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Real Estate in Bankruptcy: The Issues You're Likely to be Litigating
In the Coming Years
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Key issues

- Are we likely to see a flood tide of real estate bankruptcy cases in 2010? Reduction in lease rates, occupancy and re-sale values strongly suggests that real estate will be declining in value.
- Refinancing and hyper-amortization will further stress the market.
- Has there been a paradigm shift in attitude toward real estate cases: from the traditional “bad faith” analysis to the General Growth recognition?
- Is Bankruptcy likely to become the financing vehicle of choice, especially in view of the interest rule in *Till v. SCS Credit Corporation* ?
- Will the single asset real estate rules or the “bad faith” doctrine dampen any efforts to use bankruptcy.

Judicial doctrine of bad faith

“Single asset real estate cases” were and remain the most egregious example of “bad faith filings.” *In re 83-84 116th Owners Corp.*, 214 BR 530 (Bankr. E.D.N.Y. 1997)

Traditional bad faith doctrine:

- Filing on eve of foreclosure
- No positive cash flow
- No employees
- Single creditor
- Two party dispute

– *In re Little Creek Development Co.* 779 F.2d 1068 (5th Cir. 1986).

- Did General Growth signal a paradigm shift in which real estate will be recognized as a more legitimate debtor? Or will office buildings, etc. continue to be stigmatized?

Bankruptcy as the ideal source of refinancing?

- In 2004 the Supreme Court in *Till v. SCS Credit Corporation*, 124 S.Ct. 1951 (2004) adopted the “formula approach,” which begins with the “national prime rate” and then permits certain risk adjustments to the rate.
 - Prime plus a risk adjustment of 1% to 3%.
 - Rejection of contract rate.
 - Rejection of “coerced loan” model.

Is Till the law of the land?

- “[W]e decline to blindly adopt Till’s endorsement of the formula approach for Chapter 11. Rather . . . it might make sense to ask what rate an efficient market would produce. . . This means the market rate should be applied in Chapter 11 cases where there exists an efficient market.”
 - *In re American Homepatient, Inc.*, 420 F.3d 559 (6th Cir. 2005).
- Recommendation: urge court not to follow Till where it can be demonstrated that there is a market for commercial loans.
- Recommend court use the hybrid or blended rate, and apply one rate for the fully secured and another for the unsecured.

Single asset real estate defined: Section 101(51B)

- Single asset real estate means real property containing a single property or project, other than residential real property with fewer than 4 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 other than the business of operating the real property and activities incidental.
- Focus: is the debtor operating any other “substantial business.”

Legislative history and rationale for definition

- The definition of “single asset real estate” grew out of a distinct judicial distaste for real estate bankruptcies in the 1980’s.
- In closing, we remark that in enacting §§ 101(51B) and 362(d)(3), providing for extraordinary expedition in single asset real estate cases, Congress was motivated by a desire to accord relief in a particular familiar bankruptcy situation. That situation is where the owner of an encumbered building is attempting to avert loss of his building to his major lender who is grossly undersecured, and where there is no real hope that the owner can come forth with a viable confirmable Chapter 11 plan
- The drafters and promulgators of § 101(51B) were working in a bankruptcy context, and we have no doubt that their intention in using the phrase “single asset real estate” grew out of the common usage of that term in bankruptcy. By it, they meant a building or buildings which were intended to be income producing, or raw land.
 - *In re Kkehmko, Inc.*, 181 B.R. 47 (Bankr. S.D. Ohio, 1995).

The test for business activities?

- Single asset real estate lacks entrepreneurial effort and ‘hard work’.
 - The court held that in a non-single asset case, the debtor’s business activities are “variegated and multiple and are dependent on the entrepreneurial efforts and ongoing hard work of its principals and its other employees, and because it does not simply lease the property to tenants” as the owner of an apartment house does.
 - In re Club Golf Partners, 2007 WL 1176010 (E.D. Tex. 2007).

