akerman

Practice Update

Your Collateral Can Disappear in Chapter 11

March 11, 2025

By Jules S. Cohen

Suppose you have made a loan and your collateral includes a lien on receivables or inventory. If your borrower files Chapter 11, you are in danger of your collateral disappearing during the Chapter 11 case. Here's how.

Chapter 11

If a business gets into financial distress, it may file Chapter 11 in bankruptcy court. This stops all creditors temporarily from collecting their debts. The Chapter 11 gives the business a breathing spell to try to come up with a plan to settle its debts and rehabilitate the business. If you have a lien on receivables or inventory, the Chapter 11 stops you temporarily from taking your collateral.

The business that files Chapter 11 is now called a debtor. In almost all Chapter 11 cases, the debtor tells the judge that the business can operate on a breakeven basis paying current expenses out of current income. Usually the judge will allow the business to continue operating while it tries to put together a plan to settle its debts and tries to get the creditors to accept it. The business may continue to operate this way for several months or even longer.

What Happens To Your Collateral

Related People

Jules S. Cohen

Related Work

Bankruptcy and Reorganization

Related Offices

Orlando

At this point in the case, you are in danger of losing your receivables and inventory collateral. This is because, in operating the business, the debtor is free to collect receivables and sell inventory and use that money to pay operating expenses.

If the debtor is operating at a breakeven or better basis, it should be generating new receivables to replace the receivables it has collected, and it should be acquiring new inventory to replace the inventory it has sold. In that case the amount of the receivables and inventory remains level. Unfortunately, the debtor often fails to fulfill its prediction that it will operate on a breakeven basis and, in fact, operates at a loss.

In operating at a loss, the debtor often fails to generate enough new receivables to replace old ones and fails to acquire sufficient replacement inventory. The result is that the level of your receivables and inventory collateral steadily declines. If the Chapter 11 is unsuccessful and the business closes, there may be little of your collateral left.

How To Protect Your Collateral

Fortunately, there are protections for your collateral in the Chapter 11, but you must take action to get the benefit of those protections. You are entitled to adequate protection of your interest in the receivables and inventory. This means that you are entitled to some protection that the value of the receivables and inventory when the bankruptcy is filed is preserved and not subject to decline, which would cause you to lose some of the value of your collateral.

Here is what you can do. First, you may have your attorney request that the judge order the debtor to furnish you with monthly (or even weekly, if necessary) reports of the amount of receivables collected, the amount of new receivables generated, the amount of inventory sold, and the amount of new inventory bought.

Secondly, you should review each of these reports promptly to see how the levels of receivables and inventory are changing. If they are declining, you can request that the judge require the debtor pay you cash equal to the amount of the decline. If you can show the judge that the debtor is operating at a substantial loss and has little chance of turning the business around, the judge may allow you to collect the receivables and sell the inventory and apply the money to your loan.

Seeking a Trustee

If you think that the people managing the business are not competent or are dishonest, and if you have evidence of that, you may be able to convince the judge to appoint a trustee. The trustee will be someone who has no connection with the debtor or the creditors.

The trustee will determine whether the business can be saved. If so, the trustee can operate the business temporarily and propose a plan to settle the debts and bring the business out of Chapter 11. If the trustee operates the business, you can request regular reports of the receivables and inventory levels and seek adequate protection if they are declining, the same as if the debtor were operating the business.

Opposing the Reorganization Plan

The debtor's plan will include a provision saying when the debtor will pay you. The plan must provide that you will retain your lien on the receivables and inventory. You can vote on whether you accept or reject the plan. You will want to consider whether you will collect more money by accepting the plan or trying to defeat the plan and liquidating your collateral. There are numerous grounds to use to try to defeat the plan.

Conclusion

If your borrower files Chapter 11, you have numerous rights to protect your lien on receivables and inventory, but they all require action by you to get the benefit of those rights and successfully collect your loan.
