BANKRUPTCY ISSUES FOR THE COMMERCIAL REAL ESTATE PRACTITIONER

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Bankruptcy Issues for the Commercial Real Estate Practitioner

In these increasingly uncertain times, business bankruptcy filings likely will have an increasing impact upon commercial real estate practice. This overview covers basic bankruptcy issues for the commercial real estate practitioner, along with provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) affecting business cases, and trends in non-bankruptcy alternatives.

I. Bankruptcy Basics

A. The Chapters.

There are six types of bankruptcy cases, each designated by the chapter of the Bankruptcy Code under which the case is filed. The most relevant chapters for commercial real estate practitioners are 7 and 11:

Chapter 7 – A Chapter 7 case is a straight liquidation, which can be filed by either a business or a consumer. Once the case is filed, a trustee is appointed from the local standing panel of trustees to administer the case. The trustee becomes the owner of all property of the Debtor, except property allowed as exempt in individual cases.

Generally, claims not secured by property receive little or no distribution. Any distribution on unsecured claims is on a pro rata basis. In individual cases, the Debtor has three choices with respect to collateral pledged to a lender: 1) reaffirm the debt and keep the collateral; 2) redeem the collateral by paying the current value of the collateral in lump sum; 3) surrender the collateral to the lender.

Chapter 11 – A Chapter 11 case may be filed by a business, or by an individual whose aggregate secured and/or unsecured debt exceeds the respective limits for filing a

Chapter 13 reorganization – currently $1,184,200.00 secured and $394,725.00 unsecured. A Chapter 11 case may be filed to attempt reorganization of the Debtor's business or to attempt an orderly liquidation. Where the Debtor is a real estate holding company, its principals will often choose Chapter 11 over Chapter 7 so as to retain control of the liquidation process and avoid fees and commissions to which a Chapter 7 trustee would be entitled upon liquidation.

Upon the filing of a Chapter 11 case, the Debtor becomes a "Debtor-in-possession" and continues to operate its business through pre-petition management under court supervision, unless and until the court appoints a Chapter 11 trustee for cause. The Debtor may propose a plan of reorganization or liquidation. Creditors vote on the plan and, if confirmed, the plan becomes a new binding contract between the Debtor and its creditors. Creditors with unsecured claims may receive a pro rata distribution. Creditors with secured claims generally receive the value of the collateral paid over time under the plan.

The Debtor may also sell real or personal property free and clear of liens, with liens attaching to sale proceeds in order of priority. *See* Section I.C., *infra*. This option does not require confirmation of a plan, but merely one or two court hearings on 21 days notice to parties in interest. As a practical matter, sales free and clear of liens are utilized far more often than plans of reorganization and liquidation. Most Chapter 11 cases end up converting to Chapter 7 or being dismissed without a plan being confirmed.

Another popular exit strategy, which was recently limited by the United States Supreme Court, is the structured dismissal. *See Czyzewski v. Jevic Holding Corp.*, 137 S.

Ct. 973 (2017). A structured dismissal allows for the Debtor to exit bankruptcy without confirming a plan, but also allows for the debtor to maintain some of the protections that it would have had under a plan.

B. The Automatic Stay

The most basic element of bankruptcy is the automatic stay. The automatic stay can be likened to a large wet blanket being thrown on everything that is happening the moment the bankruptcy case is filed. Creditors must immediately cease *all* collection activities. Collection activities include any action taken to attempt to collect a debt, take possession of property or foreclose on property. Phone calls must cease. Advertisements for foreclosure must cease. Garnishments must be released. Repossessions must be halted. Demand letters must not be sent. The automatic stay applies in all bankruptcy cases, regardless of the Chapter filed. Intentional and knowing violation of the automatic stay can result in significant sanctions including punitive damages. Lenders should consult with bankruptcy counsel before taking any actions that might implicate the automatic stay.

While the automatic stay is triggered immediately upon filing, liability for making a collection effort is itself triggered by notice of the bankruptcy case. A creditor has notice when either the formal notice is received in the mail or the Debtor verbally informs the creditor that the bankruptcy petition was filed.