Examples

- Not a single asset case:
 - Marina
 - Hotels
 - Restaurants
 - Golf course
 - Parent holding company of subsidiaries which are single asset real estate.
- Is a single asset case:
 - Raw land
 - Office building
 - Apartment.

Relief from stay: section 362(d)(3)

- Court “shall grant relief from the stay. . .
 - (3) . . . unless, not later than the date that is 90 days after the entry of the order for relief
 - (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
 - B) the debtor has commenced monthly payments . . . in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditors’ interest in the real estate.”

Use of cash collateral

- BAPCPA modified 362(d)(3)– express authority of SARE debtor to use rental income for certain payments.
- “(B) the debtor has commenced monthly payments that
 - (i) may in the debtor’s sole discretion, notwithstanding 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case.”
 - are in an amount equal to interest at then applicable non default contract rate of interest on the value of the creditor’s interest in the collateral.

Application of Adequate Protection payments

- Adequate Protection payments are not necessarily “interest” and may be “principal” payments that are reducing the allowed secured claim.
- Or may be additional collateral and liquidation of additional collateral.
 - In re Vermont Investment Limited Partnership, 142 B.R. 571 (Bankr. D.C. 1992).
 - In re 354 East 66th Street Realty, Corp. 177 B.R. 776 (Bankr. E.D. N.Y. 1995)
- Tactical importance: if found to be principal, then the loan is being amortized, and the cram down of the lender is significantly easier.

The Real Estate Trinity: Litigation Involving Single-Asset Real Estate Cases, Retail Reorganizations and Liquidations

Non-Residential Lease Issues

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Non-Residential Lease Issues

- Assume nothing
- Reject complacency
- Put on your thinking cap
- Get ready to litigate

Non-Residential Lease Issues

A. 120 Days/A Bridge too far

- Extension must be granted with initial period
- Applies only to tenant debtor
- Can tenant non-debtor compel debtor landlord to assume or reject?

B. Pay to Stay/365(d)(3)

- Statutory mandate
- Right without a remedy
- Right to immediate payment
- Administrative Priority
- Sanctions for non-payment

Non-Residential Lease Issues

C. Beware of Trojans Bearing Cash: DIP and Cash Collateral Orders

- Defacto assignment of leases
- Defacto subordination of payment
- Payments from liquidators to debtor

D. Retroactive Rejection

- Does it really exist?
- Why does it matter?
- How is it done?
- What do the courts say?

Non-Residential Lease Issues

E. Landlord Claims/Stub Rent

- Proration Approach
- Billing Date Approach
- Timing Considerations
- Administrative Priority

F. Landlord Claims/Pre-Petition

- 502(b)(6)(B) “unpaid rent”
- Limited or unlimited

Non-Residential Lease Issues

G. Landlord Claims/Statutory Cap

- 502(b)(6)(A)
- 15% of rent due or lease term
- Claim limited to “rent reserved”
- Cap limited to “rent reserved”
- Treatment of non-rent damages
- Obligation to mitigate/application of mitigation proceeds
- Guarantees and Letters of Credit

Non-Residential Lease Issues

H. Landlord Claims/Post-Assumption

- 506(b)(7) Cap
- Post-assumption preference claims

I. Landlord Bankruptcy

- 120 (210) day period DNA
- Tenant Right/365(h)
- Tenant Damage Calculations
- Retained rights under lease
 - Landlord obligations released
 - Waiver of claim/offset rights
 - Shopping center restrictions apply

Non-Residential Lease Issues

J. Two Way Rejections

- Debtor as tenant/sublessor
- 365(d)(4) Rejecting tenant must surrender
- 365(h) Debtor's sublessee may retain possession
- Rejection = Termination
- Rejection = Breach
- Rights of Debtor if prime lease rejected

Non-Residential Lease Issues

K. Dueling Bankruptcies

- Landlord and Tenant in Chapter 11 cases
- Stay relief required?
- Race to assume/reject
- Tenant assumes/landlord rejects
- Landlord assumes/tenant rejects
- Both assume
- Both reject