NAVIGATING A CHAPTER 11 BANKRUPTCY: STRATEGIES FOR REAL ESTATE LAWYERS AND THEIR CLIENTS

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I. Georgia: A Debtor's Colony With An Identity Crisis

Georgia was founded as a debtor's colony in 1733, but it didn't stay that way for long. In the 1800's, the General Assembly increasingly enacted legislation that was creditor-friendly; and Georgia remains a quite creditor-friendly state today. In Florida or South Carolina, it can take months or years to foreclose on real property. Even Alabama, which does allow non-judicial foreclosure, recognizes an equity of redemption. In Georgia, by contrast, a security deed holder can divest title to real property – finally and forever – by advertising in the legal organ for four consecutive weeks and crying a sale the first Tuesday of the following month. Every debtors' bankruptcy lawyer knows not to allow vacation time the week before Foreclosure Tuesday.

Although evictions do require judicial intervention, they too are speedy in Georgia – complaints must be answered in 7 days. And, unlike states such as North Carolina, Georgia judgment creditors have an array of remedies at their disposal, including garnishment. What this all amounts to is that bankruptcy filings are prolific in Georgia. Even the recent economic boom has indirectly driven bankruptcy filings in various ways. For example, the Atlanta commercial lease market hit bottom in 2013 and has taken a steep climb since. Many landlords found themselves sitting on long term leases executed during the Great Recession that were now significantly below market. And thus, because it is so quick and easy to

evict in Georgia, these landlords naturally lie in waiting for any breach by the tenant that would allow them to evict and re-let to a higher paying tenant. Enter Chapter 11, which allows the tenant to stop the eviction process, cure over time and assume the lease over the landlord's objection. *See* discussion *infra.*

Finally, while this presentation focuses primarily on corporate bankruptcies, it should be noted that Georgia has "opted out" of the exemption scheme set forth in Section 522 of 11 USC (the "Bankruptcy Code") and provides its own bankruptcy exemptions encoded at OCGA § 44-13-100. Consistent with its creditor friendly statutory scheme, Georgia's exemptions are relatively thin compared to other states' -- such as Florida, Texas, Kansas, Iowa and North Dakota, all of which have unlimited homestead exemptions. The author clerked for a Bankruptcy Judge in the Southern District of Florida, West Palm Beach Division. The federal courthouse in West Palm Beach was situated a stone's throw from the Intercoastal Waterway, on the other side of which was Palm Beach Island. It was relatively common in those days for debtors to file Chapter 7 cases and discharge all their debts, while keeping millions – sometimes tens of millions – of dollars of equity in a Palm Beach mansion. Not so in Georgia, which allows a debtor to exempt $21,500 in a homestead (or $43,000 if the debtor is married) -- up from $5,000 not too many years ago.

II. Bankruptcy Primer for the Real Estate Lawyer

This section will cover some basics of bankruptcy law, many of which the real estate practitioner will be familiar with. The next section will discuss how to build a strategy for your client.

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:

A. 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.

B. 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. 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 confirming a plan.

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.

<u>C. The Automatic Stay</u> — 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. Real estate owners must file bankruptcy to invoke the automatic stay before a foreclosure sale is cried.

D. 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.

E. 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) 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 the 2005 overhaul of the Bankruptcy Code known as the "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. The 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.

F. Sales Free and Clear of Liens — As noted *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--
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> (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.

G. Leases and Executory Contracts — One of the significant powers granted to debtors under the Bankruptcy Code is the ability to assume or reject unexpired leases and executory contracts. Unlike a security interest, a lease cannot be modified or "crammed down" in a reorganization plan, but it can be rejected outright (with limited rejection damages) or assumed. If, as per usual, there has been a default in the unexpired lease or executory contract, then the debtor or trustee may not assume it unless, at the time of assumption, the debtor or trustee:

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease. 11 USCS § 365 (b)(1).

If a lease is terminated prior to the bankruptcy filing, then it cannot be assumed.

III. Developing a Chapter 11 Strategy for Your Client: What to Ask in the Conference Room

In Georgia, most Chapter 11 cases are filed to stop a foreclosure. In the typical scenario, the Debtor is an LLC and the Debtor's principals – even in larger real estate cases – have signed personal guarantees. If a foreclosure is being advertised and there is equity in the property, then the LLC will need to work out a forbearance agreement or file a Chapter 11 case before the sale is cried. Even if there isn't equity in the property, the guarantors might want the LLC to file Chapter 11 and buy the time to find a purchaser, so as to maximize the proceeds from the property and thereby minimize their exposure on the guarantees. As explained *supra*, Section 363(f) of the Bankruptcy Code allows a debtor, under certain circumstances, to force a short sale over the objection of secured creditors. Section 363 sales have become the most common "exit strategy" in Chapter 11 – far more common these days than plan confirmation. Indeed, if a property has many junior liens and encumbrances, sophisticated purchasers often will insist that the seller file Chapter 11 so the sale can be consummated under 363(f). There is no "cleaner" way to purchase real property than with an order from a federal court declaring that the property is free and clear of all liens, claims and encumbrances.

