

CCIM Presentation: How Bankruptcies Affect Distressed Assets

By: Tom Hillier and Ivy Grey

Davis Wright Tremaine LLP

BANKRUPTCY 101 – BASICS & CONTEXT

1. Guiding Policies

- a. Equality of Distribution
- b. Adequate Protection of Creditor's Interests Property
- c. Fresh Start for Debtor

2. Types of Bankruptcy

- a. **Chapter 7 Liquidation** – Most common; provides for independent liquidation and sale of debtor's assets owned at the time of filing and pro-rata distribution to creditors. Debtor may be an individual or business entity.
- b. **Chapter 11 Reorganization** – Assumes debtor will keep its assets and the assets will be used to generate earnings to fund a plan; permits, but doesn't require a sale. Debtor may be an individual or business entity.
- c. **Chapter 13 Adjustment of Debts** – Only individuals; debtor keeps some assets and makes payments to creditors under a plan; also called a wage earner's plan.
- d. **Voluntary vs. Involuntary** –
 1. Voluntary: Debtor files a petition for relief in the Bankruptcy Court.
 2. Involuntary: Creditors holding claims against a debtor can initiate a Chapter 7 or Chapter 11 case by filing an involuntary petition against the debtor.
 - i. 12+ Creditors: If debtor has 12 or more creditors, an involuntary petition requires the participation of at least 3 creditors who hold unsecured claims which aggregate at least \$12,300, and which are not subject to a bona fide dispute.
 - ii. Less Than 12 Creditors: If debtor has fewer than 12 creditors, one (1) creditor may initiate an involuntary petition, but the creditor must have an unsecured claim of at least \$12,300, which is not subject to a bona fide dispute.

3. Important Bankruptcy Concepts

- a. **Date of Petition** – The great dividing line.
- b. **Discharge** – A discharged debt is no longer enforceable against the debtor personally. The discharge acts as a permanent injunction against certain actions relating to pre-petition debts; prevents a creditor from beginning or continuing any law suit to enforce a discharged debt or judgment against the debtor.
 1. Under Chapter 11, plan confirmation discharges a debtor from any debt that arose before the date of confirmation. After confirmation, debtor must make plan payments and is bound by the plan which creates new contractual rights.
 2. Under Chapter 7, business entities aren't eligible for discharge
 3. Discharge does NOT affect the guarantee; the debt doesn't disappear.

4. If debt is secured by property of the debtor, creditor can still collect against the property after discharge subject to the terms of the plan.
5. Discharge Exceptions; includes such things as fraud committed by the Debtor.
- c. ***Automatic Stay*** – Acts like a restraining order; starts immediately upon filing; stays litigation efforts, any act to collect or perfect claim or interests that arose pre-petition; domestic support obligations are not stayed.
- d. ***Relief from Stay*** – The automatic stay will automatically end when property of the estate (“POE”) ceases to be POE or when the case is closed or dismissed or the debtor is discharged. In order to get take action against the debtor or POE before this time, you must request for relief (terminate, annul, modify, condition) from the stay.
 - a. ***For Cause*** – Lack of “adequate protection” (“AP”)
 - i. ***Examples of AP***: Substitute/additional liens, periodic cash payments, other protection that is the “indubitable equivalent” of the value. If your AP turns out to be inadequate you get an administrative expense claim.
 - b. ***No Equity AND Not Necessary to Reorganization***
 - c. ***After 90 Days for Single Asset Real Estate***
- e. ***Property of the Estate*** – Includes all legal and equitable interests of the debtor and any property that is community property of the debtor and his spouse. These are the assets are available to pay creditors.
- f. ***Secured & Unsecured Claims*** – Claims include any right to payment, whether or not such right is reduced to judgment, liquidated, fixed, contingent, unmatured, disputed, legal, equitable, or secured.

