Secured Transactions—To Participate or Not to Participate: A Secured Party's Question

Economic downturns often oblige secured lenders to become involved actively in the bankruptcy of their borrowers and in related disputes concerning the propriety of the lenders' secured claims and the treatment of those claims in the borrowers' reorganization or liquidation. Thus, many insolvency and workout topics have appeared in this space since the Great Recession began more than four years ago.

Today, however, we consider what might happen to a secured claim if the creditor fails, or elects not, to participate in its debtor's bankruptcy case. We are prompted to do so by a recent Mississippi federal district court decision, *Acceptance Loan v. S. White Transportation (In re S. White Transportation)*,[1] which held that a secured creditor who did not file a proof of claim or otherwise appear in a debtor's bankruptcy case did not lose its lien after confirmation of the debtor's plan of reorganization.

Background

It is a longstanding general principle of bankruptcy law that liens pass through bankruptcy unaffected.[2] An exception to this rule is U.S. Bankruptcy Code §1141(c),[3] which provides that, under certain circumstances, "property dealt with by [a Chapter 11] plan is free and clear of all [liens.]" In applying §1141(c), the U.S. Court of Appeals for the Fifth Circuit, in *In re Ahern Enterprises*,[4] ruled that a lien would be discharged under a Chapter 11 plan if four conditions were met. First, the plan must be confirmed. Second, the property subject to the lien must be dealt with by the plan. Third, the lienholder must have participated in the debtor's reorganization. Finally, the plan must not explicitly preserve the lien. The condition at issue in *S. White Transportation*, and of most interest to secured creditors, was the requirement that a secured creditor "participate" in the debtor's reorganization.

Although other courts have generally adopted *Ahern*'s four-part test, there has been little analysis of what constitutes "participation" for the purposes of §1141(c). In *Ahern* itself, an undersecured creditor did not file a proof of claim regarding its secured claim or otherwise involve itself in its capacity as a secured creditor. It was deemed nevertheless to have participated in the case because it had filed, in its capacity as an unsecured creditor, a proof of claim for the deficiency portion of its claim. The court also concluded that the debtor's plan of reorganization gave the creditor sufficient notice of the treatment of the creditor's collateral for the purposes of §1141(c). Thus, because due process was satisfied and because the creditor had participated by filing a proof of claim, albeit solely in its capacity as an unsecured creditor, the creditor's lien was extinguished under §1141(c).[5]

In an earlier case, *In re Penrod*,[6] the Seventh Circuit held that a secured creditor participated in a bankruptcy proceeding solely by filing a proof of claim. *Penrod* appeared to set a standard that a secured party's filing of a proof of claim is

sufficient participation to permit its lien to be extinguished. At least one bankruptcy court decision, however, rejected the notion that even the affirmative act of filing a proof of claim is necessary to constitute the required level of participation. The court in *In re Regional Building Systems*[7] held that nothing in §1141(c) mandates that a proof of claim be filed for a lien to be stripped. Rather, according to the court, §1141(c) dictates only that the secured creditor receive notice of the case and the terms of any proposed plan.

It was in this context that the *S. White Transportation* court addressed the question of whether constitutionally sufficient notice satisfied the participation condition outlined in *Ahern*.

Bankruptcy Court Decision

Prior to S. White Transportation's (SWT) bankruptcy, SWT and Acceptance Loan Company (Acceptance) had been engaged in extensive state court litigation. At issue in state court was the validity of a lien purportedly created by a Deed of Trust executed by SWT in favor of Acceptance. Acceptance claimed that the Deed of Trust secured a promissory note and created a first priority lien on an office building that constituted SWT's sole asset. SWT argued that the lien was invalid because the individuals who signed the Deed of Trust and promissory note were not authorized to execute those documents on SWT's behalf.

Before the state court litigation was resolved, SWT filed a voluntary petition for reorganization under Chapter 11 in the Bankruptcy Court for the Southern District of Mississippi. SWT's schedules of assets and liabilities identified Acceptance as holding a disputed secured claim. As the case progressed, SWT submitted a plan of reorganization that continued to treat Acceptance's claim as disputed. The plan provided that holders of disputed claims, including Acceptance, would receive no distributions but that two junior secured creditors with liens on the very property encumbered by Acceptance's disputed Deed of Trust would be paid in full.

