

Segment 7: When the Deal Goes Bad: Bankruptcy Issues in Real Estate Deals

Date: September 27, 2006

Time/Length: 1:00p.m. ET (60 minutes)

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When a deal does not develop as planned or there is an economic downturn, the essentials of bankruptcy law in real estate:

- Pre-planning: What to incorporate into acquisition and finance agreements
- Techniques for limiting liability
- When it's too late: Post-petition planning opportunities, including workouts

PROFESSIONAL EDUCATION BROADCAST NETWORK

**Putting the Deal Together:
The Art and Practice of Commercial Real Estate Transactions**

“Segment 7: When the Deal Goes Bad: Bankruptcy Issues in Real Estate Deals”

September 27, 2006

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COMMERCIAL REAL ESTATE TRANSACTIONS AND THE BANKRUPTCY CODE

- **Mortgages and Other Financing Arrangements**
- **The Automatic Stay**
- **Bad Faith Filings and Single Asset Real Estate Cases**
- **Purchase and Sale Agreements**
- **Preferences and Other Avoidable Transfers**

Mortgages and Other Financing Arrangements

Default and Remedy Provisions:

- What are the events constituting default; what notice, if any, is necessary; and how does bankruptcy alter the landscape?
 - *Automatic Stay of 11 U.S.C. § 362¹*
 - Broad injunction against actions affecting debtor or property of the estate, arising automatically from the moment petition is filed
 - Mere giving of notice of default may violate the stay
 - Duration of any grace period may be extended if petition filed after default but before expiration of grace period. *See* § 108(b) (contract grace period that has not expired on petition date lasts until the later of the expiration of grace period under the contract or 60 days from order for relief).
 - Mortgagee forced to obtain relief from stay under § 362(d) to place mortgagor in default in first instance and seek additional stay relief to permit exercise of mortgage remedies.

¹ Unless otherwise indicated, all chapter and section references are to the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*

- DRAFTING TIP: *Consider self-operative default clauses*
 - *Benefits*: No notice/stay violation issues and avoid delay caused by § 108 extension
 - *Possible downside*: In the absence of prompt action, trustee or debtor-in-possession (“DIP”) could have a waiver argument
 - Payment defaults for interest, principal or other charges should occur without notice and without grace
 - Avoid § 108(b) delay to stay relief; waiver highly unlikely
 - Payment defaults for insurance premiums, real property taxes and amounts owed for labor and materials should occur without notice and without grace
 - Avoid tax liens, mechanic’s liens or lapsed insurance coverage
- Section 365(e) makes bankruptcy default and ipso facto clauses unenforceable
 - Mortgaged property still becomes property of the estate under §541(c)(1)(B)
- Under §1124(2), mortgage defaults can be cured and loans reinstated on original terms or modified pursuant to a confirmed Chapter 11 plan under §1129(b)(2)(A)

DRAFTING TIP: Keep default clauses anyway – they should include a wide range of default triggers including those that would not implicate the Code, e.g., assignment for the benefit of creditors under state law

DRAFTING TIP: Any bankruptcy or ipso facto should be drafted to include the insolvency of any guarantor so that the insolvency of a non-debtor guarantor, e.g., parent company or affiliate of the debtor) can trigger the bankruptcy default.

Leasehold Mortgages

- *Rejection of Leases When Debtor is Lessor Under § 365(h)(1)*
 - When an unexpired lease of real property, under which debtor is lessor, is rejected, lessee may:
 - (1) treat lease as terminated if the rejection amounts to a breach that would give rise to a termination right under terms or applicable non-bankruptcy law; or
 - (2) elect to retain rights appurtenant to real property under lease for balance of term and any renewals or extensions if option is lessee's.
 - If rejected, lessee must surrender possession and will have a claim for damages arising out of the rejection
 - *No limit* to lessee's claim for damages from lessor-debtor's rejection as there is under §502(b)(6) for lessors with claims for damages arising out of lessee-debtor's rejection under § 365
 - DRAFTING TIP: If a mortgage on the leasehold is contemplated, consider adding a clause that rejection by lessor's trustee will have no effect on the mortgagee's lien
 - DRAFTING TIP: Consider clause extending leasehold mortgagee's lien to the right of lessee under §365(h) to continue the lease and requiring lessee-mortgagor to obtain mortgagee's consent before electing to treat lease as terminated upon rejection by lessor's trustee
 - Should assist mortgagee in demonstrating that cause exists for relief from stay under §362(d) if mortgagor seeks to treat as terminated without mortgagee's consent.
 - DRAFTING TIP: Consider clause effectuating an absolute assignment to mortgagee of lessee's claim for damages and lessee's right to control any litigation arising out of the lease as well as requiring immediate notice to mortgagee by lessee of a filing by lessor
 - Upon receipt of notice, mortgagee should file a notice of appearance to stay apprised of developments in lessor-debtor's bankruptcy case

