

Chapter 29

FOREIGN INVESTMENT IN US REAL ESTATE: BANKRUPTCY ASPECTS

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INTRODUCTION TO US BANKRUPTCY LAW

An investor in US real estate should understand the basics of US bankruptcy law, as the law affords the bankruptcy court broad powers to restructure the interests of creditors or to limit their claims. The need for such understanding is most obvious when an investor intends to purchase assets of a seller under bankruptcy court protection, though it may also arise in case of a bankruptcy of a foreign lender's borrower, an investor's tenant or the investor itself (or its US subsidiary).

While US bankruptcy law has counterparts in insolvency laws around the globe, several aspects distinguish it from other insolvency regimes. These include the possibility of the debtor restructuring and emerging from bankruptcy as a reorganized entity, the concept of a debtor-in-possession and the availability of debtor-in-possession financing.

First, US bankruptcy law offers the possibility of a debtor's reorganization and emergence as an entity absolved of its pre-petition liabilities. A debtor that seeks relief under Chapter 11 of the bankruptcy code is more likely to survive than

one in certain foreign insolvency proceedings. The goal of Chapter 11 is not only to provide creditors with equitable distribution of the debtor's assets or value, but also to rehabilitate a financially viable business. Accordingly, a US debtor is given time to restructure while in Chapter 11 and to emerge as a reorganized entity.

Second, in contrast to regimes where an administrator or trustee is appointed to manage the business in insolvency, a Chapter 11 debtor's existing management typically continues to operate and manage the business during the pendency of the Chapter 11 proceeding. In such cases, the debtor is known as a "debtor-in-possession." As a debtor-in-possession, the company has all the rights otherwise available to a Chapter 11 trustee and must perform all of the duties and obligations of such a trustee.

Third, a market exists in the US for additional financing (called "DIP financing") for debtors in bankruptcy because the bankruptcy code provides special protection to lenders that provide post-petition loans. These lenders often are able to

secure their loans with liens equal in priority, or even senior to, pre-petition liens on the debtor's assets. DIP financing is rare in single-asset real estate bankruptcies (described in greater detail later), but quite common in other business bankruptcies, such as those involving retail chains.

US BANKRUPTCY PROCESS

Commencement of the Case and the Automatic Stay

The US bankruptcy code details the rights and obligations of debtors, creditors, equity holders and other parties upon the commencement of bankruptcy proceedings. While the code provides various forms of relief depending on the type of debtor and its financial situation, the two most common are liquidation (under Chapter 7) and reorganization (the usual course under Chapter 11, though it is possible to liquidate under Chapter 11). In most cases, a debtor will seek bankruptcy relief voluntarily, although in limited circumstances unsecured creditors have the ability to involuntarily commence a bankruptcy case against a debtor. Unlike many foreign insolvency regimes, a debtor need not be insolvent in order to file for bankruptcy protection, and it is not required to seek bankruptcy protection if it is insolvent. A solvent company, for example, would be within its rights to seek bankruptcy protection as a way of managing a sudden onslaught of litigation. Conversely, an insolvent company has the right to pursue a consensual restructuring with its creditors without the involvement of the bankruptcy court.

A bankruptcy case is commenced by the filing of a petition with the bankruptcy court. The filing (supplemented by other filings for relief) affords various benefits and protections to the debtor. The commencement of a bankruptcy case automatically creates an estate composed of all of the debtor's assets (wherever located and by whomever held), over which the bankruptcy court is vested with exclusive world wide jurisdiction.

In other words, any interest the debtor holds in its assets, whether tangible or intangible, becomes a part of the bankruptcy estate and is directly subject to the jurisdiction of the bankruptcy court. The formation of the estate acts as a line of demarcation between the debtor's pre- and post-petition debts and obligations.

Moreover, subject to limited exceptions, the commencement of a bankruptcy case imposes an automatic stay prohibiting other parties from taking any action related to a pre-petition obligation of the debtor that may have any adverse effect on the debtor's estate. The automatic stay continues in effect for the duration of the bankruptcy proceedings unless lifted by the bankruptcy court either for cause (including a lack of adequate protection of a creditor's interest in property or if the debtor does not have equity in certain encumbered property and such property is not necessary to an effective reorganization). Actions taken in violation of the automatic stay generally are invalid, and the bankruptcy court may order relief to return to the estate unlawfully taken property and may impose sanctions on the violating party.