Throughout the course of the bankruptcy, Acceptance was sent numerous notices, including a copy of SWT's plan of reorganization and notice of the hearing to confirm the plan. Additionally, the state court proceeding between SWT and Acceptance was stayed on the eve of trial by SWT's bankruptcy filing. Acceptance's knowledge of SWT's bankruptcy and the proposed treatment of its claim was therefore not in dispute. Nevertheless, Acceptance did not appear before the bankruptcy court, did not attend the meeting of creditors and filed no proof of claim. Acceptance's counsel acknowledged that Acceptance received all of the notices but said that Acceptance did not appear in the bankruptcy due to "inadvertence and oversight."[8] Without Acceptance's involvement, SWT's plan was confirmed without objection.

Following confirmation, Acceptance filed a request for a declaratory judgment, asking the bankruptcy court to find that its lien was unaffected by the plan and that the lien held first priority. Acceptance also requested that the bankruptcy court determine whether or not its lien survived the bankruptcy. As an alternative, in the event the bankruptcy court determined that the lien did not survive the bankruptcy, Acceptance requested that the bankruptcy court amend the confirmation order to provide that its lien survived the bankruptcy.

The bankruptcy court denied Acceptance's declaratory judgment requests, ruling that Acceptance's lien did not survive because §1141(c) operated to discharge it. Citing *Ahern*, the bankruptcy court stated that the purpose of the participation requirement is to ensure that a secured creditor receive constitutionally sufficient notice of its lien's treatment under a plan.[9] Because Acceptance conceded receiving notice of both SWT's bankruptcy and reorganization plan, the bankruptcy court held that the participation requirement set forth in *Ahern* had been satisfied.[10]

Acceptance appealed this decision to the federal District Court for the Southern District of Mississippi.

District Court Decision

The district court reversed the decision below on the basis that Acceptance had not "participated" in the reorganization to the extent required by §1141(c). Judge Halil Suleyman Ozerden reasoned that mere notice of a bankruptcy and a Chapter 11 plan was insufficient to satisfy the "participation" condition. In reaching this determination, the court looked to the definition of "participation" as that word is commonly used. The court noted that *Black's Law Dictionary* defines "participation" as "[t]he act of taking part in something, such as a partnership, a crime or trial." The term, according to Ozerden, necessarily requires some action.[11]

In further support of its holding, the district court noted the long-standing principle that liens generally pass through bankruptcy unaffected. It reasoned that where the statutory language is "not unambiguous," courts should be reluctant to interpret Bankruptcy Code provisions to effect a major change in pre-Code practice.[12] The court also stated that extinguishing Acceptance's lien would be inequitable because a lien is a property right and the law eschews forfeitures of property rights.[13] Assuming, the court reasoned, that Acceptance indeed had a valid first priority lien as it asserted, the loss of that lien would be particularly unjust: Acceptance would receive nothing while two junior creditors with liens on the same property—the debtor's sole asset—would be paid in full.

Not surprisingly, SWT has appealed the district court's decision to the Fifth Circuit,[14] and, as of the deadline for submission of this article, the parties are in the process of briefing their arguments. Thus, the decision is not final.

Observations

S. White Transportation prompts a number of observations.

Assuming that the district court's ruling is upheld on appeal, it is positive for secured creditors. It stands for the proposition that a secured party cannot suffer the stripping of its lien under §1141(c), even if it has received notice of the bankruptcy and the plan of reorganization, if it has not otherwise involved itself actively in the debtor's Chapter 11 case.

- Although the ruling is good news for secured creditors, its precedential value as of now is uncertain. *S. White Transportation* is only a district court decision; while potentially persuasive in light of the sparse case law on the issue, it is not controlling authority outside the Southern District of Mississippi and may not even be controlling in other cases in that district.[15] Further, secured creditors should be cautious when relying on this case because at least one bankruptcy court decision, *Regional Building Systems*, has suggested that any notice that is constitutionally sufficient satisfies the participation requirement. Of course, the Fifth Circuit's opinion on the appeal may provide clarity, as well as more widespread authority, on these matters.
- Even if a secured creditor chose not to file a proof of claim or otherwise involve itself actively in the bankruptcy in reliance on *S. White Transportation*, a debtor could file a proof of claim on the creditor's behalf pursuant to Bankruptcy Code §501(c). Whether that step would constitute "participation" by the creditor for the purposes of §1141(c) is itself an interesting question, but taking the action one step further, the debtor could then object to the secured claim that it itself filed. This circumstance could present the creditor with a difficult practical choice—respond so as to protect its claim and thereby possibly "participate" in the bankruptcy case, or risk impairment or abandonment of its claim. It is arguable, however, that a creditor's involvement compelled by this tactic would not satisfy the participation condition established in *Ahern*.

