LENDING AND RESTRUCTURING ALERT
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NY Federal Court Limits Requirement on Creditor to Collect

Accounts Receivable in a Commercially Reasonable Matter Article 9 of the Uniform Commercial Code ("UCC") generally requires a secured creditor to liquidate accounts receivable collateral in a commercially reasonable manner. But when does that requirement apply?

A Manhattan federal judge recently held that a secured creditor is obliged to make commercially reasonable collection efforts only if it takes possession and control over the collection of the accounts receivable, or if the borrower justifiably relies on the creditor's collection efforts. Thus, if the secured creditor obtains the exclusive right to collect the receivables, the borrower can expect it to collect them in a commercially reasonable manner.

This decision is noteworthy because most reported decisions reviewing the commercial reasonableness of a secured creditor's disposition of its collateral after a default deal with the sale or lease of goods or property -- not the liquidation of accounts receivable.

The Facts

In this case, the FDIC sued a corporate borrower and guarantors on defaulted notes. The guarantors asserted that the FDIC failed to collect the borrower's accounts receivable in a commercially reasonable manner. The FDIC established that it neither took nor agreed to receive exclusive responsibility to collect the receivables. In fact, the borrower not only didn't cooperate with the collection efforts of the FDIC or the failed bank, its principals contacted customers and told them to pay the borrower, not the FDIC or the failed bank, thereby hampering the FDIC’s collection efforts.

The Decision

The court stated that letters from the FDIC and the failed bank advising the borrower's customers to pay them directly did not, under the circumstances, demonstrate the requisite control necessary to trigger the UCC's requirement that the creditor make commercially reasonable collection efforts. Accordingly, the court ruled that the requirement of commercial reasonableness did not apply.

Although this decision interpreted provisions of Article 9 of the UCC pre-dating the statute’s July 1, 2001 overhaul, the court noted that the terminology of the relevant statutory provisions remain substantially the same for the purposes of this discussion. This holding, therefore, appears to survive last year’s major revisions to Article 9.

When Should a Single-Asset Chapter 11 Case Be Dismissed as a Bad Faith Filing?

A recent Delaware federal court’s decision helps answer this question. The debtor was a Delaware limited partnership whose sole asset was approximately 8,000,000 limited

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partnership units (the “Prime Units”) that were exchangeable for common shares of beneficial interest in a Maryland real estate trust. The Maryland trust and its affiliates owned, managed or developed real estate, primarily in the Chicago metropolitan area, including 27 office properties and 30 industrial properties.

The Facts

The debtor had pledged the Prime Units to secure a $62 million loan to Vornado PS, L.L.C. (“Vornado”). After the debtor failed to repay that loan when it matured, Vornado acquired a senior $40 million loan that was also secured by the Prime Units. Vornado then gave the debtor notice that it intended to sell the Prime Units at public auction. Vornado also commenced litigation after the debtor denied its defaults. The debtor filed its Chapter 11 case only sixteen hours before the auction was scheduled to take place. The debtor’s bankruptcy schedules revealed that the debtor had only five unsecured creditors, no cash or operating income, and no assets except for the Prime Units and some alleged litigation claims.

The Decision

In affirming the bankruptcy court's decision granting Vornado’s motion to dismiss the Chapter 11 case as a bad faith filing, the Delaware District Court noted that in assessing the good faith of a particular filing, courts typically review the record for various factors, including: (a) debtor owns one primary asset; (b) few unsecured creditors; (c) no ongoing business or employees; (d) petition filed on eve of foreclosure; (e) two-party dispute that can be resolved in pending state court litigation; (f) no cash or income; (g) no pressure from non-moving creditors; (h) prior bankruptcy filing; (i) improper pre-petition conduct; (j) no possibility of reorganization; (k) debtor formed immediately pre-petition; (l) debtor filed solely to invoke automatic stay; and (m) debtor’s subjective intent. This case illustrates that a Chapter 11 case may be dismissed if a review of the above-listed factors demonstrates blatant abuse. No single factor in determinative of a lack of good faith. Rather, the courts review the totality of the facts and circumstances in each case. Here, the district court found that the record demonstrated that this filing fell much closer to the “patently abusive” than the “clearly acceptable” end of the filing spectrum, even assuming that the debtor could successfully reorganize. Though not explicitly stated, it appears that the lack of cash and operating income, the small number of unsecured creditors, and the timing of the filing coupled with the existence of only one secured creditor heavily affected the district court’s decision.

Lenders should be cautioned that the Delaware court stated that there is nothing inherently wrong with a single asset debtor filing a Chapter 11 petition shortly before or after commencement of a foreclosure action, and that whether a case was filed in good faith is left to the discretion of the bankruptcy court. But, it remains the debtor’s burden to prove that the totality of facts and circumstances support a finding of good faith.

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