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in the news

Loan Enforcement and Creditors' Rights

December 2016

Lender's Edge Newsletter

In this Issue:

Enforcement of a Commercial Loan After the Property Securing the Loan is Sold or Transferred

Enforcement of due-on-sale clauses started growing in popularity in the 1970s as a result of instability in the economy and rising interest rates. To circumvent higher interest rates, borrowers resorted to alternatives to conventional bank financing, such as mortgage assumptions. Because of this trend, lenders began exercising their rights contained in the due-on-sale clauses of their loan documents and requiring the balance of their loans to be paid in full when properties were sold. In response, borrowers mounted challenges to such clauses as against public policy for unreasonably restraining alienation of property.

Unfortunately for lenders, certain courts began ruling that due-on-sale clauses were not to be enforced unless certain criteria were met – e.g. the lender showing that it was harmed by the transfer or that its enforcement was not "unreasonable." See *La Sala v. American Sav. & Loan Assn.*, 5 Cal.3d 864, 882 (1971) ("When such enforcement is not reasonably necessary to protect the security, the lender's use of the clause to exact collateral benefits must be held an unlawful restraint on alienation"). Even when the subject loan documents explicitly stated that the loan could be accelerated upon a "transfer" of any portion of the property, some state courts refused to enforce these due-on-sale provisions. The courts usually based their decisions on state policies that encouraged transferability of property. Therefore, any "unreasonable" restraint on the transfer of property was found to be unenforceable.

This changed with the passage of the Garn Act in 1982, which preempted state laws that prohibited the enforcement of due-on-sale provisions. *See, e.g., Aetna Cas. & Sur. Co. v. Valdosta Federal Sav. & Loan Ass'n*, 175 Ga. App. 614, 616 (1985) ("Georgia laws restricting the enforcement of 'due-on-sale' provisions have been pre-empted by the Garn-St. Germain Depository Institutions Act of 1982"); *Western Life Ins. Co. v. McPherson K.M.P.*, 702 F. Supp. 836, 840-41 (D.Kan. 1988) ("The Garn–St. Germain Act has preempted state restrictions on due-on-sale clauses involving all lenders"); *Warrington 611 Associates v. Aetna Life Ins. Co*., 765 F. Supp. 229, 235 (D.N.J. 1989) ("Warrington's reliance … is misplaced in that those cases were decided prior to a 1982 Act of Congress that declared, in preemption of state law, that due-on-sale clauses are valid and enforceable"). The Garn Act stated, in relevant part:

> Notwithstanding any provision of the constitution or laws (including judicial decisions) of any State to the contrary, a lender may enter into and enforce a contract containing a due-on-sale clause with respect to a real property loan ...
>
> The exercise by the lender of its option pursuant to such a clause shall be exclusively governed by the terms of the loan contract, and all rights and remedies of the lender and the borrower shall be fixed and governed by the contract.

12 U.S.C.A. § 1701j-3.

Under the Garn Act, the "transfers" covered are not limited to sales or other conveyances of fee title of the real property. Assuming proper language is contained in the loan documents, the Garn Act allows acceleration and enforcement of a commercial loan if any interest in the property is transferred. For example, if there is a stock transfer, membership interests in the borrower are transferred to another party, or if a junior lien or encumbrance is placed on the property, such transfers may trigger a lender's right to accelerate, and such acceleration may be protected under the Garn Act. See, *e.g., U.S. v. Med O Farm, Inc.*, 701 F.2d 88, 90 (9th Cir. 1983) (court rejected shareholders' argument that stock transfers do not trigger due-on-sale clause).

Even though the Garn Act went into effect more than 30 years ago, many lenders and attorneys still operate under the belief that acceleration and enforcement of a commercial loan based on certain transfers (such as a junior lien being placed on the property), is only allowed if the lender is able to prove that there is a resulting danger to the property and that lender's enforcement is "reasonable" under the circumstances. This is not the standard. The only thing the lender needs to show is that there was a transfer and said transfer was prohibited in the loan documents.

Considerations in Connection with Bankruptcy Remote Entities

The "bankruptcy remote entity" can be a useful tool for lenders to lower the risk profiles of their borrowers.