Relief From the Automatic Stay

Creditors may receive relief from the automatic stay upon motion and at least 14 days notice of hearing to parties in interest. The grounds for stay relief are set forth in 11 U.S.C. § 362(d) and include lack of adequate protection of the creditor's interest in

property; or the Debtor's lack of equity in property coupled with the property's not being necessary to an effective reorganization. In Chapter 11 cases, any consent order relating to relief from stay, prohibiting or conditioning the use, sale or lease or property, providing adequate protection, etc., must be noticed to parties in interest, who will have 14 days to file objections.

Relief From the Automatic Stay in Single Asset Real Estate Cases

Subsection (3) of § 362(d) provides a special rule for "single asset real estate" cases, defined by the Code as

> real property constituting 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 by a Debtor other than the business of operating the real property and activities incidental thereto.

11 U.S.C. § 101(51B).

Section 362(d)(3) provides that a holder of an interest in single asset real estate shall be granted stay relief unless within 90 days of the order for relief (or 30 days after the court determines the case is a single asset real estate case, whichever is later), the Debtor either: (a) files a reorganization plan with a reasonable possibility of being confirmed within a reasonable time; or (b) the Debtor commences interest payments to the creditor at the then applicable non-default contract rate.

Single asset real estate cases have been much more prolific after BAPCA, which modified the definition of single asset real estate by deleting the limitation to cases with no more than $4 million in secured debt. BAPCA also clarified that the Debtor may

make the interest payments under § 362(d)(3) from rents that secure the creditor's claim, without court approval.

C. Sales Free and Clear of Liens

As noted in Section I.A., *supra*, the Bankruptcy Code allows sales of property free and clear of liens, with liens attaching to proceeds of the sale in order of priority. This procedure is frequently employed to sell properties with encumbrances, such as mechanic's and materialman's liens, that would prevent their sale outside the bankruptcy setting. Section 363(f) provides the criteria for sales free and clear of liens, as follows:

> **(f)** The trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if--
>
> **(1)** applicable nonbankruptcy law permits sale of such property free and clear of such interest;
>
> **(2)** such entity consents;
>
> **(3)** such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> **(4)** such interest is in bona fide dispute; or
>
> **(5)** such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

II. BAPCA Impact on Commercial Bankruptcy Cases

While the changes brought by BAPCPA in the consumer area received the most notoriety, significant, though sometimes subtle changes were enacted to impact Chapter 11 and business cases. The following are highlights of some of the more significant changes BAPCPA brought to commercial bankruptcies:

A. Taxes

(1) 11 U.S.C. § 1129(a) requires that priority tax claims must be paid in full within five (5) years from the entry of the Order for Relief, basically the commencement of the Bankruptcy Case. Tax claims must receive the same treatment as the best treated unsecured claims under the Debtor's Plan of Reorganization.

(2) The taxing authority now has the specific authority to offset taxes against refunds. See 11 U.S.C. § 362(b)(26).

(3) Under BAPCPA, tax claims are entitled to interest at the rate determined by applicable non-bankruptcy law. 11 U.S.C. § 1129(a).

B. Treatment of Government Claims

Under BAPCPA, there is now an exception to discharge to governmental claims if related to misrepresentation, fraud, etc. by Debtor (for example, representations made to HUD, SBA or other government lenders).

C. Critical Vendors

Under prior case law, vendors whose products were essential to the Debtor's survival were given certain priorities with respect to pre-petition shipments. Certain of these provisions were codified in 11 U.S.C. § 503(b)(9), granting an administrative expense claim for the value of goods received within twenty (20) days of bankruptcy filing as long as they were received in the ordinary course of business.

D. Reclamation

Under 11 U.S.C. § 546(c)(1), notice of reclamation demand must be made within forty-five days after receipt of goods by the Debtor, or twenty days after the filing, whichever is later. These reclamation rights are subject to prior rights of secured

creditors. Even if the seller fails to make a demand in writing for goods, he may still have the right to assert a claim for an administrative expense claim under 11 U.S.C. § 503(b)(9).

E. Priority Claim for Wages

The former law did afford some protection to employees for unpaid wages subject to an amount cap and a limited look-back period of ninety days. That period has now been expanded to 180 days and the maximum administrative expense claim for wages has been increased to $12,475.00.

