THE
NATIONAL LAW REVIEW

When and How Can Chapter 7 Bankruptcy Trustee Liquidate Your Collateral?

Thursday, May 19, 2016

So you are chugging along with a foreclosure action (either on real and/or personal property) only to be stopped in your tracks by the borrower filing a voluntary *Chapter 7 bankruptcy* petition. The usual, immediate thought is – "better contact our bankruptcy counsel to obtain relief from the automatic stay." Well, perhaps, or perhaps you might want to contact the Chapter 7 Trustee first (either directly or through your bankruptcy counsel). Why? Maybe the Chapter 7 Trustee would be interested in liquidating that collateral for you though the bankruptcy system.

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As an initial matter, it is universally recognized that a Chapter 7 Trustee may not administer fully encumbered assets, and especially not solely for the benefit of the secured creditor. As such, a Chapter 7 Trustee should generally abandon the property, not administer it, because it will not produce any benefit to unsecured creditors.

Ah, but therein lies the hook – can there be a benefit for unsecured creditors?

Despite the prohibition against the sale of fully encumbered property, Chapter 7 Trustees may seek to justify their liquidating the collateral through a negotiated "carve-out" agreement with the secured creditor. By the "carve-out" agreement, the secured creditor can agree to have some portion of its lien proceeds be paid to others. However, there has to be funds making the way down to unsecured creditors.

Notably, the so-called "carve-out" agreements are typically embodied in a stipulation you negotiate with the Chapter 7 Trustee and require Bankruptcy Court approval. The relatively recent Ninth Circuit Bankruptcy Appellate Panel (BAP) decision underscores that these agreements will not automatically be approved just because the secured creditor consents. In re KVN Corp., 514 B.R. 1 (BAP 9th Cir. 2014). As the BAP noted, there must be a meaningful distribution to creditors and by that to unsecured creditors. This conclusion was recently followed by the Eastern District of New York Bankruptcy Court in the In re All Island Truck Leasing Corp. decision. 2016 Bankr. LEXIS 634, (Bankr. E.D.N.Y. 2016) (noting an agreement to pay administrative claims only is insufficient).

Naturally, and logically, a typical lender question is

Why should I give up some of my proceeds to other creditors?"

Well, that will depend on a number of factors, but here are some of the benefits of potentially negotiating that "carve-out" agreement with the Chapter 7 Trustee.

First, timing – the Trustee, depending on your state and how far you were in your foreclosure, can probably liquidate the asset quicker through either a private sale or auction process. I was recently involved in a situation where the Trustee liquidated a multi-million dollar vacation home in less than 4 months. The state court foreclosure process would have taken easily twice as long.

Second, value — in many cases buyers will pay a higher amount to buy the asset through the bankruptcy process obtaining a 363 Order with the asset completely free and clear of all liens, claims and encumbrances. These sales tend to, generally speaking, do better than state court auction sales. Related, the Chapter 7

Trustees often, especially in the auction area, have far more notice and publication than in a state court process.

Third, cost evaluation — what you might have to give up, depending on the priority claims ahead on unsecured creditors, might be similar or less than the fees and expenses you would otherwise incur pursing the state court foreclosure route. Obviously each case will vary in terms of (a) the amount of administrative or priority claims that need to be covered and (b) how much needs to go to unsecured creditors in order for the Bankruptcy Court to be able to conclude there will be a "meaningful distribution" to unsecured creditors.

In concluding, there is no bright-line test as to what will be considered a "meaningful distribution" and this will be analysis you need to consider on a case-by-case basis. Also, it is worth noting that not all bankruptcy judges or Chapter 7 Trustee like this concept, but they are certainly becoming much more common (and there is now some good appellate authority by the BAP Decision noted above).