A bankruptcy remote borrower typically will, at the lender's request, include in its operating agreement a provision that requires a unanimous vote by the borrower's members before the borrower can seek bankruptcy protection. One of those members must be "independent" and approved by the lender at origination. This structure is intended to give the lender comfort that the borrower will not seek bankruptcy protection.

There are many benefits to this lending structure. By lowering the risk profile, higher-risk borrowers have a better chance of receiving financing. Likewise, already-creditworthy borrowers can get better terms, including better interest rates, by agreeing to a bankruptcy remote structure. In addition, the structure is often used in commercial real estate loans where the lenders intend not to retain the loans in their warehouses, but instead intend to sell them, together with other loans, as part of a loan securitization. This financing structure opens up markets to investors who otherwise might not participate in the financing marketplace, or find their options limited in such marketplace, which makes additional capital available to borrowers.

In *In re Doctors Hospital of Hyde Park, Inc.*, 507 B.R. 558 (Bankr. N.D. Ill. 2013), the court highlighted these benefits in upholding a bankruptcy remote provision. The court noted that bankruptcy remote borrowers simply are able to get a better deal because their risk profiles are improved, and it noted that bankruptcy remote entities encourage the securitization of loans. The court further recognized that "any tools for securitization of debt has several economic benefits, including stimulating loan supply, increasing the liquidity, allowing a broader range of investors to access a class of assets usually limited to banks, and increasing risk diversification." See also *In re Orchard at Hansen Park, LLC,* 347 B.R. 822, 826 (Bankr. N.D.Tex. 2006) (upholding provision in LLC agreement that required unanimous consent and vote of independent manager prior to filing bankruptcy petition); *In re NNN 123 North Wacker, LLC*, 510 B.R. 854, 859 (Bankr. N.D. Ill. 2014) (enforcing LLC agreement requiring approval of independent manager and unanimous consent of members to file bankruptcy petition because corporate formalities of LLC were observed); *In re Green Power Kenansville, LLC*, 2004 WL 5413067, at *4 (Bankr. E.D.N.C. Nov. 18, 2004) (upholding operating agreement provision that placed authority to put the corporation in any bankruptcy proceeding with independent manager); *accord In re Pasta Bar By Scotto II, LLC*, 2015 WL 7307246, at *3 (Bankr. S.D.N.Y. Nov. 19, 2015 (holding that provision in operating agreement requiring supermajority of LLC members to approve bankruptcy filing was enforceable and thus filing based only 50 percent approval was not authorized).

Notwithstanding the mutual benefits to lenders and borrowers alike, some recent bankruptcy court decisions have limited the use of bankruptcy remote lending. Those decisions seemingly ignore the benefits of bankruptcy remote lending and sometimes ignore state law applicable to borrowers' organizational documents; instead, they cite the notion that public policy forbids parties from agreeing to prohibit a bankruptcy filing. In *In re Bay Club Partners-472, LLC*, 2014 WL 1796688 (Bankr. D. Or. 2014), for example, the court refused to enforce bankruptcy remote provisions of an operating agreement because the provisions prohibited outright the borrower from filing a bankruptcy petition. In *In re Intervention Energy Holdings, LLC,* 2016 WL 318557662 (Bankr. D. Del. 2016), the court held that, because the independent member of the borrower was the lender, the bankruptcy remote provision effectively prohibited a bankruptcy filing. In *In re Lake Michigan Beach Pottawattamie Resort LLC,* 547 B.R. 899 (Bankr. N.D. Ill. 2016), the independent member was also the lender, and the borrower agreement allowed the lender to vote based solely on its own interests regardless of the borrower's needs. The court held that such a provision improperly amounted to a prohibition on bankruptcy filings and violated state law that places a fiduciary duty on LLC members to act in the LLC's best interests. *Id.*