F. Utilities

Greater protection is now afforded to utility creditors. No longer can the Debtor propose administrative expense status to the power company or other utility in order to provide adequate assurance of performance. Under § 366(b), Debtor is required to provide cash or cash equivalent to the utility within twenty days, or the provider is authorized to cut off service.

G. Leases and Executory Contracts

11 U.S.C. § 365(d)(4) now provides that an unexpired lease for non-residential real property where Debtor is lessee is deemed rejected and requires immediate surrender of the lease if not assumed or rejected by the end of the earlier of: (a) 120 days from the date of filing; or (b) upon confirmation of a Plan. The Debtor is permitted only one extension of time to assume or reject, but that extension may not exceed 90 days. Thus, the Debtor is required to assume or reject all of its non-residential real property leases within seven months. In the past, Debtors were allowed to extend the deadline beyond this seven-month limitation, and oftentimes leases were auctioned or sold.

Forcing Debtors to assume or reject on this shortened schedule impairs the ability of Debtors with multiple locations to reorganize, and has made Chapter 11 less attractive to large retailers.

H. Severance and KERP Plans

The filing of bankruptcy often causes key employees to seek new jobs. Keeping these key employees in place is often key to any successful reorganization. In the past, liberal severance packages and Key Employee Retention Plans were used to keep senior management and other essential employees in place. BAPCPA provisions severely limited these plans.

(1) 11 U.S.C. § 503(c) now limits the ability to make retention payments to management. Payments must be essential to keep the insider, there must be a bona fide offer from a third party prospective employer at a certain amount, and the individual must be essential to the management of the Debtor for the retention payments to be approved.

(2) Section 503(c) also limits severance payments to an insider of the Debtor to that amount which is part of a program that is generally applicable to all full-time employees and the amount of such payment cannot be greater than ten times the amount of the mean severance pay given to non-management employees during the calendar year in which the payment is made.

Aside from being tremendously complex to calculate, these rules make it far more difficult to retain key employees through the early and often confusing stages of reorganization cases.

I. Plans

Under revised 11 U.S.C. § 1121(d), the Court may not extend the Debtor's period of exclusivity to file a Plan beyond eighteen months from the date of commencement of the case. In larger, more complex cases, this has opened the door for competing plans from creditors or minority interests, even where the Debtor is not in a position to offer its Plan through no fault of its own.

J. Individual Chapter 11 Cases

Individuals engaged in business or professions (i.e., doctors, dentists, accountants) have always been entitled to file for reorganization under Chapter 11. Until the BAPCPA, these individuals were afforded a particular and unique privilege . . . their future earnings received after the filing were not classified as assets of the estate under 11 U.S.C. § 541. Thus, a physician who filed Chapter 11 under the old law could retain all of his earnings and effect a settlement with his creditors with only those assets that existed as of the date of filing. Needless to say, this caused considerable consternation and was eliminated in 2005. 11 U.S.C. § 1115 expands property of the estate of an individual Debtor in Chapter 11 to include property acquired after commencement of the case and future earnings until the closing, dismissal or conversion of the case.

Some Courts have construed the BAPCA revisions so as to make it effectively impossible for an individual Chapter 11 debtor to confirm a plan unless unsecured creditors are paid in full. See, e.g., In re Akinpelu, 530 B.R. 822 (2015).

III. ALTERNATIVES TO BANKRUPTCY FOR THE INSOLVENT BUSINESS

Stay Out of Court

Dealing with substantial debt without the protection of a court can be dicey. While an entire body of law has developed around preferences under the Bankruptcy Code, *see* 11 U.S.C. § 547, the preferring of creditors under the laws of Georgia is (with the exception noted below) openly sanctioned. O.C.G.A. § 18-2-40 provides:

> "A Debtor may prefer one creditor over another, and to that end he may rightfully give a lien by mortgage or other legal means, sell in payment of the debt or transfer choses in action as collateral security, where the surplus in such case is not reserved for the Debtor's own benefit."

See also Bank of Cave Spring v. Gold Kist, Inc., 173 Ga. App. 679 (1985). All that is required is that the Debtor proceed in good faith.