4. First Days of a Chapter 11 Case

- a. ***First Day Orders*** – Usually administrative, notices, hire professionals, business emergencies (obtain financing, cash collateral, critical vendors, etc). Debtor requests authority for debtor to perform numerous actions or avoid certain requirements. Usually heard within 48 hours of filing without full notice to all creditors. Often temporarily granted with later final approval.
 1. ***Examples***: Motion to Consolidate and for Joint Administration; Motion to Approve Use of Cash Collateral and Adequate Protection; Motion to Authorize Post-Petition Secured Credit; Motion to Extend Time to Assume or Reject Unexpired Leases of Nonresidential Real Property
- b. ***Continuing Operations***
- c. ***Debtor in Possession and Trustees & Examiners***
- d. ***Funding the Bankruptcy – Cash Collateral Orders***
 1. ***Cash Collateral*** – A debtor in possession may not use cash collateral without the consent of the secured party or authorization by the court, which must first examine whether the interest of the secured party is adequately protected. Can be derived from other collateral, a creditor must have an interest in it; requires either consent or adequate protection

2. Adequate Protection – When cash collateral is spent, the secured creditors are entitled to receive additional protection under section 363. Pending consent/authorization, the debtor in possession must segregate and account for all cash collateral in its possession. A party with an interest in property being used by the debtor may request that the court prohibit or condition this use to the extent necessary to provide adequate protection to the creditor.

COMMERCIAL REAL ESTATE BANKRUPTCY MATTERS

Leases & Executory Contracts

1. ***Leases & Executory Contracts*** – A debtor has 120 days from the petition date to assume or reject the lease (90-day extension allowed).
 - a. *Time for Making a Decision*
 1. Chapter 11 – A lease of non-residential is deemed rejected unless it has been assumed.
 2. Chapter 7 – Trustee must decide within 60 days of filing or contracts deemed rejected; can be extended for 60 days, but not for non-residential real property leases; if a debtor assumes the debt, then the debtor personally (not the estate) assumes the benefits and burdens of the lease.
 - b. *Effects of Rejection, Assumption, and Assignment*
 1. Property of the Estate: If rejected, then no longer POE; if assumed, then rights under contract or lease are POE; if assigned, then proceeds if any are POE
 2. Claims: If *rejected*, then creditor gets an unsecured claim for pre-petition defaults and for breach resulting from rejection and a priority administrative expense claim for post-petition obligations; if *assumed*, then creditor gets a priority administrative expense claim for all obligations under the lease post-petition or pre-petition; if *assigned*, then creditor gets no claim against the estate, creditors must now look solely to the third party assignee to recover any damages.
 - c. *Landlord (as Debtor)-Specific Rules*
 1. The landlord/debtor evict tenants; even if it rejects the lease. The tenant has the right to remain in possession; but the trustee can use the rejection to terminate some services. In turn, tenant can claim rejection damages and can use set off to reduce rent payments.
 2. Sub-Tenants: If you are a tenant under a sublease and the sub-landlord files for bankruptcy, your right to occupy the property will likely be terminated if the sub-landlord rejects the master lease. You may retain your rights to possess the property, however, if you have a non-disturbance agreement with the ultimate landlord or if you are a third party beneficiary of a non-disturbance clause in the master lease.
 - d. *Tenant (as Debtor)-Specific Rules* – If tenant rejects, the landlord will be entitled to lease rejection damages consisting of what the tenant owes in rent from the date of petition through the natural lease termination date. The Code imposes a cap on

those damages equal to the greater of one year of rent or 15 percent of the rent, not to exceed three years, for the remaining term. The automatic stay prevents the landlord from evicting the tenant for failure to pay pre-petition rent; landlord is entitled to collect rent on a current basis after Chapter 11 is filed.

1. Tenant Rejection: The court will treat or allow the lease rejection damages as a general unsecured claim, with hopes of getting paid sometime in the future after a reorganization plan is approved by the court and/or distributions from the estate are made to creditors.
 2. Tenant Assumption: Landlords have some protections regarding any proposed assumption or assumption and assignment: adequate assurance of future performance; tenant must cure all monetary defaults and pay damages for non-monetary defaults as a prerequisite to the assumption and assignment. (Shopping-center landlords are afforded additional protections including limitations on potential assignees.)
 3. No Decision: If the debtor doesn't make a decision within the required time then the lease is deemed rejected and debtor must immediately surrender the premises to the landlord.
 4. Eviction: If a tenant is not paying post-petition rent, then the landlord may ask the court to compel payments or to get relief from stay in order to evict the tenant.
- e. Gap Period Performance – Non-debtor must continue to perform while debtor is deciding; debtor must continue to perform.
 - f. No assumption and assignment if the lease terminated pre-petition.
 - g. Loan commitment or other financing arrangement cannot be assumed