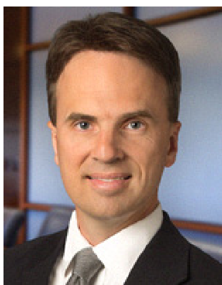
There is no doubt that an independent director in a borrowing entity should consider what duties he may have to the entity's owners – including potential fiduciary duties – before determining whether to vote in favor or against a contemplated Chapter 11 filing by the entity. If the independent director ultimately does vote for bankruptcy, he or she should plan to be able to demonstrate the process that led to its decision, and how that process took into account more than the lender's interests. And, if such a director indeed does breach his fiduciary duties, he should be held responsible to those owners to the extent provided by state law. None of this, however, alters the fact that state law governs the enforceability of a borrowing entity's operating agreement, and it is state law, rather than judicial notions of public policy or fairness, that should govern whether an entity has acted in accordance with its organizational document – or whether, by contrast, it has acted *ultra vires* – in filing a petition in Chapter 11. If the act of filing a Chapter 11 petition was *ultra vires* in the first place, then a strong case can be made that the bankruptcy judge, tempted to consider public policy rather than state law, is without jurisdiction to make the very determination in the first place.

Also, in connection with forbearance or other workout agreements that enact "independent director" or, similarly, "consent to stay relief" provisions, bankruptcy courts should take into account the benefits that flowed to the borrowing entity in connection with such an agreement. This is important because it may be the lender's and borrower's very execution of that agreement that staved off a bankruptcy in first place and enabled the borrower to live another day. Vendors and creditors, both secured and unsecured, likely were not parties to any such agreement, and thus, at least as to "consent to stay relief" provisions, their legitimate views regarding the pending Chapter 11 and potential reorganization also should be taken into account. Equity holders, however, are another matter. The entity owned by them consented to such provisions as part of a workout – and received the benefits of such workout. Bankruptcy courts should give the company's equity holders little consideration when they later blithely contend that their company should not be bound by bankruptcy remote provisions or by consent to stay relief provisions.

Lenders should avoid provisions in their loan documents and workout agreements that outright prohibit bankruptcy – such provisions go too far. Lenders should also avoid simply placing themselves on a borrower's board of directors. By the same token, however, bankruptcy remote provisions should be given fair consideration by bankruptcy courts, which should be mindful of the doctrine of *ultra vires* – and of their own jurisdiction – when considering them. The proper consideration may well be whether the independent director acted in accord with applicable state law in determining not to vote in favor of a Chapter 11 filing (and whether the company's owners may have claims against him), rather than whether a filing debtor's organizational document can be simply cast aside for the sake of notions of public policy that are inconsistent with applicable state law.

For More Information

For questions regarding this information, please contact the author below, a member of Polsinelli's **Loan Enforcement and Creditors' Rights** practice, or your Polsinelli attorney.



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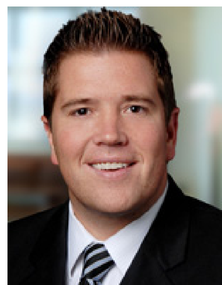

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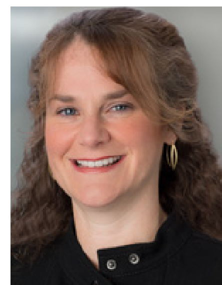

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Polsinelli has one of the largest creditors' rights practices in the nation. Our lawyers are situated from coast to coast, from New York to Los Angeles, and have practiced for more than 28 years in state courts, federal courts, and bankruptcy courts in more than 40 states. Our lawyers practice law with an eye – always – toward the business objectives of our clients. We realize that lenders enforcing their rights with respect to special assets are looking to remain constantly informed, want to know their alternatives, and want to maximize return in the shortest period of time and in the most cost-efficient manner possible. Accordingly, we can tell you about differences in enforcement procedures from state to state, the amount of control a lender can expect to assert in connection with those procedures, and the expected timing and cost of such procedures. New York, Dallas, Chicago, and Los Angeles are different places, and they bring diferent experiences to enforcing lenders. We can tell you what to expect in each of those locaions, and everywhere in between.

Maximization of recovery – and its flipside, minimizatoon of loss severity – is not simply about foreclosures and suits on promissory notes and guaranties, although those remedies are very important to lenders. It is also about speed, for time of resolution is the single most important contributor to loss severity. It is also about preservation of assets during the period of time that it takes to enforce those ultimate remedies. We know this, and we have assisted lenders with moving quickly to protect their collateral – obtaining the appointments of receivers, obtaining restraining orders, obtaining orders of replevin, and obtaining other forms of extraordinary relief that are designed to preserve collateral, and sometimes even add value to it, pending disposition.

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**2016 BTI Client Service A-Team Report*

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