In the real estate context, the automatic stay prevents secured creditors, such as mortgagees and mezzanine lenders, from foreclosing on their security interests. It also prohibits lessors of real property from terminating unexpired leases and other parties from terminating contracts on the basis of a pre-petition breach, unless they obtain permission from the bankruptcy court. For instance, a lender's attempt to institute foreclosure proceedings or a landlord's attempt to terminate a lease and evict a bankrupt tenant will be treated as without legal effect as long as the automatic stay is in place. The automatic stay is supplemented by a separate prohibition on the enforcement of termination clauses in contracts or leases (contract provisions that provide for the *ipso facto* termination of a contract or lease

either upon a bankruptcy filing or due to the insolvency or financial impairment of the debtor). Special provisions of the bankruptcy code apply to financing commitments and swaps and other derivative contracts.

Chapter 7 versus Chapter 11

As noted above, debtors most often seek relief under the bankruptcy code in the form of Chapter 7 liquidation or Chapter 11 reorganization. The primary goal in a Chapter 7 liquidation is to make distributions to the debtor's creditors through a quick sale (liquidation) of the debtor's assets. In all Chapter 7 cases, a trustee is appointed to administer the estate and supervise the orderly sale of estate assets and payment to creditors.

In most Chapter 11 cases, the debtor's primary goal is to reorganize its business so that it may emerge as a viable entity through a court-approved plan of reorganization which sets forth a scheme for distribution to creditors. As stated above, the bankruptcy code permits the debtor to remain in possession of its business and assets and to administer its own bankruptcy estate as a "debtor-in-possession,"¹ with all of the rights and duties of a Chapter 11 trustee. Because Chapter 11 reorganizations are far more common than Chapter 7 liquidations among significant commercial enterprises, the focus of this discussion will be Chapter 11 reorganizations.

Debtors' Rights and Obligations

Asset Sales

The protections afforded to a debtor by the automatic stay are balanced by certain restrictions on its freedom to use or sell its assets. The bankruptcy code requires the court's prior authorization for transactions involving the debtor's property outside the normal course of its business. A debtor's sale of fixed assets, such as real estate, could be considered a non-ordinary course

transaction, unless the debtor's business involved the purchase and sale of real estate on a regular basis, as with a residential home or condominium builder. The debtor generally can sell assets free and clear of all liens, so long as any creditor with an interest in such assets is afforded "adequate protection," including a replacement lien in other property of the estate or a lien on the proceeds of the sale (described in greater detail below).

In the Chapter 11 context, the debtor's assets may be sold with the approval of the bankruptcy court. In an effort to solicit the "highest and best offer," as debtors are required to do when conducting an asset sale, debtors typically will engage in a marketing process among potentially interested parties in which it will solicit preliminary bids, and select an initial bidder (often referred to as a "stalking horse"). To ensure that the estate obtains the most value for the assets, bankruptcy courts generally will require that an auction for the assets be held. The stalking horse bidder, which likely will have expended considerable time and effort on the preparation of its initial bid, often will request, and be granted, protections within the bidding procedures to limit the harm it could suffer if the debtor ultimately receives and accepts a higher and better offer for the assets. Such bid protections typically include a break-up fee and expense reimbursement.

A secured creditor is entitled to "credit bid" its claim in a sale of assets over which it has a lien — to set off its claim against the purchase price of the assets. This effectively permits a secured creditor to ensure that a debtor does not sell its collateral below the amount of the secured creditor's claim, unless it consents to such a sale.

Pre-Petition Contracts

Parties to "executory contracts" with a debtor are not entitled to terminate these contracts

¹ The right of a debtor to become a debtor-in-possession is not absolute, and the bankruptcy court may appoint a trustee to administer the debtor's estate if cause is shown.

following the commencement of a bankruptcy proceeding.² The debtor may decide, subject to bankruptcy court approval, to assume or reject its executory contracts or unexpired leases.³ To the extent that the debtor wishes to continue receiving the benefits of a pre-petition contract following its emergence from bankruptcy, it must assume the contract and perform under its terms after having cured any outstanding defaults. With the approval of the bankruptcy court, the debtor also has the right to assume and then assign to a third party an executory contract or unexpired lease. With certain limitations,⁴ this right overrides any language in the contract or lease that expressly prohibits assignment or conditions assignment on consent of the other party to the contract. Conversely, a debtor may reject an executory contract or unexpired lease; the rejection will be deemed a pre-petition breach of the contract entitling the counterparty to a pre-petition claim for any damages arising from such breach.

