

# **BANKRUPTCY CONSIDERATION FOR LOAN DOCUMENTS AS WELL AS LOAN MODIFICATION AGREEMENTS**

## **LORMAN SEMINAR ON COMMERCIAL AND REAL ESTATE LOAN DOCUMENTS**

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### **DISCLAIMER**

The legal summaries contained in this essay are intended for informational purposes only. Before using or relying on any of this information, you are encouraged to confer with appropriate counsel.

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## **I. SYNOPSIS**

This article addresses recent developments in creditor case law particularly in the areas of Article 9, bankruptcy, and corporate liability:

- Article 9 rules for identifying corporations in financing statements are specific and inflexible. Recent case law confirms that trade names are unacceptable when filing financing statements
- Recent Illinois case law seems to suggest that courts are holding non-shareholder "owners" of corporations accountable where the non-shareholders are attempting to limit liability by putting friends, relatives, etc. as puppet shareholders and directors
- Changes in payment terms may not always doom creditors during bankruptcy preference periods.
- Secured creditors under Chapter 13, must file claims on or before the bar date to ensure payments under Chapter 13 plans.
- Secured creditors have a right to deficiency judgments in state courts where the debtor has offered to surrender collateral in a Chapter 13 confirmation.

## **II. TRADE NAMES CLOSE BUT NO CIGAR WHEN FILING ARTICLE 9 FINANCING STATEMENTS.**

Using an incorrect name when perfecting a security interest, particularly against an incorporated entity, is one of the easiest defenses available for a debtor or other creditors under revised Article 9. One of the amendments reflected in revised Article 9 is contained in 810 ILCS 5/9-503(a) and (c). Section 9-503(a) of revised Article 9 requires financing statements to contain the name of corporate debtor "indicated on the public record of the debtor's jurisdiction of

organization" and Section 9-503(c) states: "A financing statement that provides only the debtor's trade name does not sufficiently provide the name of the debtor." One creditor who filed a financing statement using debtor's trade name under Illinois law realized its error pursuant to these statutes in Wisconsin Bankruptcy court. *In re FV Steel and Wire Company*, 310 B.R. 390 (Bankr. E.D. Wis. 2004). Relying on earlier Illinois case law, the creditor attempted to argue earlier cases that allowed trade names looked ultimately to see whether filed financing statements were seriously misleading. *In re Paramount Int'l, Inc.*, 154 B.R. 712, 715 (Bankr. N.D. Ill. 1993). The creditor, citing *Paramount*, an earlier Illinois bankruptcy case, argued that as the trade name had similar name elements as the organizational name, that it was not seriously misleading. *FV Steel*, 310 B.R. at 392. The bankruptcy court disagreed. The court determined that not only was the creditor's situation different than that of the creditor in *Paramount* where the debtor changed its name a month after giving a security interest (while retaining the old organizational name as its trade name), but in addition, the creditor in *FV Steel* failed to meet the seriously misleading standard under revised Article 9.

§9-506(c) of Revised Article 9 defines seriously misleading in the negative as:

If a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement that fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a), the name provided does not make the financing statement seriously misleading. 810 ILCS 5/9-506(a)

In essence, this section renders a financing statement effective only if a computer search run under the debtor's correct name turns up *the* financing statement with the incorrect name. In *FV*

*Steel*, the search under the correct name turned up no filings. 154 B.R.at 392. In addition, the court, quoting Steven O. Wiese, the ABA advisor to the Revised Article 9 Drafting Committee, emphasized that courts have no discretion in the matter stating that "the simple solution is to get the debtor's name right". *Id.* at 393-394.

With organizational names the rule is relatively clear cut; however, with legal names of individuals, the rule seems a bit more obscure. *See* Pearson, Honorable John K. and J. Scott Pohl, *If the Name Is Bubba, You'd Better Spell It Right*, 25-5 ABIJ 24, June 2006. Retired Kansas Bankruptcy Judge John K. Pearson analyzes the Kansas Supreme Court case of *Pankratz Implement Co. v. Citizens National Bank*, 130 P.3d 57 (2006). In that case, one creditor had used the name "Roger" instead of the appropriate name "Rodger" and the court held that this was not an appropriate name. *Pankratz* at 59. The holding of *Pankratz* stands for the narrow proposition that misspellings are not appropriate legal names. *Pearson* at 71. The larger question remains, however, what is an appropriate legal name? As Judge Pearson states:

But there is no bright-line definition of legal name for an individual. Problems abound: It is impossible to even list the variations of names that people adopt or are given at birth. marriage often results in one--or lately both---of the parties changing their name without much in the way of formalities. And of course, Hollywood abounds with various stage names. *Pearson* at 71.

