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From the Bankruptcy Courts: Balancing Equities to Determine the Rights of an Unauthorized Postpetition Secured Lender

Alan N. Resnick
Maurice A. Deane School of Law at Hofstra University

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Balancing Equities to Determine the Rights of an Unauthorized Postpetition Secured Lender

Imagine giving a debtor a substantial loan to finance the acquisition of property—relying on a security interest in the acquired asset to secure the loan—without knowing that the debtor previously filed a Chapter 11 petition and has been operating as a debtor in possession. After discovering the debtor's bankruptcy status, you also learn that the procedural requirements for obtaining postpetition financing had not been satisfied and that the bankruptcy court and creditors' committee were unaware of the loan transaction. What are a lender's rights under these circumstances?

The Ninth Circuit was faced with a similar situation in *In re McConville*.[1] The debtors in that case were in the business of dealing in distressed real estate. On July 8, 1993—only one week before they filed a Chapter 11 petition—the debtors entered into a contract to purchase eight apartments located in a building in Oakland, California. The seller was the Bayview Federal Bank and the total purchase price was $122,000. The debtors paid a nonrefundable $10,000 down payment and the closing was set to take place within thirty days after the contract signing. On July 14, 1993, the debtors filed a Chapter 11 petition.

Financing the Transaction

Although the debtors were counting on funding from Robert Kamp so that they could complete the purchase of the property, Kamp was unable to provide the funds by the closing date. The debtors then paid the seller an additional $5,000, also nonrefundable, in exchange for a short extension of the closing date to August 13.

David Margen and Lawton Associates, as lenders, agreed to give the debtors a $107,000 short-term bridge loan to tide them over until Kamp came through with his funding. According to the court of appeals, these bridge lenders believed that the property was worth more than $122,000 and "were told by Kamp that the Debtors' credit was

* Benjamin Weintraub Distinguished Professor of Bankruptcy Law, Hofstra University School of Law, Hempstead, N.Y.; Counsel to the firm of Fried, Frank, Harris, Shriver & Jacobson, New York, N.Y.; Reporter to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States; member of the National Bankruptcy Conference. The views expressed in this article are the author's own.

[1] In re McConville, 110 F3d 47 (9th Cir. 1997).

good and that he was looking for other opportunities to lend to the Debtors."[2] The court also pointed out that there was no evidence that the debtors informed the seller, the bridge lenders, or Kamp that they had filed a Chapter 11 petition. The court also found that the bridge lenders did not require a loan statement from the debtors and received no representation as to their assets and liabilities.

On August 12, the debtors executed a thirty-day promissory note payable to the bridge lenders, and a deed of trust on the real estate that was being acquired. The note was for the principal amount of $107,000 with interest at the rate of 12 percent. The bridge lenders kept $10,000 of the loan proceeds as a fee, and the remaining $97,000 was used to purchase the property the next day. The deed of trust was duly recorded on August 13. All of this was done while the bridge lenders were unaware that the debtors were in Chapter 11.

One month after the execution of the note and recording of the deed of trust, the Chapter 11 case was converted to a Chapter 7 liquidation and a trustee was appointed. The bridge lenders moved for relief from the automatic stay so they could foreclose on the real estate, but the bankruptcy court denied the motion.[3] The trustee then commenced an adversary proceeding against the bridge lenders seeking to void the lien created by the deed of trust, alleging that it was an unauthorized, postpetition transfer of property of the bankruptcy estate that may be avoided under Section 549(a) of the Bankruptcy Code.

Section 549(a) gives the trustee the power to avoid, with certain exceptions, any transfer of property of the bankruptcy estate that occurs after the filing of the bankruptcy petition if the transfer is not authorized by the Code or by the bankruptcy court. An important exception to the avoidance power in Section 549(a) is in Section 549(c), which protects a good faith purchaser of real property who has no knowledge of the bankruptcy case and who pays fair equivalent value for the property unless, before the transfer, a copy or notice of the bankruptcy petition was filed in the office where the real estate transfer would be recorded. The purpose of this provision is to protect a buyer who was unaware of the seller's bankruptcy case and who could not have detected the bankruptcy filing by checking in the appropriate real estate recording office at the time of the transaction. If the good faith purchaser has paid less than fair equivalent value, Section 549(c) provides that the purchaser is given a lien on the property transferred to the extent of any present value paid for the property.

Bankruptcy Court Voids the Unauthorized Lien

In determining whether the trustee could avoid the lien in *McConville*,

[2] Id. at 49.

[3] See 11 USC § 362.

the bankruptcy court held that (1) although they were purchasers in good faith, the bridge lenders nonetheless violated the automatic stay under Section 362(a)(4)[4] by recording the deed of trust; (2) the transfer was not within the scope of the exception for good faith purchasers under Section 549(c); and (3) the debtors had acted in violation of Section 364 of the Code, which sets forth the requirements for obtaining postpetition credit. The bankruptcy court, based on this reasoning, entered a judgment in favor of the trustee, declaring that the bridge lenders had no lien against the proceeds from the sale of the real estate.

