Bankruptcy Basics for Commercial Real Estate Developments

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Ordinarily an article on the topic of Commercial Real Estate Development 101 would be a review of basic due diligence checklists for both sales and financings. However, given the current economic downturn, this space will be better used to review bankruptcy basics[1] for commercial real estate developments, with particular emphasis on the 2005 Bankruptcy Reform Legislation[2] and the treatment of regulatory actions in the bankruptcy context.

A list of bankruptcy provisions most likely to affect a commercial real estate development include:

- The Automatic Stay, imposed by Section 362[3]
- Use, Sale or Lease of Property, authorized by Section 363
- Executory Contracts and Unexpired Leases, governed by Section 365
- Preferences, recoverable under Section 547
- Fraudulent Transfers, recoverable under Section 548
- Abandonment of Property, allowed by Section 554

Although this is not an exhaustive list and the treatment will be abbreviated, these are the sections encountered in most bankruptcies of real estate assets.

Positives/Negatives of Automatic Stay

The automatic stay prevents any action against the debtor to collect a debt or foreclose on real estate collateral owned by the debtor, while its bankruptcy case is pending, unless the court grants relief. If your client is the owner of a financially distressed project, this is very good news, since it will allow necessary "breathing room" to propose an effective plan of

reorganization. However, if you represent an office complex with one or more financially distressed tenants in bankruptcy, this very same breathing room may be the death knell for positive cash flow and ultimate success of the complex. As mentioned, the court may grant relief from the automatic stay, but that is unlikely during the first 120 days of the case—the debtor's exclusivity period—during which time only the debtor may propose a plan of reorganization.[4] Relief from the stay requires either: a lack of adequate protection[5]; or a showing that the debtor has no equity in the project[6] and that property is not essential to an effective reorganization of the debtor.

Limitation on Automatic Stay

An extremely important limitation on the automatic stay was added by Congress in 2005 to deal with the single-asset real estate case (SARE). This case is defined as one involving a single property or project, other than residential property of fewer than four units, that generates substantially all the gross income of a debtor and that has substantially no business other than operating the property. In such a case, the automatic stay remains in effect only if the debtor files a confirmable plan of reorganization or commences monthly payments to secured creditor(s) on or before the later of 90 days from the filing of the case or 30 days from the date the court determines that the debtor has "single-asset real estate."

Allowable Chapter 11 Property Transactions

A Chapter 11 bankruptcy debtor is allowed to use, sell, and lease its property in the ordinary course of its business. However, its use of cash collateral requires either the consent of each affected creditor or a court order authorizing the proposed use, sale, or lease. Most disputes over use, sale, or lease of the debtor's property revolve around the negotiation of an order determining the boundaries that will be placed on the debtor's actions. Again, the debtor usually will be granted a good deal of discretion during its exclusivity period. One of the things that the 2005 Bankruptcy Reform Legislation accomplished was the insertion of protections against the disclosure of "personally identifiable information" about individuals that might occur as an incident of the use, sale, or lease of the debtor's property,[7] but this issue is usually peripheral in a real estate case.

Under Section 365, the debtor may assume or reject executory contracts and unexpired leases. If assumed, then any pre-existing defaults must be cured (which may be effected through the debtor's proposed plan of reorganization) and the debtor must provide adequate assurance of future performance. One of the most significant revisions of

the 2005 Bankruptcy Reform legislation was the change to both the timing and means of assuming/rejecting commercial real estate leases. Under previous law, the debtor had 60 days from the filing of the case to decide whether to assume or reject, and the debtor had to take some affirmative action to achieve either result. There were few limits placed on the extension of this time period and landlords' attempts to regain control over space leased to a debtor were often frustrated. Under the new law, the commercial lease is deemed rejected (without any action by the debtor) upon the earlier of: 120 days from the filing of the case, or confirmation of a plan of reorganization. A single extension, limited to 90 days, may be granted "for cause." Subsequent extensions require the landlord's consent.[8] At most, therefore, landlords may have to wait for seven months. Although this may still seem to be an inordinate amount of time, it is a vast improvement.