### **III. NON-SHAREHOLDERS NOT JUDGMENT-PROOF IN CORPORATE LAWSUITS.**

Creditors must oftentimes consider creative options when naming a limited liability entity as party to a lawsuit. The alter ego theory for piercing the corporate veil provides one possible

alternative. A recent Second District Appellate Court of Illinois case *Fontana v. TLD Builders, Inc.*, the Appellate Court of Illinois, Second District, followed the familiar case of a contractor, who abandoned housing construction. *Fontana v. TLD Builders, Inc.*, 362 Ill. App. 3d 491 (2d Dist, Dec. 2005). Although the director of the contractor corporation was the contractor's wife, the homeowners decided to sue the non-shareholder contractor husband directly utilizing the doctrine of piercing the corporate veil. *Id.* at 494. Illinois applies a two pronged veil test requiring:

(1) a unity of interest and ownership that separate personalities of corporation and individual no longer exist [Determined by looking to a myriad of factors such as inadequate capitalization, failure to issue stock, failure to observe corporate formalities, etc.]; and

(2) that circumstances existing allowing corporate existence would be unjust. *Id.* at 500-504.

In *Fontana*, there was no doubt that corporate formalities by the owner, the wife, were not followed. For instance, there was only \$1,000 initial capitalization, no corporate formalities observed, roles within the corporation were uncertain (wife thought she was co-owner with husband when indeed she was not), no dividends were paid, and corporate and personal assets were commingled. *See Id.* at 775.

The contractor husband used his most obvious defense; he was not an owner so therefore the first prong of piercing the corporate veil could not be met. The husband was aware that Illinois had an alter ego doctrine in the case of *Maculuso v. Jenkins*, 95 Ill. App. 3d 461, 465 (1981) used to hold outside parties liable where the parties exercise ownership control over the

corporation to such a degree that separate personalities of corporation and defendant do not exist; however, the contractor argued that the holding of *Macaluso* was limited to non-profit cases. *Fontana*, 362 Ill. App. at 501. The Appellate court disagreed. The Appellate court focused on the fact that corporate veil is an equitable remedy so courts will always look to substance rather than form and therefore the issue of non-profit versus profit in this case was of no consequence. *Id.*; *See also Macaluso*, 95 Ill. App.3d at 564. In *Fontana* the court found that the non-shareholder contractor held ownership control over the corporation where the wife was a "puppet" director, the contractor signed all contracts between corporation and homeowner with his own individual signature, and there was obvious personal commingling of assets where personal "loans" were made to the corporation and non-wage deposits were made into the contractor's personal check account. 362 Ill. App. 3d 491 at 507.

#### **IV. CREDITOR BUSINESS RELATIONSHIP WITH DEBTOR MAY HELP MEET EXCEPTIONS TO TRUSTEE PREFERENCE POWER**

Juanita Herring, who is a law student at Northern Illinois University, wrote an excellent article in the July 2006 Kane County Bar Brief article entitled *Sometimes Playing Nice is the Key: In re National Steel Company Helps Creditors Hedge Potential Risks in Lieu of Debtor Bankruptcy* analyzes the case of *In re National Steel Co.*, 2006 WL 950654, 4 (Bankr. N.D. Ill). Previous courts had defined, particularly with what constitutes payments made by debtor in the ordinary course of business in order to meet exceptions to bankruptcy trustee's preference power to include conduct between the parties, length of transactional relationship, and unusual activity. *In re Tolona Pizza Products Corp.*, 3 F.3d 1029 (7th Cir. 1993); *See also* 11 U.S.C. §547(c). The court in *National Steel* addressed whether a contractual change in payment contract terms

during the ninety day preference period could qualify two payments made pursuant to those terms as in the ordinary course of business. *In re National Steel Co.*, 2006 WL at 2. The key factors in the case became whether the contractual change was forced upon the debtor and whether the change actually altered the payment practices. *Id.* at 4-6. Neither factor had occurred. *Id.*

