Who Is a Secured Creditor and What's the Difference Between a Secured Creditor and an Unsecured Creditor?

A secured creditor is a creditor whose claim is supported by a security interest in a debtor's assets. A classic example of a secured creditor is a lender who has a loan agreement with the debtor under which the amount of the loan is secured by a lien on all the debtor's assets. However, not all secured creditors look the same. Indeed, while many secured creditors are lenders, others can have security interests arising from state law (e.g., a mechanic's lien) or a judicial lien arising from a judgment against the debtor.

Secured creditors can also differ based on the extent to which they are secured. For example, a creditor with a $100 million claim secured by an asset worth $100 million is fully secured, but a creditor that has a $100 million claim secured by lien on an asset worth $60 million is "under secured" — this creditor has a $60 million secured claim and a $40 million unsecured claim. Likewise, a secured creditor may have a different priority lien than another. For example, if two creditors each have $60 million claims, each backed by a security interest in a $100 million asset, but Creditor A has a first lien security interest and Creditor B has a second lien security interest, Creditor A must be paid its full $60 million claim before Creditor B can be paid at all. Because the collateral is only worth $100 million, once Creditor A is paid in full, Creditor B's claim is only secured for $40 million (because only $40 million in collateral remains after paying Creditor A), and therefore, holds an unsecured claim for $20 million.

An unsecured creditor is a creditor who holds a claim against the debtor, but whose claim does not have the support of a lien or security interest. In a Chapter 11 bankruptcy, secured creditors must be paid in full (to the extent of their security interest) before any unsecured creditor can be paid at all. Unsecured creditors can take many forms — trade vendors, contract counterparties, landlords, governmental entities, and employees, to name a few.

Key Issues

- **DIP Lenders.** A DIP (short for "debtor-in-possession") lender is a secured creditor that makes a loan to a debtor *after* it has filed for bankruptcy in order to fund the Chapter 11 case. DIP loans are, for example, used to provide funding to pay for the debtor's professional expenses or run a marketing and sale process to sell the debtor's assets. In exchange for lending to a debtor already in bankruptcy, a DIP lender is given "super priority" status, placing it at the top of the priority scheme, ahead of pre-petition secured creditors. A DIP lender can be a pre-petition lender that opts to extend credit to a debtor, or it could be a new lender with no previous lending relationship with a debtor.
- **Credit Bidding.** In cases involving a sale of the debtor's assets, secured creditors sometimes can avail themselves of credit bidding. A credit bid allows a secured creditor to offset an outstanding secured claim against the proposed purchase price for a debtor's assets in a bid. For example, if a secured creditor wants to bid $100 million for substantially all a debtor's assets in a bankruptcy sale process, and it has a $60 million secured claim, the secured creditor can make a $100 million bid comprised of $40 million in cash and $60 million in a credit bid. If that creditor wins the auction, it will no longer hold a $60 million secured claim, but it will have purchased the debtor's assets (presumably worth $100 million in market value) with only $40 million in cash on hand. Credit bidding can give secured lenders interested in buying assets an advantage over other bidders who would need to provide cash (or find funding) for the full purchase price of their bids.

Takeaway

Secured creditors hold significant leverage and have important advantages in a Chapter 11 case. Experienced bankruptcy counsel can help these creditors make the most of their status. Meanwhile, it is just as important for unsecured creditors to be well advised when navigating Chapter 11 cases — while unsecured creditors may not have the same advantages as secured creditors, they can still achieve a favorable result in a Chapter 11 case with proper guidance.