- DRAFTING TIP: If possible, mortgagee should seek recognition in the lease itself of lessor's acknowledgement of assignment to mortgagee of lessee's right of election under §365(h)
- *Rejection of Leases When Debtor is Lessee Under § 365*
 - Mortgagee may be able to get mortgagor-lessee to agree to assign lease to mortgagee in lieu of rejection under § 365(a)
 - BAPCPA² CHANGE IN LAW: §365(d)(4) amended to create a bright line deadline for assumption or rejection of unexpired lease of non-residential real property
 - Congress reduced court's discretion to grant unlimited extensions
 - Lease must be assumed or rejected by the earlier of
 - (1) 120 days after commencement of bankruptcy case; or
 - (2) date of entry of order confirming plan.
 - May be extended prior to expiration for "cause" for 90 days
 - no further extensions unless lessor consents in writing
 - Mortgagee should attempt to take an assignment of lessee-debtor's right to seek extension of time to assume or reject
 - Mortgagee should seek agreement of lessor that mortgagee is successor tenant in event of rejection of lease by lessee debtor
 - Though rejection by lessee-debtor is a breach of the lease under § 365(g), most courts find that the lease is *not* terminated

Sale-Leaseback Transactions Compared to Mortgages

- *Bankruptcy Implications of Sale-Leaseback Compared to Mortgage*
 - With respect to *preferences* under § 547, better to be a lessor because lessor not required to return ordinary course rental payments received

² Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (most provisions effective as of October 17, 2005)

- within 90 days of filing date, while an under-secured mortgagee might be required to disgorge loan payments made during the same period
- With respect to *post-petition payments*, better to be a lessor because lessor likely will receive timely rent payments post-petition (unless and until lease is rejected); if mortgagee undersecured, no post-petition interest; if mortgagee oversecured, allowable post-petition interest under § 506(b) not payable until close of case
 - BAPCPA CHANGE IN LAW: When a non-residential lease is assumed and later rejected, § 503(b)(7) limits lessor's priority administrative expense claim for rent to two years following rejection of the lease (excluding penalties), minus sums received from other parties
 - With respect to *deficiency claims*, better to be a mortgagee because deficiency not subject to statutory limitation while lessor's damages are capped under § 502(b)(6)
 - With respect to *modification of the contract terms*, better to be a lessor because lease terms cannot be modified by court while mortgage is subject to cramdown
 - *Recharacterization of a Sale-Leaseback as a Financing Transaction*
 - Under certain circumstances, a court may recharacterize a sale-leaseback as a financing arrangement, e.g., a mortgage or a joint venture
 - Seller-lessee debtors seek recharacterization to avoid the application of §365(d)(3) and (4), while purchaser-lessors seek recharacterization to avoid the cap of § 506(b)(6) limitation on lessor's damages for lease rejection
 - § 365(d)(3) requires debtor lessees to timely make scheduled post-petition rental payments, imposing costs on delay tactics associated with surrender of unwanted leased space
 - § 365(d)(4) compel expedited rejection or assumption.
 - § 365 will *not* apply at all to a recharacterized transaction, meaning debtor will not have to assume or reject the contract – or cure any outstanding defaults as a prerequisite to assumption

- Recharacterization analysis looks at the economic substance of transaction, not upon holder of title, form of the transaction or denomination of transaction as “lease”
 - Similar to analysis under UCC of whether an arrangement is a lease or a security interest
- If lessee, upon compliance with terms of lease, has option to become owner for no additional consideration, lessor has no substantial interest in leased property at expiration of least term and transaction likely to be deemed a financing arrangement
- If lessee assumes and discharges substantially all of the risks and obligations ordinarily attributed to outright ownership, transaction likely a financing arrangement
- In such cases, “rental payments” are essentially payments of principal and interest on a loan secured by the real property
- Recharacterization favors debtor-lessee if value of premises is less than outstanding balance of debt
 - no post-petition interest
 - possible cramdown
- Recharacterization favors non-debtor party if value of collateral exceeds debt balance
 - non-debtor will enjoy benefits of fully-secured creditors under §506(b) and will avoid the cap on lessor’s damages arising out of rejection of lease

Assignment of Rents

- Right of mortgagee to directly collect rents made conditional on default
- Must give notice to tenants, who may insist on court order or indemnification from mortgagor before payment mortgagee.
- “Collateral” assignment is a security interest in rents as added security for loan

- Mortgagee holding assignment of rents must prove that
 - (1) prove that post-petition rent is subject to its lien under state law
 - (2) prevent trustee or DIP from using post-petition rents, which are cash collateral, without court approval under §363(c)(2); and
 - (3) seek adequate protection under §363(e) if such authorization is granted
- § 506(c) states that trustee may recover from property securing an allowed secured claim the “reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim”
 - May allow trustee to apply rent payments to operating expenses, e.g., taxes, insurance premiums
- Assignment of rents should include assignment of the right to claim damages arising out of rejection of a lease subject to the assignment
- Real estate lender with assignment of rents needs to be aware of possible *preference* issues under §547(b)
 - Is assignment executed and recorded within 90 days of bankruptcy to secure antecedent debt (or within one year if lender is an insider)?
 - When is assignment perfected under state law such that assignee is entitled to actually receive rents?
 - When is rent actually paid?