In determining whether contractual changes were forced upon debtor, *National Steel* turned to the nature of negotiations: whether unilateral or bilateral. *In re National Steel*, 2006 WL 950654, 6. The parties in *National Steel* conducted regular annual payment terms negotiations where the terms were bilaterally agreed upon. *Id.* The change that occurred during the preference period was no exception. In addition, the change itself did not alter or "speed-up" payments to creditor. *Id.* at 5. As such, the court found the changes in the ordinary course of business. In sum, the although contract changes had occurred, they were cosmetic and did not alter accounting practices for the debtor.

Juanita Herring offers some sound planning advice to increase creditor's chances of falling within the §547(c) exceptions:

- 1) Get to know your debtor's accounting system: One factor that saved the creditor in *National Steel* was the fact that the changed terms did not actually change the accounting practices for the debtor. 2006 WL 950654 at 5.
- 2) Negotiate on a regular basis for payment term changes: Courts turn a watchful eye towards creditors who only turn to "negotiations" when notified of potential bankruptcy.
- 3) Offer incentives to protect recurring transactions: Giving a debtor incentives can promote faster payment turnaround which is more likely to be enforced as a customary practice during a preference period.

Herring, Juanita, *Sometimes Playing Nice is the Key: In re National Steel Company Helps Creditors Hedge Potential Risks in Lieu of Debtor Bankruptcy*, Kane County Bar Briefs, July 2006, pgs.41-42.\_\_\_\_\_

**V. SECURED CREDITORS REQUIRED TO FILE TIMELY CLAIMS IN CHAPTER 13**

\_\_\_\_\_A decision handed down in mid-July of 2006 clarified the duty of secured creditors in filing timely claims in a Chapter 13 case. *In re Jerry N. Hogan and Cynthia A.*, 16 CBN 731 (Bankr., N.D. Tex 2006). The bankruptcy court addressed two separate Chapter 13 cases with the related legal issue of a secured creditor filing claims months after the bar date for filing proofs of claims. The trustees for both debtors, citing the Bankruptcy Code, argued 11 U.S.C. §502(b)(9) that the claims were not timely filed. *Hogan*. The secured creditors, citing Federal Rules of Bankruptcy Procedure Rule 3002(a), argued that the procedural rules only provide for unsecured creditors stating specifically that "[a]n unsecured creditor or an equity security holder must file a proof of claim or interest for the claim or interest to be allowed," and as such, a secured creditor may come into a Chapter 13 at whatever point necessary. *Hogan*.

In the absence of any specific statutory provision guiding the timeliness standard for Chapter 13 secured creditors, the court compared initially Rule 3002(a) with Rule 3021 which only allows for distribution for creditors "whose claims have been allowed." *Hogan*. Rule 3021, the court reasoned, requires filing for all creditors in order to receive payment under the plan. *Hogan*.

In addressing the issue of timeliness, the court initially looked to §502(b)(9) which allows for an affirmative defense for a debtor where claims are filed tardily. Citing *In re Dennis*, 230 B.R. 244, 249 (Bankr. D. N.J. 1999), the Texas bankruptcy court emphasized that if

Congressional intent had been to except Chapter 13 from this affirmative defense, it would have expressly done so as is the case for claims filed under §726(a). The court then determined whether it had discretion to allow for late claims or whether discretion was forbidden by statute under F.R. Bankr. P. 3002(c) which addresses what constitutes timely filing for Chapter 13. F.R. Bankr. P. 3002(c) only allows for court discretion with a governmental unit, an infant, or an incompetent person. *Hogan*. The court compared the provision of Rule 3002(c) to Rule 9006 which allows for time-extension for excusable neglect. Citing *Pioneer Investment Services Co. v. Brunswick Associate Limited Partnership*, 507 U.S. 380 (1993), the court held that Rule 9006, although generally applying to time requirements under the rules, does not, pursuant to Rule 9006(b)(3), apply to filing of claims. With the filing of claims, *Pioneer* holds, Rule 3002(c) governs exclusively. As such, no court discretion is allowed. *Pioneer*, 507 U.S. 389 n.4.