The district court affirmed the bankruptcy court's decision, holding that a lender that had acquired a lien on real property was not a "purchaser" within the meaning of Section 549(c). Because the bridge lenders were not "purchasers" within the meaning of Section 549(c), they could not be treated as good faith purchasers of real estate.

The bridge lenders appealed to the Ninth Circuit, where both parties originally focused their arguments on the application of Section 549. The trustee argued that the lien was a "transfer" of property of the estate for the purpose of applying Section 549(a), so that it may be avoided under that section. The bridge lenders, however, argued that the exception under Section 549(c) was applicable to protect them.

The court of appeals rejected both arguments based on binding decisions in the Ninth Circuit "which simply hold that the creation of a lien does not transfer property for purposes of Section 549."[5] The court indicated that the only way for it to change this precedent was to call for an en banc hearing, which it was not prepared to do because it found another way to resolve the case.

The court of appeals determined that Section 364(c)(2) of the Bankruptcy Code provided a basis for avoiding the lien of the bridge lenders. Under that provision, if the trustee is unable to obtain post-petition unsecured credit allowable as an administrative expense,[6] the court, after notice and a hearing, may authorize the obtaining of credit secured by a lien on unencumbered property of the estate. Although Section 364 speaks to the rights of a trustee to obtain credit, it is applicable to a debtor in possession by reason of Section 1107(a).[7] The court noted that Section 364 was applicable to the debtors in *McConville* and that, before the appointment of the trustee in the converted case, the debtors "were fiduciaries of their own estate owing a duty of care and

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[4] See 11 USC § 362(a)(4), which automatically stays "any act to create, perfect, or enforce any lien against property of the estate."

[5] Supra note 1 at 49. The court cited In re Schwartz, 954 F2d 569 (9th Cir. 1992), and In re Shamblin, 890 F2d 123 (9th Cir. 1989).

[6] See 11 USC § 503(b)(1).

[7] See 11 USC § 1107(a), which, with a few exceptions, gives a debtor-in-possession the rights and powers of a trustee.

loyalty to the estate's creditors."[8] The debtors did not satisfy the requirements of Section 364(c)(2) in that they did not obtain court approval for the secured financing transaction.

The next task for the court of appeals was to determine the appropriate remedy or resolution of the proceeding.

> An appropriate remedy for this disregard [of § 364(c)(2)] is cancellation by the court of the transaction. It is disruptive of bankruptcy for an estate to obtain fresh credit without regard to the court now supervising the estate. It is within the power of that court to rescind the contract unlawfully made.[9]

Balancing the Equities

But the court of appeals did not automatically rescind the transaction in *McConville*. Rather, it recognized that "[t]he exercise of this corrective power . . . should not occur without regard to the equities of the situation, for, within the limits set by the code, a bankruptcy court must do equity."[10] In emphasizing the need to focus on the equities of the particular case, the court of appeals cited the famous decision in *Bank of Marin v. England*.[11] In that case, the Supreme Court declined to apply the former Bankruptcy Act literally when to do so would have led to an unjust result for an innocent party who dealt with a debtor without knowing that the debtor was in bankruptcy. Justice William O. Douglas, referring to the former Bankruptcy Act, wrote that "we do not read these statutory words with the ease of a computer. There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction."[12]

The court then went on to identify the equities in *McConville*.

> The equities here are these: On the one hand, as the Lenders have not ceased to remind us, their loan enabled the Debtors to carry out their contract and so obtain the property for the estate. Moreover, the Trustee stipulated that the Lenders were in good faith, so that the question of their knowledge of the Debtors' actual bankruptcy was removed from the case. On the other hand, the Lenders had to know that the Debtors' position was precarious. The Debtors' inability to obtain the loan they'd counted on, the absence of any effort to get bank financing, and the total amount paid for the loan signalled their situation. In addition, the Lenders' failure to ask for any representation of the Debtors' financial condition amounted to pretty much willful blindness. The Lenders' lack of knowledge of the Debtors' bankruptcy was not unavoidable."[13]

Based on these circumstances, the court of appeals held that it would be equitable for the bridge lenders to get back the amount that they had lent, less the amount that they had

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[8] Supra note 1 at 50.

[9] Id.

[10] Id.

[11] Bank of Marin v. England, 385 US 99 (1966).

[12] Id. at 103.

[13] Supra note 1 at 50.

already been paid. In essence, the lenders should receive no benefit from their loan—no fees and no interest—but should be restored to the position they were in when they extended the credit. In this case, the court held that the bridge lenders were entitled to a lien on $97,000 of the proceeds from the sale of the property.