Potential Bankruptcy Strategies for Stakeholders in Real Estate Transactions; Relevant Provisions of the U.S. Bankruptcy Code

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In light of the ongoing economic impacts of the COVID-19 pandemic, and although Chapter 11 of the U.S. Bankruptcy Code pertains to many industries, there are certain real estate related provisions of which owners and tenants should remain particularly aware in planning strategies to cope with the fallout from the current health crisis.

To raise awareness in that regard, the following is a general summary of some of the more critical provisions of the Code.

Single Asset Real Estate Entity

Generally speaking, a single asset real estate entity is one that owns a single property (excluding a residential property having less than four units) that generates substantially all of the gross income of the debtor and on which no substantial business is being conducted by the debtor other than the business of operating the real property.

This provision is a product of significant bank industry lobbying and is designed to expedite the real estate Chapter 11 process. The time to file a plan for reorganization for a single asset real estate entity is shortened to 90 days from the 120 day exclusive period. The debtor must either (1) file a plan that has a reasonable possibility of being confirmed within a reasonable period of time, or (2) commence payments to the secured creditor on a monthly basis in an amount which represents interest at the non-default rate on the value of the underlying collateral.

The single asset entity provisions apply broadly to apartment buildings, office buildings, warehouses and any other structure in which the business of the property owner is that of management – as distinguished from the business of a tenant at the property. In situations in which the

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building owner and the building business operator are affiliated, an issue will arise with respect to the separation of the entities. In such a case, if the business files the Chapter 11, it will not be deemed a single asset real estate entity. Where the property-owning entity files, bear in mind that the election to be treated or not to be treated as a single asset real estate entity is in the first instance that of the debtor. Lenders may challenge the election of the debtor.

Section 362: The Automatic Stay

The stay comes into existence automatically upon the filing of a bankruptcy. While there are many exceptions to the stay, the baseline is that the stay enjoins the prosecution of claims against a debtor and the property of the debtor. So, for example, upon the filing of a petition all lawsuits are stayed, foreclosures are stayed, and motions for the appointment of receivers are stayed.

If a landlord has terminated the lease of a tenant in accordance with the terms of the lease prior to the filing of the bankruptcy, the lease is no longer considered property of the debtor's estate and so the eviction proceeding can continue in the state court (although not during the COVID-19 pandemic).

The stay can also have an impact on option agreements although the case law seems to indicate that the stay will not toll the passage of time under an option agreement. Under certain state laws, provided that a subcontractor has taken the proper steps to file a contractor's lien prior to the filing of a bankruptcy, the stay may be modified so as to enable the contractor to perfect the lien post filing with the date of perfection relating back to the date of filing of the contractor's lien.

Landlords and tenants each must evaluate the strategy with which they approach the COVID-19 crisis, keeping in mind how they may best insulate themselves from, or protect themselves in the event of a chapter 11 filing.

Section 363: Sale, Use and Transfer of Assets Including "Cash Collateral"

This section allows the debtor whose assets are real estate (as well as other assets) to sell its assets outside of a plan free and clear of liens, claims and encumbrances, with such to attach to the proceeds of the sale. The sale will require court approval, and in certain circumstances the consent of the lien holder. When properly strategized, this provision is a very useful tool to a debtor.

Another part of section 363 deals with the debtor's use of cash generated from leases or receivables which are pledged to a secured creditor. Cash collateral is a concept involving cash in which the debtor and the secured creditor have an interest. Before the debtor can use the cash collateral for the operation of its business, it must secure either the consent of the secured party or court approval. A court will want the debtor to show that the secured party will be adequately protected for the debtor's use of cash collateral. The ability of a debtor to use cash collateral is significant since without it, business continuation is unlikely, and the Chapter 11 is doomed.

Section 364: Borrowing by the Debtor During the Proceeding

This section provides that the debtor may borrow money during the proceeding with the court's approval. Under certain conditions the debtor may borrow on a secured basis if there is no other available means of borrowing. When a debtor makes an application to the court to approve a loan on a secured basis, the debtor must show that the terms are reasonable and that absent the loan the debtor would be unable to operate. In exchange for the loan, the debtor is permitted to provide the lender with a super priority administrative claim and a post-petition lien on assets.

An issue may arise when the lender seeks to have what is called a priming lien, meaning that the lender wants its position to be prior to existing secured loans. In such a case, the debtor must persuade the court that doing so will not prejudice the collateral position of an existing lender – typically a very difficult task.

Section 365: Executory Contracts and Leases

This section provides the process by which a debtor (landlord or tenant) may deal with its lease.

When the debtor is the landlord, the landlord may reject the lease, or it may assume the lease. If the landlord rejects the lease it frees the landlord from all the obligations under the lease such as repair and maintenance obligations. The tenant may, however, elect to remain in possession for the balance of the term of the lease provided that it continues to make the monthly rental payments plus additional rent as defined in the lease. The tenant is not responsible for making payments for services that it does not receive because of the landlord's rejection. The tenant will also have a damage claim against the landlord for the cost of replacing the landlord's obligations, but the rejection damage claim is an unsecured claim.

If the tenant files the bankruptcy it, too, may assume or reject the lease. If it is in default prior to the filing date, in order to assume the lease, it must negotiate a cure that is acceptable to the landlord. If the tenant rejects the lease, it must vacate the space and the landlord will have a rejection damage claim against the tenant which is limited to the greater of one year's rent or 15% of the remaining rent reserved, not to exceed 3 years of reserved rent. The rejection claim is an unsecured claim.

In order to retain possession of the space during a Chapter 11 proceeding, however, a debtor-tenant must pay as an administrative expense the rent reserved in the lease. Failure to do so gives the landlord the right to relief from automatic stay and a right to terminate the lease.

Section 1129: Plan Confirmation

This section sets forth the requirements of confirmation. In order to confirm a plan at least one class of creditors that is impaired must vote in favor of the plan. A favorable vote requires not less than 2/3 of the dollar amount of allowed claims and 50% in number of the creditors holding allowed claims. Note that the computation is in terms of those voting.

In some cases, where there is a secured creditor with a mortgage on real property, the secured claim may be "undersecured." This occurs when the value of the collateral has diminished as of the date of filing of the petition because, for example, there is a loss of tenants. As a result, the value of the mortgage is reduced by the lack of value in the real estate. In such cases, the secured claim may be bifurcated into a secured claim and an unsecured claim. If the unsecured claim is large enough, then the secured creditor in a two-class plan may control both classes and block confirmation.

The above examples of provisions of the Bankruptcy Code impacting stakeholders in real estate transactions including landlords and tenants are reflective of the firm's many years of experience and broad understanding of the Code and its impact on businesses in the real estate sector.

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