The court justified it's pro-debtor reasoning in *Hogan* by addressing a number of pro-creditor provision in the Bankruptcy Code and Procedure:

- 1) Debtor or a trustee may file a proof of claim on behalf of a creditor under Fed. R. Bankr. P. 3004 and obtain an enlargement of the deadline for "good cause shown."
- 2) The secured creditor continues to have a lien on the underlying collateral and may object to automatic stay if the debtor's plan makes no provision for creditor's value and "where the sole reason for the disallowance of creditor's secured claim was the creditor's failure to file a timely proof of claim." *In re Lee*, 182 B.R. 354, 357 (Bankr. S.D. Ga. 1995).

**VI. SEVENTH CIRCUIT RESTORES RECOURSE RIGHTS OF SECURED CREDITORS IN CHAPTER 13**

The United States Court of Appeals for the Seventh Circuit has recently interpreted the provisions of elusive “hanging” paragraph of 11 U.S.C. §1325(a) of the Bankruptcy Code. See *In Re Craig Wright*, 2007 U.S. App. LEXIS 15843 (7th Cir 2007). The paragraph, unnumbered at the end of section 1325(a) was a response to the cram-down provisions of the old code (which crammed down a court ordered substitution of money for collateral on secured debt and in doing often underestimated the market value of the collateral occurring most often with the purchases of vehicles) and states:

For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle (as defined in section 30102 of title 49) acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing. 11 U.S.C. §1325(a).

Under section 11 U.S.C. §506 referenced in §1325(a) divides loans into secured and unsecured portion being the amount that debt exceeds currently value of collateral. The majority of courts prior to the *Wright* decision determined with 506(a) no longer an option in a Chapter 13 surrender of collateral scenario, when a debtor surrenders collateral pursuant to §1325(a)(5)(C) where a Chapter 13 plan can be confirmed if debtor surrenders collateral, the debtor has fully satisfied the debt and creditors have no remaining recourse. *Wright* at [3]. The court in *Wright* disagreed, and stated that where the federal code was silent as to what remedies were allowed to a creditor in the code absent 506(a), state law will then step in to determine rights and

obligations. *Id.* In most cases this law is contract or UCC which both allow for deficiency judgments. *Id.* In looking to congressional intent the court stated:

Section 306(b) of the 2004 Act, Publ. L. 109-8, 119 Stat. 23, 80 (Apr. 20, 2005) which enacted the hanging paragraph, is captioned “Restoring the Foundation for Secured Credit.” This implies replacing a contract-defeating provision such as §506 (which allows judges rather than the market to value the collateral and set an interest rate, and may prevent creditors from repossessing) with the agreement freely negotiated between debtor and creditor.” *Wright* at 9.

## **VII. CHECKLIST FOR MODIFYING LOAN DOCUMENTS**

1. Have all the Guarantors reaffirm the modified loan documents.
2. If the Bank committed errors, have all the borrowers and guarantors release the Bank from any wrongdoing.
3. If the Lender has sold some of the Borrower’s collateral, have the Borrowers and Guarantors ratify the sale.
4. Get new financial statements from borrowers and guarantors.
5. If the collateral is not readily salable in a recognized market, spell out in the default section of the note how the collateral is to be sold and have the borrowers and guarantors “sign off” on the agreed disposition of sale.
6. Check the corporate structure of the business to see if it has changed since the last time the documents were signed.

**VIII. AVOIDING COMMON DOCUMENTATION ERRORS AND DETERMINING WHO ARE IN FACT THE BORROWERS - *This is a Revision of an Article by Scott D.H. Redman, Crowley Barrett & Karaba, Ltd.*, Copyright (c) 2004 Crowley, Barrett & Karaba, Ltd. (For education use only)**

**Introduction**

There is no such thing as a standard commercial loan. It is common for a complex commercial loan to have at least thirty or more items on a closing checklist. Errors can easily be made and it is therefore important for the banker and the lawyer to make sure that the transactions are properly documented, from initial due diligence to proper structure to final documentation. The following section highlights some common errors and issues that surface in the loan documentation process.