There is, however, a *quid pro quo* for the 363(f) mechanism: the sale is open to competing bidders. From the standpoint of the debtor, the bankruptcy estate and the guarantors, this maximizes the value of the property being sold. But, for the "stalking horse" bidder, it presents a risk. It is customary for bankruptcy courts to grant stalking horse bidders break-up fees and overbid protections to minimize risk and compensate expenses incurred in bringing the deal to the table. But, if the stalking horse wants the property at all costs, it must be prepared to bid up if necessary.

When representing a corporate debtor, it is sometimes difficult to draw the line between your client's interests and the interests of the client's principals. This is particularly important when representing a Chapter 11 debtor-in-possession, because the lawyer has fiduciary duties to the bankruptcy estate and its creditors. In the debtor/creditor scenario – and particularly the Chapter 11 scenario – the interests of a corporate debtor and its principals often will conflict. A corporate Chapter 11 filing, for instance, frequently springs lawsuits on the personal guarantees of the debtor's non-filing principals; so, the principals will need to get their own litigation counsel to avoid entry of a judgment on the guarantees until the corporate Chapter 11 debtor has had time to get take-out financing approved or get a sale approved. The last thing a lawyer wants to do is devise a strategy for the corporate debtor that has the unintended effect of throwing its principals under the

bus. Therefore, when advising a client at the initial meeting, it is very important to understand the principals' personal financial pictures and assess the impact on them individually.

For instance, if a lender has advertised for foreclosure on a property that has little or no equity, and the client does not otherwise have a reason to save it, one option would be to forego a Chapter 11 filing and allow the lender to foreclose. Georgia has a statutory confirmation procedure that protects debtors and guarantors from a lender scheming to low-ball a credit bid to create a large deficiency. OCGA § 44-14-161. The confirmation statute was enacted in the Great Depression, and requires the foreclosing creditor to show in a judicial proceeding that it credit-bid the true market value of the property. However, in *HWA Properties, Inc.*, v. *C&S Bank*, 746 S.E. 2d 609 (Ga. App. 2013), the Georgia Court of Appeals held that a guarantor may waive these confirmation protections in the guaranty itself. This is an exception that more or less swallows the rule, as most guarantees have this waiver language.

Another issue for the conference table is whether any principals have received debt repayment from the debtor in the past year. Section 547 of the Bankruptcy Code allows a trustee or debtor-in-possession to sue creditors who were repaid on account of antecedent debt within 90 days before the bankruptcy petition date, if such payment allows the creditor to receive more than it otherwise

would have received in a hypothetical Chapter 7 liquidation. However, if the creditor is an insider, the look-back period extends to a year. In practice, even if there has been such an insider preference, Chapter 11 debtors-in-possession usually decide not to sue the debtor's principals, as the principals' assistance in the reorganization process typically outweighs any anticipated recovery. However, if the case ultimately is unsuccessful and converts to Chapter 7, then the Chapter 7 trustee will not be so kind.

If the lawyer can get past these concerns with the corporate debtor and its principals, then Chapter 11 can be a versatile and highly effective tool for the real estate owner. So long as the secured creditor is adequately protected (either by an equity cushion or some amount of monthly payments or both), the debtor often can buy very significant time in Chapter 11. Section 1121 of the Bankruptcy Code provides an "exclusivity period" during which the debtor is protected from any creditor filing a competing Plan. If the debtor can show good cause, the statute allows the bankruptcy court to extend the exclusivity period up to 18 months after the bankruptcy petition date. Many debtors are able to enjoy bankruptcy protection for even longer. As we all know, timing is everything in the real estate and capital markets. It can mean the difference in the debtor being able to sufficiently market property, find a take-out lender, force a short-sale under Section 363 or confirm a plan – possibly with provisions that "cram down" the lender's secured claim and

reduce the contractual interest rate. Even the threat of a bankruptcy filing can give the debtor significant leverage in negotiating a forbearance agreement. If your client is in default or even distress, it is wise to call a bankruptcy lawyer sooner rather than later.