Post-Petition Contracts

Debtors are permitted to enter into contracts after filing a bankruptcy petition and are bound to perform such contracts. Any payments due under post-petition contracts and any damages arising from breach of such contracts are afforded priority status as administrative expenses, ranking senior to the claims of all other unsecured creditors. Contracts assumed by the debtor in bankruptcy are treated like post-petition contracts, so that any damage claims arising after a petition likely will be afforded priority status.

Avoidance Actions

Debtors in Chapter 11 and trustees in Chapter 7 or 11 are granted powers to set aside certain pre-petition transactions that are found to be fraudulent conveyances or preferential transfers.

A fraudulent conveyance is a transfer of assets that has the effect of inappropriately moving assets beyond the reach of creditors. The bankruptcy code allows a debtor to pursue a fraudulent conveyance action under either the fraudulent conveyance provisions of the bankruptcy code or under other applicable state law. For instance, a debtor might sue a third-party transferee to recover a parcel of real property that it transferred to the third party in order to hide it from attachment by creditors. In some instances, an official committee representing the debtor's creditors or a liquidating trust formed pursuant to a confirmed plan of reorganization may bring such actions on behalf of their constituents.

A preferential transfer is a transfer of property by the debtor to a creditor within a specified period of time prior to the commencement of the bankruptcy case that enables such creditor to receive more than it would have received through a distribution in a Chapter 7 liquidation case. To bring an action to set aside a preferential transfer, the debtor or trustee must show that the transfer was made: (i) to or for the benefit of a creditor; (ii) for or on account of an antecedent debt; (iii) while the debtor was insolvent; and (iv) within 90 days prior to the commencement of the debtor's bankruptcy case if the transferee is not an "insider" or within one year prior to the commencement of the bankruptcy case if the creditor was an "insider."

A distressed entity might, for example, transfer assets to pay a creditor with which it has had a long-standing relationship in order to preserve the relationship. Because the goal of bankruptcy is to provide equitable treatment to all creditors, the preference provisions of the bankruptcy code

² The term "executory contract" generally refers to contracts under which performance obligations remain outstanding from both sides.

³ Leases, in this context, are limited to true leases, not disguised financial arrangements.

⁴ See, for example, the discussion of shopping center leases on page 223.

permit the debtor to seek to recover such transfers from the transferee.⁵

Treatment of Claims

A core function of the bankruptcy process is to make a distribution of the debtor's assets for the benefit of creditors in whole or partial satisfaction of their pre-petition claims. The bankruptcy code establishes a hierarchy for the payment of claims based on their priority, with secured claims taking first priority and equity interests being satisfied after all other claims are paid in full. Generally, a plan of reorganization will not be confirmed by the bankruptcy court if it fails to provide that claims will be paid in accordance with the established hierarchy, illustrated in Exhibit 1.

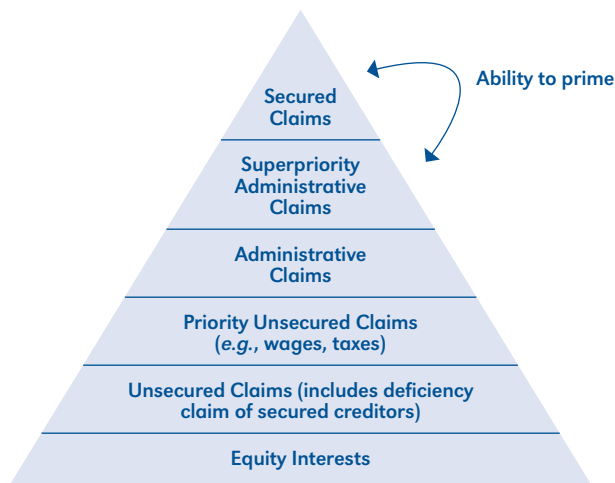
The bankruptcy code defines a “claim” as a right to payment — whether or not reduced to judgment, liquidated, fixed, contingent, matured, disputed, legal, equitable or secured — or a right to an equitable remedy for breach of performance if such breach gives rise to a right to payment,

whether or not reduced to judgment, fixed, contingent, matured, disputed or secured.

Creditors holding liquidated, unliquidated, contingent or disputed claims against a debtor at the time the company files its Chapter 11 case hold “pre-petition” claims against the debtor. In contrast, “post-petition” creditors are those whose claims arise after the debtor commences its Chapter 11 case. In order to emerge from Chapter 11, a debtor must pay in full post-petition claims (which are referred to as administrative expenses and have priority over general unsecured claims). In a typical case, the debtor is not required to pay pre-petition claims in full, but rather, to emerge from bankruptcy it must pay creditors holding those claims at least as much as they would be paid if the debtor liquidated its business under Chapter 7.

