



# Bankruptcy Fundamentals for Real Estate Investors & Advisors

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**Collaborative. Accountable. Authentic.**  
**Legal Solutions for Business Objectives.**



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# What is Bankruptcy?

- It is a fresh start for Debtors who are in financial distress.
  - The automatic stay prevents “the commencement or continuation ... of a judicial, administrative, or other action or proceeding against the debtor” which arose prior to the debtor’s bankruptcy filing. 11 U.S.C. § 362(a)(1).
  - Commenced voluntarily by filing a bankruptcy petition in the United States Bankruptcy Courts.
    - Can be commenced in any bankruptcy court “in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement....” 28 U.S.C. § 1408.
    - For a single-asset real estate LLC, this will generally be the court where the asset is located.
  - Sometimes commenced involuntarily:
    - By three or more creditors holding undisputed claims of at least \$21,050; or
    - One creditor holding a claim of at least \$21,050 if there are only 12 such creditors.
  - Creation of the bankruptcy “Estate”
    - “[A]ll legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C. § 541.

# Liquidation and Reorganization

- Chapter 7
  - Individual and corporate Liquidation
- Chapter 11
  - Corporate reorganization
  - Individuals are permitted to file under chapter 11, but it is rare (because it is expensive)
- Chapter 12
  - Family farmer or fisherman reorganization
- Chapter 13
  - Individual reorganization
  - Debt limit
- Chapter 9 and 15

# Chapter 7 - Liquidation

- Chapter 7 Trustee is appointed to find and liquidate unencumbered assets for the benefit of creditors. 11 U.S.C. § 704.
- Unsecured creditors are rarely paid in full, generally receive pennies on the dollar of what they are owed.
- After liquidation, an individual debtor receives a discharge of their debt. 11 U.S.C. § 727.

# Chapter 11 - Reorganization

- The goal of Chapter 11 is to keep the debtor in business.
- Debtor remains in possession of their assets, otherwise known as a “debtor-in-possession”.
- First day motions – minimizing disruption to business operations:
  - Motion to use cash collateral, motion to approve debtor-in-possession financing, motions to employ professionals (attorneys, chief restructuring officers, etc.).
- Use, Sale, or Lease of Property of the Estate
  - A debtor may continue using, selling, or leasing its property in the ordinary course of business without court authorization.
  - Actions outside of the ordinary course require court approval.
  - If a Debtor has equity in collateral, it may seek to sell the collateral through bankruptcy. In doing so, it must agree to pay the secured creditor from the proceeds of a sale.

# Adequate Protection

- A secured creditor is entitled to have its interest in property adequately protected. 11 U.S.C. § 363(e). “Adequate protection means that the value of the creditor's interest in the collateral must be protected from diminution while the property is being used or retained in the bankruptcy case.” *In re Gallegos Rsch. Grp., Corp.*, 193 B.R. 577, 584 (Bankr. D. Colo. 1995).
- “[T]he code specifically ensures the protection of a secured creditor's assets against any decrease in value from the beginning of the automatic stay, and, because the stay is instituted the moment the petition is filed, the protection from depreciation also begins at that moment.” *In re Stembridge*, 394 F.3d 383, 387 (5th Cir. 2004).
- Adequate protection can take several forms:
  - Cash payments
  - Replacement liens
  - Anything else constituting the “indubitable equivalent of the entity's interest in the property being sold, used or leased.” *In re EQK Bridgeview Plaza, Inc.*, 447 B.R. 775, 784 (Bankr. N.D. Tex. 2011).

# Relief From the Automatic Stay

- If the debtor does not provide adequate protection, the creditor is entitled to relief from the automatic stay. 11 U.S.C. § 362(d)(1).
- Relief from the stay may also be granted where (1) the debtor has no equity in the collateral and (2) it is not necessary for the debtor's effective reorganization.
  - “The test for determining equity under the first part of § 362(d)(2) involves a comparison between the total liens against the property and the property's current value.” See *Debra Jo Bowman v. Jack Bond (In re Bowman)*, 253 B.R. 233, 238 (B.A.P. 8th Cir. 2000).
  - The debtor bears the burden of proving collateral is necessary for its reorganization. 11 U.S.C. § 362(g)(2).
- If a creditor obtains relief from the stay, it can institute or continue proceedings under state law to foreclose on collateral.

# Executory Contracts and Leases

- A debtor may assume or reject executory contracts and leases as part of the reorganization process. 11 U.S.C. § 365.
  - A contract is executory if both parties have remaining obligations.
- To assume an executory contract, the debtor must:
  - Cure existing defaults
  - Compensate parties for any pecuniary loss suffered
  - Provide adequate assurance of future performance
- If a contract is rejected, the creditor is entitled to an unsecured claim for damages arising out of the breach of contract.
- The decision to assume or reject requires court approval. A debtor is not obligated to assume or reject until confirmation of a plan.
- Shopping Center Lease protections

# Plan Confirmation and Avoidance Actions

- The “Plan” is the debtor’s plan to pay creditors and emerge from bankruptcy as an operating business.
  - Plan Requirements
    - Proposed in good faith and feasible
    - If a creditor votes against the plan, the court must determine if the plan is in the best interests of creditors. Would creditors receive more from a liquidation?
  - Secured creditors get paid the value of their secured claim. If they are undersecured, they may have both a secured and unsecured claim.
- Preferences and Fraudulent Transfers
  - The estate may pursue actions to recover certain transactions made before bankruptcy.
  - In bankruptcy, the goal is equitable treatment of creditors. Transfers made prior to bankruptcy which favor a creditor over others or which were made for less than reasonably equivalent value may be set aside.

# Treatment of Leased Assets in Bankruptcy

- Application of Bankruptcy Basics to Commercial Leases
  - “Property of the Estate”: Following a tenant’s bankruptcy filing, the property of the estate is created consisting of all the property and assets the tenant owns or has an interest in at the time of the filing.
    - Leases are property of the estate (expired leases are not, including those that expire while bankruptcy is pending).
  - Automatic Stay: The filing by a tenant of bankruptcy automatically enjoins any landlord action against the tenant or their property.
  - Assumption, assignment or rejection of Lease (US Bankruptcy Code §365)
    - Tenant typically has 120 days to assume or reject subject to 90-day extension.
  - Section 502(b)(6) Cap
    - Landlord’s claim for damages capped at greater of (i) one year’s rent, or (ii) 15% of the unpaid rent for the remainder of the term, not to exceed three years.

# Minimizing Bankruptcy Risk

- Lease Negotiations
  - Form of Lease Security
    - Security Deposit
      - “Property of the Estate”
      - Subject to the automatic stay
    - Letter of Credit
      - Not “Property of the Estate”
      - Not subject to the automatic stay
    - Guaranty
      - Not “Property of the Estate”
      - Not subject to the automatic stay (provided guarantor has not filed for bankruptcy)
      - Landlord’s claims not subject to 502(b)(6) cap
  - Ipso Facto Clauses
- Termination of Lease Before Bankruptcy Filings

# Upcoming Webinars

## Workouts Without Bankruptcy: Legal Tools for Real Estate Recovery

- Wednesday, February 25

## Tenant Bankruptcy: What Landlords and Asset Managers Need to Know

- Wednesday, March 4

## Landlord Bankruptcy: Safeguarding Tenant Interests and Lease Rights

- Wednesday, March 11



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