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The code sections on both preferences and fraudulent transfers are designed to preserve as much value as possible in the debtor's assets to ensure fair and equitable treatment of all creditors. As a result, these are two mechanisms that allow the debtor to revoke transfers made within specified time periods prior to the filing of a bankruptcy case. The pre-viously transferred property is brought back into the debtor's possession and control for the benefit of all creditors. The preference period is 90 days prior to the filing of the case (or one year for insiders) and will pick up delinquent payments and sometimes property transfers. The fraudulent transfer period is one year, plus any additional time period afforded by applicable state fraudulent transfer laws. Avoidable fraudulent transfers are those for which the debtor does not receive reasonably equivalent value. The developer and/or landlord should not avoid making transfers or payments because of the risk of a preference or fraudulent transfer determination; however, it is prudent to bear in mind the possibilities when conducting business with a financially troubled enterprise.

In 2005, Congress attempted to put to rest the possibility that a lender or other non-insider could be liable for a preference made more than 90 days before bankruptcy to an insider. The theory under which the avoidance was permitted was a benefit accruing to an insider as a result of the transfer to a non-insider within the one-year period. Now, avoidance of transfers to non-insiders are allowed only when they occur during the ninety-day period preceding the filing of the case. This was one of the few 2005 amendments that applied retroactively, that is, to cases pending on the effective date of the legislation.

Finally, an abandonment order removes property from the bankruptcy case and means that the automatic stay no longer prohibits actions to foreclose liens and security

interests affecting the property. Delin-quent tenants may be evicted. The debtor and any landlords/creditors are free to take action under applicable state law, without interference by the bankruptcy court. When the property in question is subject to state or federal regulatory actions, such as environmentally-impacted property, the issue may become quite complicated.[9] The standard set forth in Section 554 provides that abandonment is permissible when the property is burdensome to the estate or has inconsequential value and benefit. In the case of contaminated properties, the U.S. Supreme Court has prohibited abandonment when it would violate a state's environmental laws.[10] Lower courts have taken these two standards and developed a list of seven factors to be considered in deciding whether to allow abandonment. In actuality, the determination often turns on only two questions:

1.) Whether the debtor has unencumbered assets to pay for remediation or other environmental obligations, such as fines and penalties.

2.) Whether there is a present or imminent threat to public health and safety.

Because the answer to the first question is usually no, the majority of cases have allowed abandonment. As a result, the debtor's assets are not consumed by environmental obligations and the secured creditors are not saddled with the cleanup liability.

Hopefully, this brief overview has provided insights, ideas, and strategies about potential approaches to your next insolvency situation.

Endnotes

1. For this article, we assume that a debtor owning a single real estate asset files for reorganization under Chapter 11 of the U.S. Bankruptcy Code.

2. For information about the 2005 Bankruptcy Reform Legislation, the author has relied heavily on William Houston Brown and Lawrence R. Ahern, *2005 Bankruptcy Reform Legislation with Analysis* 2d, West, (2006).

3. All Section references are to Title 11 of the United States Code.

4. Section 1121.

5. Complete treatment of what constitutes adequate protection is beyond the scope of this article; however, generally it means some level of cash payments designed to maintain the status quo while reorganization possibilities are explored.

6. Valuation issues are always tricky and present fertile ground for arguments on both sides.

7. Section 363(b)(1).

8. Section 365(d)(4).

9. For information on the effect of the automatic stay on contaminated real estate, the author has relied heavily on Lawrence R. Ahern and Darlene T. Marsh, *Environmental Obligations in Bankruptcy,* Thomson Reuters forthcoming.

10. Midlantic Nat. Bank v. New Jersey Dept. of Environmental Protection, 474 U.S. 494 (1986).