2. *Landlord (as Creditor)Related Provisions*

- a. Eviction When Lease Terminates Pre-Bankruptcy: The stay does not apply to actions to recover possession of the leased premises if the lease is terminated prior to the date the bankruptcy petition was filed, on the basis the lease would not be considered an asset of the debtor's estate at the time the bankruptcy petition is filed.
 1. If the tenant is behind and likely to file bankruptcy, if the lease provides, you should consider terminating the lease. If you wait until the tenant files bankruptcy, then you will have to wait until the lease is rejected in order to get rid of the defaulting tenant. Even if the space is technically empty, you will not be able to re-lease the space to another tenant until the lease is rejected.
- b. Security Deposit:
 1. A landlord may use the security deposit to offset the total amount of lease rejection damages and pre-petition damages because it is entitled to setoff as a secured creditor to the extent of the security deposit. Landlord must get relief from stay to effect a set off of a security deposit post-petition.
 2. A security deposit is an asset of the bankruptcy estate.

3. Landlord has a perfected (through possession) security interest in the deposit, and courts have permitted landlords to retain security deposits to the extent of their allowable claims.
- c. *Going out of business sales*: the debtor shall have no more than seven months to complete a going out of business sale, unless the landlord agrees to allow a longer period.

3. *MasterLease Issues*

- a. Attornment
- b. Subordination
- c. Non-disturbance

4. *Use, Sale, and Lease of Property*

- a. *Leasing space in a building during landlord's bankruptcy*:
 - a. Ordinary: The debtor may use, sell or lease POE in the ordinary course of business without notice or hearing in most circumstances.
 - b. Extraordinary: If not in the ordinary course of business, the trustee after notice and an opportunity for a hearing, may use, sell and lease property of the estate outside the ordinary course of business with court authority.

Administrative Expense Claims for Leases

- b. ***Priority***: Administrative Expense claims are high priority and include unpaid rent and other items of damages during the bankruptcy.
 - a. Chapter 11 – If the debtor obtains confirmation of a plan of reorganization, this claim must be paid in full in cash.
 - b. Chapter 7 – If the case is converted to Chapter 7, some payment on this claim is likely.
- c. ***Pre-Petition Rent and Damages***: In addition to lease rejection damages, the landlord is also entitled to any pre-petition damages consisting of rent due and unpaid as of the petition date, as well as legal fees if provided for in the lease.
 - a. There is no cap on pre-petition damages.
 - b. The landlord is entitled to both lease rejection damages and pre-petition damages as an unsecured claim.
- d. ***Post-Petition Rent***: If the debtor remains at the leased premises post-petition, landlord is entitled to rent during the bankruptcy until the tenant rejects the lease, surrenders and vacates the premises, or assumes the lease.
 - a. The rent is considered an administrative expense.
 - b. The Code does not cap administrative rent, which means the debtor could be subject to any cost-of-living adjustments and other rent charges provided for in the lease.

MISCELLANEOUS ISSUES

Single Purpose, Single Member LLCs

a. Why Are SPEs So Common in Commercial Real Estate?

- i. Theory: Unlikely to become insolvent as a result of its own activities and adequately insulated from the consequences of a related party's insolvency. Credit analysis assumes borrower is not subject to economic problems unrelated to the mortgaged property.
- ii. Limitations: Purpose, Activities, Indebtedness, Fundamental Actions
- iii. Relationships to TIC Transactions

b. Changing Landscape of SPE Transactions

- i. Consolidation: Originally, the structure of the SPEs seemed unlikely to allow consolidation in bankruptcy, the judicial view is changing.
 1. Substantive v. Administrative Consolidation
- ii. Corporate Family Theory of Consolidation: Secured lenders were concerned about substantive consolidation. The court did not substantively consolidate, but instead created the "corporate family" view. Court looked at the interests of the group of debtors as a whole rather than at the individual entity level. So, while the debt is not consolidated, the court's decisions are made by viewing the group as a whole engaged in a common enterprise.

c. Common Problems SPEs & TICs

- i. Structure
- ii. Tax Consequences

Non-Bankruptcy Workouts

- a. *Buying a Troubled Note*: What is involved for your client to buy the note and take the property from the borrower?