Automatic Stay

- Relief obtained by motion, commencing a contested matter under Fed. R. Bankr. P. 9014
- Relief from stay under § 362(d) for
 - (1) “cause” including lack of adequate protection;
 - (2) when debtor has no equity in property and property is unnecessary for an effective reorganization; and

- (3) in the case of a secured creditor of a *single asset real estate* debtor, if the debtor has not within 90 days of entry of order for relief (or 30 days after the court finds that debtor is subject to this provision, whichever is later) either
 - (a) filed a plan of reorganization that has a reasonable probability of being confirmed within a reasonable time; or
 - (b) commenced making monthly payments in an amount equal to the then applicable non-default contract rate of interest on the value of the creditor’s interest in the real estate
 - These payments may be made from rent or other income from the property irrespective of § 363(c)(2)’s restrictions on the use of cash collateral
- “Single asset real estate” means “real property constituting a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto.” §101 (51B)
 - BAPCPA CHANGE IN LAW: amends definition of single asset real estate to remove the \$4,000,000 cap on noncontingent, liquidated secured debts
- §362(b)(10) excludes from the protection of the automatic stay acts by lessors to retake possession of nonresidential real property the lease for which has expired by its terms before or during a bankruptcy case

Bad Faith Filing and Single Asset Real Estate

- Dismissal of case or termination of stay appropriate if case filed in bad faith
- §1112(b): dismissal for “cause,” includes bad faith, diminution of the estate and unauthorized use of cash collateral that harms creditors
- Bad faith factors include:
 - Was case filed immediately prior to or after the commencement of a foreclosure proceeding?

- Does debtor have few or no unsecured creditors?
- Can the case be characterized as a two-party dispute between the debtor and mortgagee?
- Is there a realistic possibility of an effective reorganization?
- Was debtor created – or the property transferred to debtor – for the sole purpose of filing a bankruptcy case?
 - BAPCPA CHANGE IN LAW: amended § 1112 limits the court’s discretion by mandating dismissal or conversion upon a finding of cause (absent “unusual circumstances”)
- While a total waiver of the right to seek bankruptcy relief by a borrower is unenforceable, a court may find a pre-petition agreement between lender and borrower that borrower waives right to object to relief from stay as cause for relief from stay under §362(d) or cause to dismiss or convert under §1112

Purchase and Sale Agreements

- Executory contracts under § 365 – may be rejected or assumed by trustee or DIP
- Monetary damages for rejection, not specific performance
 - Exception: §365(i), which allows purchaser in possession to make payments and take title as per contract even if seller’s trustee objects
 - Intended for land sale contracts but could have broader applicability
 - Purchaser may try to obtain possession of property before closing via a short term lease to take advantage of §365(i)
- If deed in escrow and seller cannot revoke, court likely will find contract not executory and not rejectable
- If purchaser has paid part of the purchase price and seller files for bankruptcy, §365(j) gives purchaser a lien on the property to the extent of the payment

- Issues related to priority and enforceability of lien exist so contract should include mortgage-like rights and remedies for non-debtor purchaser
- If purchaser is debtor, and rejects sale contract, non-debtor seller has claim for damages in amount allowable under state law – not capped like lessor’s damages under §506(b), even if purchase stems from exercise of an option in a lease

Fraudulent Transfer and Foreclosure

- BFP v. Resolution Trust Corp., 511 US 531 (1994)
 - Under §548(a), the price received at a real estate foreclosure sale constitutes “reasonably equivalent value” if sale complies with all of the requirements of state law.
- DRAFTING TIP: Limit guarantor liability to the limit of its solvency to avoid attack of any performance under the guaranty as a fraudulent transfer

Preferences and Insider Guaranties

- BAPCPA CHANGE IN LAW: §547 is amended to overturn the Deprezio case, 874 F.2d 1186 (7th Cir. 1989), which extended the preference period from 90 days to one year for non-insider creditors if the transfer benefited an insider
 - “Insider,” §101(31) – principal of, related to, or affiliated with debtor
- Now, a transfer made between 90 days and one year before bankruptcy filing to an entity that is not an insider but that benefits an insider is not recoverable from the non-insider
 - Should result in greater willingness by lenders to permit insider guaranties

- *Ordinary Course Defense Expanded Under BAPCPA*
 - §547(c)(2) now requires the creditor to prove that a transfer was made in payment of a debt incurred by the debtor in the ordinary course of the debtor's business, and that such transfer was made
 - (1) in the ordinary course of the business of the debtor and the transferee; OR
 - (2) made according to ordinary business terms
 - Previously, a creditor had to show both (1) and (2)
 - Amendment should reduce need for expert testimony regarding industry practices
- *BAPCPA Preference Venue Change*
 - 28 USC §1409 amended to provide that an action to recover a non-consumer debt against a non-insider of the debtor for less than \$10,000 must be brought in district in which defendant resides
- *§549 and the Good Faith Purchase Defense*
 - §549(c) has been amended to protect mortgage lenders who in good faith, without knowledge of debtor's bankruptcy, take a lien against debtor's property post-petition