- Regardless of how the Fifth Circuit rules on appeal, intentionally ignoring a bankruptcy as a device to preserve liens is not a tactic most secured creditors can be expected to adopt. Lienholders generally will prefer to involve themselves actively in bankruptcy cases so as to maximize the likelihood that their rights are not eroded and their collateral is not wasted, used without adequately protecting the lienholders' interests or disposed of for inadequate consideration. Nevertheless, for secured parties who do not participate in a case because they genuinely are ignorant of its pendency or (like Acceptance) due to inadvertence or oversight, *S. White Transportation* may buttress a defense against a debtor's effectively ex parte attempt to strip liens through the reorganization plan.
- If upheld, *S. White Transportation* may affect the decision-making calculus for those secured creditors who are weighing the risks and benefits of active involvement in a case. This could be true especially for foreign creditors. Although Bankruptcy Rule 7004 permits nationwide service of process against domestic parties in adversary and other proceedings in a bankruptcy case, foreign creditors who are not present in the United States may want to remain beyond a bankruptcy court's jurisdiction notwithstanding that their collateral is involved in the case. *S. White Transportation* may increase the likelihood that such creditors elect not to file a proof of claim, if they believe their liens may nevertheless pass through bankruptcy unaffected and they can protect their interest sufficiently by monitoring the case without participating in it actively.

Conclusion

S. White Transportation sheds light on a relatively obscure area of law about which secured transactions lawyers should be aware. If upheld on appeal, the decision would provide an additional arrow to the secured creditor's quiver of defenses against having its lien stripped in bankruptcy.

For more information about the topics raised in this Legal Update, please contact:

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Endnotes

1 473 B.R. 695 (S.D. Miss. 2012).

2 *Dewsnup v. Timm*, 502 U.S. 410, 112 S.Ct. 773, 116 L.Ed.2d 903 (1992); *Long v. Bullard*, 117 U.S. 617, 6 S.Ct. 917, 29 L.Ed. 1004 (1886).

3 11 U.S.C. §§101, et seq.

4 *Elixir Indus. v. City Bank & Trust* (*In re Ahern Enters.*), 507 F.3d 817 (5th Cir. 2007).

5 Id. In *In re Be-Mac Transport*, 83 F.3d 1020 (1996), the Eighth Circuit found that the participation requirement had not been met even though a secured creditor participated in the bankruptcy as an unsecured creditor, but not as a secured creditor. This decision can be explained partly by the fact that the bankruptcy court improperly disallowed the creditor's secured claim as untimely. Thus, the creditor attempted to participate in the proceeding, but the bankruptcy court erroneously denied its right to do so.

6 50 F.3d 459 (7th Cir. 1995). See also *In re Richard Louis Alexander*, 435 Fed. Appx. 563 (7th Cir. 2011) (citing *Penrod* and stating "[a] secured creditor need not file a 'proof of claim' unless the creditor wishes to take part in the distribution of estate assets").

7 251 B.R. 274 (Bankr. D. Md. 2000), aff'd 254 F.3d 528 (4th Cir. 2001).

8 *In re S. White Transp.*, 455 B.R. 509, 514 (Bankr. S.D. Miss. 2011).

9 Id. at 516.

10 The bankruptcy court also denied the motion to amend the confirmation order, finding that such action would, in reality, be an amendment to the plan itself, and that Acceptance did not have standing to amend plan.

11 473 B.R. 695, 702.

12 Id.

13 Id. at 702-03.

14 *In re S. White Transp.*, 473 B.R. 695 (S.D. Miss. 2012). Appeal docketed, No. 12-60648 (5th Cir. Aug. 17, 2012).

15 Case law suggests that district court rulings in a bankruptcy appeal may not create binding precedent even in the same district. See *In re Kar Dev. Assocs.*, 180 B.R. 624, 626 (Bankr. D. Kan. 1994) ("A decision of a single district judge in a multi-judge district is not the law of the district and [bankruptcy judges] are not bound to follow the prior cases."), aff'd, 180 B.R. 629 (D. Kan. 1995); *In re Gaylor*, 123 B.R. 236 (Bankr. E.D. Mich. 1991) (district court decisions are not binding precedent). See generally J. Maddock, "Stemming the Tide of Bankruptcy Court Independence: Arguing the Case For District Court Precedent," 2 ABI L. Rev. 507 (1994).