptcy representation, please contact:

- Brett D. Anders — 816.360.4267 | banders@polsinelli.com
- Michael A. Campbell — 314.552.6805 | mcampbell@polsinelli.com

or any member of our Creditors Rights, Loan Enforcement and Creditor Bankruptcy Representation practice group.



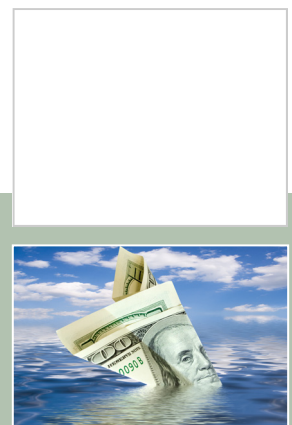
About Polsinelli Shughart's Creditors Rights, Loan Enforcement and Creditor Bankruptcy Representation PRACTICE GROUP

Brett D. Anders Practice Area Vice-Chair <i>Kansas City</i> 816.360.4267 banders@polsinelli.com	Aaron C. Jackson <i>Kansas City</i> 816.360.4277 ajackson@polsinelli.com	Andrew J. Nazar <i>Kansas City</i> 816.395.0641 anazar@polsinelli.com	Terrance M. Summers <i>Kansas City</i> 816.360.4212 tsummers@polsinelli.com
Michael A. Campbell Practice Area Vice-Chair <i>St. Louis</i> 314.552.6805 mcampbell@polsinelli.com	G. Edgar James <i>Kansas City</i> 816.395.0661 ejames@polsinelli.com	Thomas J. O'Neal <i>Springfield</i> 417.829.3801 toneal@polsinelli.com	Jerry L. Switzer Jr. <i>Chicago</i> 312.873.3626 jswitzer@polsinelli.com
Andrew M Bond <i>Kansas City</i> 816.360.4246 abond@polsinelli.com	Shanti M. Katona <i>Wilmington</i> 302.252.0924 skatona@polsinelli.com	Anthony C. Porcelli <i>Chicago</i> 312.873.3629 aporcelli@polsinelli.com	Michael M. Tamburini <i>Kansas City</i> 816.360.4185 mtamburini@polsinelli.com
Michelle L. Clardy <i>St. Louis</i> 314.552.6830 mclardy@polsinelli.com	Scott S. Magdziak <i>Kansas City</i> 816.360.4105 smagdziak@polsinelli.com	Jason L. Pyrz <i>Chicago</i> 312.873.3645 jpyrz@polsinelli.com	Angela S. Taylor <i>Kansas City</i> 816.360.4143 ataylor@polsinelli.com
Sherry K. Dreisewerd <i>St. Louis</i> 314.552.6806 sdreisewerd@polsinelli.com	Ryan J. Mason <i>St. Louis</i> 314.552.6884 rmason@polsinelli.com	Peter J. Schmidt <i>Chicago</i> 312.873.3627 pschmidt@polsinelli.com	Jennifer K. Vath <i>Kansas City</i> 816.360.4287 jvath@polsinelli.com
Robert J. Edwards <i>Kansas City</i> 816.360.4164 redwards@polsinelli.com	Matthew R. Moriarity <i>Kansas City</i> 816.360.4184 mmoriarity@polsinelli.com	Scot J. Seabaugh <i>St. Louis</i> 314.552.6845 sseabaugh@polsinelli.com	Christopher A. Ward <i>Wilmington</i> 302.252.0922 cward@polsinelli.com
David D. Ferguson <i>Kansas City</i> 816.360.4311 dferguson@polsinelli.com	Jason A. Nagi <i>New York</i> 212.644.2092 jnagi@polsinelli.com	Jean Soh <i>Chicago</i> 312.873.3628 jsoh@polsinelli.com	Lynn K. White <i>St. Louis</i> 314.552.6804 lwhite@polsinelli.com
Daniel J. Flanigan <i>Kansas City New York</i> 816.360.4260 212.644.2090 dflanigan@polsinelli.com			
Howard B. Gelt <i>Denver</i> 720.931.8143 hgelt@polsinelli.com			
Amy E. Hatch <i>Kansas City</i> 816.360.4178 ahatch@polsinelli.com			

Lenders in today's market are under severe stress from rising defaults, distressed portfolios and problem credits of all types. Attorneys in the Creditor's Rights, Loan Enforcement and Creditor Bankruptcy Representation Law group have assisted numerous lenders with creative remedies that help lenders maximize their recoveries.

As one of the largest and most experienced creditors rights group in the Midwest, we offer our clients the highest level of knowledge and most comprehensive set of creative solutions for their troubled loans. In addition, we communicate with our clients in an efficient and effective way through AMS extranets, which allow us to provide them with reports and the ability to upload documents and information in a safe and secure environment.

To learn more, visit us online at www.polsinelli.com.



If you know of anyone who you believe would like to receive our e-mail updates, or if you would like to be removed from our e-distribution list, please contact Therese O'Shea via e-mail at toshea@polsinelli.com.

Polsinelli Shughart PC provides this material for informational purposes only. The material provided herein is general and is not intended to be legal advice. Nothing herein should be relied upon or used without consulting a lawyer to consider your specific circumstances, possible changes to applicable laws, rules and regulations and other legal issues. Receipt of this material does not establish an attorney-client relationship.

Polsinelli Shughart is very proud of the results we obtain for our clients, but you should know that past results do not guarantee future results; that every case is different and must be judged on its own merits; and that the choice of a lawyer is an important decision and should not be based solely upon advertisements.

Polsinelli Shughart® is a registered trademark of Polsinelli Shughart PC.

About Polsinelli Shughart PC

With more than 500 attorneys, Polsinelli Shughart PC is a national law firm that is a recognized leader in the areas of business litigation, financial services, bankruptcy, real estate, business law, labor and employment, construction, life sciences and health care. Serving corporate, institutional and individual clients regionally, nationally and worldwide, Polsinelli Shughart is known for successfully applying forward-thinking strategies for both straightforward and complex legal matters.

The firm can be found online at www.polsinelli.com.