**A. Be Careful to Monitor a Business Name Change Or a Change In Its Ownership Structure.**

A Borrower's business requirements can change frequently. A lender must keep up with any organizational changes that take place with respect to your loan parties, particularly your borrower. In addition to obvious organizational changes such as a change in your borrower's name, other changes such as registration of a previously unregistered borrower entity and relocation of collateral are all issues that must be addressed quickly and accurately.

If your borrower is not an entity that was formed by registration with a governmental agency (typically the Secretary of State) and it changes form into an entity that is created by registration (for example, a general partnership formally converting to a limited liability company), you must continue perfection of your personal property liens by filing a UCC-1 against the new borrower entity in the state in which it is now formed. The Uniform Commercial

Code generally provides a 4 month grace period for this filing, although we highly recommend that the filing be made immediately. Because the lender wants notice of this change as early as possible, we prefer not to remove “name change” covenants from loan documents.

If collateral is moved from one state to another, because of the new method of perfecting, based on the state of organization of the borrower, there is little concern from a UCC-1 standpoint. However, if the collateral is moved into (a) a new leased location or (b) a public warehouse or other third party (e.g., a co-packer or distributor), the lender must take action to protect its collateral. In the case of a leased location, the lender should be concerned about statutory or contractual landlord’s liens and should seek a proper waiver or subordination agreement to be signed by the potential lienholder. Similarly, if the collateral is now in a public warehouse, a proper lien waiver must be obtained. If a third party (other than a public warehouse) has possession of the collateral, the lender must be concerned with not only any rights that the third party may claim in the property (e.g., does some document or local statute give the third party lien rights?), but is it possible that the lenders to that third party could claim an interest if they were to start enforcement proceedings against the third party?

**B. Know What Type of Entity Your Borrower Chose.**

It is possible for an entity not to be what it appears to be; therefore, improperly documenting a loan based on the wrong form of borrower entity can be disastrous. Accordingly, it is important to confirm, prior to closing, that all necessary formalities for formation of the borrower entity have taken place. For example, for a limited liability company: (a) Have the Articles of Organization been filed with the Secretary of State? (b) Have all the members (and

the manager, as applicable) signed an operating agreement? and (a) Have the members all contributed their stated capital?

If an entity has not been properly formed, it is possible that it could be treated under state law as a general partnership. If that is the case, and the proposed state of organization is different than the state where the principal place of business is located, there will be UCC perfection issues that must be resolved at closing.

Similarly, if a borrower is intended to be a general partnership consisting of two partners, and one drops out at the last minute, it ceases to be a partnership (because you cannot have a partnership with only one partner) and the sole remaining partner becomes your borrower (doing business under an assumed name) and UCC perfection must be accomplished accordingly.

### **C. Guaranty By Spouse**

Regulation B and the federal Equal Credit Opportunity Act (ECOA) limit when a creditor may require an applicant's spouse (unless spouse is co-applicant) as a guarantor. Furthermore, Regulation B and the ECOA *apply in the commercial context*. Specifically, Section 202.7(d)(1) of Regulation B states that a creditor can “not require the signature of an applicant's spouse or other person, other than a joint applicant, on any credit instrument *if the applicant qualifies under the creditor's standards of creditworthiness* for the amount and terms of the credit requested.” 12 CFR § 202.7(d)(1) (emphasis added).

Section 202.7(d)(5) provides that if an applicant is deemed unqualified and the personal liability of an additional party is necessary, “the applicant's spouse *may serve as an additional party, but the creditor shall not require that the spouse be the additional party.*” 12 CFR § 202.7(d)(5) (emphasis added).

There is an ongoing debate about the scope of the remedy for a violation of Regulation B. In some case law dealing with Regulation B finds courts rule that the borrower must raise it as an affirmative defense. (See, 8 U. Miami Bus. L. Rev. 215, 218 (2000)). The effect of a successful affirmative defense based on a violation of Regulation B will render the entire debt void. Because of this harsh result, many courts still recognize the debt, but will simply allow the impermissibly bound guarantor to escape liability. Id. at 221.