But see O.C.G.A. § 18-2-75(b), part of the Uniform Voidable Transactions Act, which allows for a transfer to be voidable where the transfer was made "to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent." This provision mirrors the preference rules for insiders under Section 547 of the Bankruptcy Code.

What is a Composition?

A composition is an agreement between a Debtor and its creditors whereby, in consideration of immediate payment, the creditors agree to accept less than full payments of their debts, in full and complete satisfaction of the debt. Such an agreement usually involves an insolvent Debtor with more than one creditor.

Another type of creditor agreement is an extension agreement where the payment of the debt is not reduced pro-rata but which extends the time in which the Debtor may satisfy the claims in full.

While composition agreements can be used to achieve a liquidation, they are more commonly used so Debtor can retain and continue operating its business. The goal is to give the Debtor a fresh start without the filing of a bankruptcy case.

Accord and Satisfaction

An accord and satisfaction involves an agreement with a single creditor to accept less than full payment in satisfaction of a claim. Obviously, an accord and satisfaction is similar to a composition, however, a composition involves not only an agreement between the Debtor and creditors, but also an agreement between the creditors to each accept less than full payment. Another difference is that a composition takes effect immediately upon its execution, even though it may provide for future payments. The composition replaces the original debt (beginning to appear quite similar to a Plan of Reorganization in a Chapter 11 case). The accord and satisfaction does not take effect until payment is made. Thus, the composition operates as a novation, whereas the accord is in the nature of a suspension until fulfilled.

Consideration

It is the mutual promises of the creditors to accept less than full payment in satisfaction of their claims that provides the consideration to support the composition agreement. The general rule is that a creditor's agreement to accept less than the entire amount due in exchange for a release of the debt is without consideration. A

composition is an exception to the rule since it is the joint agreement among the creditors that provides the consideration.

<u>What Type of Document is Required for a Composition?</u>

There is no standard form for a composition agreement. It should be in writing, and should indicate the intent of all parties. A composition may be agreed to at a meeting of creditors or the Debtor may send out an offer to its creditors seeking their acceptance of the proposed composition.

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<u>Must All Creditors Enter Into the Agreement?</u>

All creditors do <u>not</u> have to enter into the composition agreement in order for the agreement to be valid. Those creditors who do not agree are not bound, and may pursue other collection efforts.

Composition agreements are often made contingent on a certain number or percentage of creditors accepting. If that requisite amount is not met, the creditors who had accepted are not bound. But, it is the Debtor or its advisors who select the percentage or amount required to accept, not the arbitrary provisions of the Bankruptcy Code.

Why Would Debtor Choose a Composition With Creditors Rather Than Bankruptcy?

Possible benefits of pursuing a composition with creditors instead of bankruptcy:

(1) Composition avoids the stigma associated with bankruptcy.

(2) Composition is private whereas bankruptcy opens the Debtor's financial affairs to public scrutiny, including competitors.

(3) Composition is generally faster and far less costly than bankruptcy.

The ABC's of Assignments for Benefit of Creditors

An Assignment for Benefit of Creditors is a form of Debtor relief whereby a Debtor voluntarily transfers its property to an assignee in trust so that the assignee can quickly liquidate the property and distribute the proceeds on a pro-rata basis to creditors.

The essentials for an ABC would include the Debtor as assignor, an assignee (or Trustee) and creditors who can enforce the assignment. The assignee takes the Debtor's assets subject to existing liens and other valid encumbrances. However, the assignee is granted the power, pursuant to UCC § 9-301 and (3) to avoid any security interest which is unperfected under state law when the assignment occurs.

A valid ABC vests the assignee with full legal and equitable title to all of the Debtor's property. This transfer places the Debtor's property beyond the Debtor's control, but also out of the reach of the Debtor's creditors. Creditors rights to the property after the assignment is their right to share in the distribution of the proceeds at some future date.

An ABC is a creature of state law, although they were also known at common law. Some forty (40) states have statutes authorizing ABCs, including Georgia. See O.C.G.A.