#### **D. Notifying Account Debtors**

Commercial loans are often secured by the borrower's accounts. If the accounts are the primary source of collateral the lender may have a "lock box" arrangement with the borrower in which the borrower's account debtors forward payment directly to the lender for deposit in the borrower's operating account. In a lock box arrangement the lender is able to closely monitor and match the borrower's collections versus the level of receivables reported by the borrower. In many cases where the accounts are not the primary source of collateral the borrower collects payments and is entitled to use them while not in default. The security agreement should grant the lender the right to contact the borrower's account debtors and demand direct collection in the event of default. In any event, insert a clause which states that if any of the guaranties are voided the remaining terms of the loan document remain in full force & effect. The following language is taken from such a notice made on behalf of a lender:

"We represent The Lender, which has been informed that you owe various amounts to Debtors, Inc. for products/services. You are hereby notified that Lender claims a perfect first priority security interest in all of the accounts receivable of Debtors, Inc.

Pursuant to the agreement of Debtors, Inc. and the Illinois Uniform Commercial Code, The Lender demands that any and all future payments by you or on your behalf to Debtors, Inc. be made payable to The Lender and forwarded to the undersigned, its attorneys, until notified otherwise by the undersigned. If you make any payments directly to Debtors, Inc. after the date of this notice, then The Lender may seek recovery for such payment from you.”

**E. Continuation of the Lender’s Security Interest**

Under Article 9 of the Uniform Commercial Code, a UCC-1 financing statement is valid for a period of 5 years from the date it is filed. The lender must continue the filing prior to the expiration of that 5 years period by filing a continuation statement, but no earlier than the date 6 months prior to the expiration of the 5 years period. Because of the changes brought about by the revisions to Article 9, a special form of UCC-1 filing may be necessary if, for example, your old expiring filing was based on the location of the borrower’s principal place of business and the borrower’s state or incorporation is in a different state (e.g., a Delaware corporation with its principal place of business in Illinois). In that case UCC-1 that contains the date, jurisdiction and filing number of the old filing will need to be filed in the new location. A lender needs to continue to be alert to this type of issue as, under revised Article 9, the old filing remains valid for its full statutory period and many lenders have forgotten the transitional rules for revised Article 9 (which were the subject of many seminars in 2000 and 2001).

**F. Liens Subordination**

The introduction of a subordinated creditor into a lending relationship must be carefully considered and, more importantly, carefully documented. The following are a number of the

reasons why a senior lender should seriously consider denying a borrower's request to introduce a subordinated loan and lien into a loan relationship:

- Additional debt could result in an overextended borrower, leading to financial difficulties and possibly default.
- A senior creditor actions in managing the borrower's assets (e.g., through a mortgagee in possession order or a receiver) may be challenged by the subordinated creditor.
- The existence of a subordinated lien will inhibit a deed in lieu of foreclosure transaction and could prevent a successful workout.
- A subordinated creditor could attempt to force the senior lender to marshal the borrower's assets prior to collecting on the assets that serve as collateral for the subordinated loan.
- A subordinated creditor may win the race to seize unencumbered assets of the borrower.
- A second mortgage may ultimately prime the senior mortgage for certain subsequent advances.
- The subordinated creditor's consent would be necessary for certain types of actions, such as conversion of a property to condominium, execution of a lease that requires a non-disturbance from all lien holders, or granting of an important easement over the property.
- A subordinated creditor may change the priority of a senior mortgage that has been materially amended without its consent.
- In the event of a casualty or condemnation, a subordinated creditor will be a co-payee of the insurance proceeds or condemnation award.

A well-drafted and comprehensive subordination agreement will attempt to address these issues. Such an agreement requires the assistance of counsel as well as a thorough review of the subordinated loan documents. Typically, such an agreement will severely restrict the types of payments the subordinated creditor may receive and will prohibit any enforcement action by the

subordinated creditor without the senior lender's consent (sometimes this "blocking" is limited to a specific time period - for example, 180 days).

In short, a lender that merely relies on the fact that his mortgage or lien has statutory seniority over the subordinated creditor's lien is asking for trouble.

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