§ 18-2-41 *et. seq.* ABCs have always been an attractive and useful liquidation device for any business Debtor who wishes to avoid the costs, delay, aggravation and tainted reputation of the bankruptcy process. ABCs were used with some frequency up until 1978. With the enactment of the Bankruptcy Reform Act of 1978, the process of bankruptcy became far more attractive and available to business Debtors (though certainly no less expensive) and use of ABCs became quite rare. With the changes made to business bankruptcy filings by the BAPCPA in late 2005, there has been renewed interest in ABCs as a viable alternative to bankruptcy.

Who Can Make an ABC?

Generally, any person, partnership, or corporation can make an ABC. The assignment must be in writing.

Must Consent of Creditors be Obtained?

Creditors do not have to consent to the assignment made in an ABC. However, creditors who object to the assignment will not find any assets on which to levy since they have been conveyed to the assignee. Furthermore, they have no claim against the assignee. In order to reach the Debtor's assets, a dissenting creditor would have to show that the assignment was a fraudulent conveyance or that it was void for failure to comply with the specific requirements of the Georgia statute.

Does Debtor Obtain a Discharge Through an ABC?

The United States Constitution specifically grants to Congress the power to enact bankruptcy legislation. Based upon this power, Federal Courts have consistently ruled that the States may not enact bankruptcy-like legislation, and one of the primary indicia

of such laws is the grant of a discharge of debts. Georgia's law with respect to ABCs makes no mention of discharge or release of debt.

However, it appears that Debtors may still use coercive tactics and could possibly achieve the contractual equivalent of discharge. For instance, the assignment may require the creditors to submit claim forms that recite that acceptance of distribution under the ABC will forego any further action by creditor on its claim. Some States, Texas for instance, actually provide for a discharge of remaining debt provided the assignment process results in a certain minimum distribution (one-third of claims). Georgia does not.

What Document Must be Used for an ABC?

No particular form of assignment is required. The Georgia Statute, O.C.G.A. § 18-2-44, does require:

(1) That the assignment convey all of Debtor's property;

(2) That it identify any land owned by Debtor;

(3) That it identify all goods, wares and merchandise with a statement, as accurate as possible of the purchase price and selling price of the entire lot;

(4) That it describe any shares of capital stock, livestock or personal property not connected with any mercantile or manufacturing business; and

(5) That Assignor must also attach a list of all creditors, with addresses and amounts due to each.

In addition, all assignments must be recorded in the same manner as deeds. Creditors must be notified within thirty (30) days of the assignment. The assignee is

required to make a written inventory of all property assigned, and the Debtor/assignor must execute an affidavit, swearing to the validity of the list.

Duties and Powers of the Assignee

Generally, anyone who could serve as a Trustee can be an assignee under an ABC. Both individuals and corporations can serve. Unlike the circumstances in a bankruptcy case, the Debtor actually plays a significant role in the selection of the assignee. It is not uncommon for the assignee to be a creditor.

The assignee is required to carry out the duties and functions imposed upon him by the assignment. The assignee succeeds to all rights of the assignor, but is specifically empowered to attack and set aside fraudulent conveyances and to recover property conveyed by the assignor for the purpose of hindering, delaying or defrauding creditors.

The primary function of the assignee is to liquidate the Debtor's assets and pay the proceeds to creditors.

Compensation of Assignees

Generally, the assignee (and any professionals hired by the assignee) is entitled to reasonable and fair compensation. While compensation may be specified in the assignment document, provisions allowing excessive compensation would be treated as a sign of fraud.

Can the Assignee Continue the Debtor's Business?

As previously noted, the primary duty of the assignee is to liquidate Debtor's assets. As such, he should not be authorized to continue the Debtor's business. However, a significant disposition could be sale of the going concern, particularly if this would bring the best price, which would obviously be in creditors' best interests.

Why ABC Instead of Bankruptcy?

ABC's have always been an attractive option to the corporate Debtor since the assignment results in the corporation becoming an empty shell with no assets. Consequently, there are no assets left on which a creditor could levy. This process could be the most expedient and least costly means of wrapping up the business affairs of an insolvent corporation. It also avoids the delay, aggravation, and tainted reputation of the bankruptcy process.