Following the commencement of a bankruptcy case, the debtor is required to file a schedule of its assets and liabilities, after which a “bar date”

EXHIBIT 1



⁵ As a general matter, the avoidance action provisions of the bankruptcy code (preferential transfers and fraudulent conveyances) do not apply to “safe harbored” financial contracts, such as derivative contracts.

will be set. The bar date is the date by which all claims must be filed by creditors. By filing a proof of claim, the creditors subject themselves to the jurisdiction of the bankruptcy court for the resolution of their claims. Once a proof of claim is filed, the debtor has an opportunity to object if it does not agree with the validity or the amount of the claim. The bankruptcy court will allow or disallow the claims and use a variety of methods to value them. The allowance process is essentially a trial within the bankruptcy case to determine the validity or extent of the purported claims. The bankruptcy court will estimate the probable value of claims that are unliquidated or contingent.

Plan Process

In order to emerge from Chapter 11, a debtor must obtain court approval (“confirmation”) of a plan of reorganization, typically proposed by the debtor itself, though under limited circumstances other parties may submit plans of reorganization. The Chapter 11 plan will classify all claims against the debtor and set forth the treatment of such claims — most importantly, setting forth the amounts to be distributed to each class of creditors and the procedures for such distribution.⁶ Creditors whose claims are “impaired” — those whose legal rights have been altered by the plan — will be permitted to vote on the plan and unimpaired creditors will be deemed to have accepted it. Creditors receiving no distribution under the plan will be deemed to have rejected it.

A plan not approved by all creditor classes may still be confirmed by the bankruptcy court through a procedure referred to as a “cram-down.” To qualify for cram-down, at least one impaired class of creditors must have voted to accept the plan, it must not “discriminate unfairly” between the non-accepting classes and it must be “fair and

equitable.” A plan does not “discriminate unfairly” if it treats all similarly situated creditors or equity holders identically. The code sets out certain requirements for a plan to be considered “fair and equitable.” In order to satisfy the fair and equitable standard with respect to a class of secured creditors that has voted against the plan, the plan must provide that those creditors either (x) retain their lien and receive deferred cash payments in an aggregate amount at least equal to the amount of their allowed claim and of a present value equal to the value of the allowed claim, or (y) receive the “indubitable equivalent” of their claim. Further, the plan must provide that each unsecured creditor that votes against the plan receives property of a value equal to the allowed amount of its claim or, if it does not, the claim must be paid in accordance with its “absolute priority,” meaning no holder of a claim or interest junior to its class can receive or retain any value through the plan.

Once confirmed, all constituents are bound by the plan’s terms. After a short appeal period, the plan becomes effective and a debtor’s pre-petition debts are discharged if, under the plan, the debtor continues to engage in business. Debts incurred after the bankruptcy petition are considered administrative expenses of the estate and must be paid in full prior to the debtor’s emergence from bankruptcy protection. Except as provided in the plan, bankruptcy discharge vests all property of the estate in the debtor, free and clear of all claims and interests, and enjoins any collection, recovery or offset of any pre-petition debt or claim against the reorganized debtor.⁷

SINGLE-ASSET REAL ESTATE CASES

Persons holding interests in or liens on real property should be aware of special provisions under the bankruptcy code that allow secured

⁶ The plan of reorganization must provide the same treatment for claims and interests that are substantially similar to each other. Therefore, substantially similar claims and interests are placed into the same “class” and all claims within a particular class receive the same treatment under the plan.

⁷ The bankruptcy court may not issue a discharge if the plan provides for the liquidation of all or substantially all of the property of the estate or the debtor does not engage in business after consummation of the plan.

creditors of single-asset real estate debtors to foreclose upon their security interests more easily than in other bankruptcy cases.

Generally, single-asset real estate cases involve a dispute between a borrower and its secured lenders. Typically, when a single-asset real estate borrower is unable to satisfy its mortgage obligations, the lenders commence foreclosure proceedings under applicable state law. To prevent a foreclosure sale and to obtain the protection of the bankruptcy code's automatic stay, the borrower may file for Chapter 11 protection before the foreclosure sale.

Classification as "Single-Asset Real Estate" Debtor

The bankruptcy code lists three criteria for a debtor to constitute a "single-asset real estate" debtor. First, it must own real property that is a single property or project, other than residential real property with fewer than four residential units. Second, it must generate substantially all of its income from that real property. Third, it must not be involved in any substantial business other than the operation of that real property and its incidental activities. The test for independent substantial business activity is objective, meaning that the bankruptcy court looks to whether a reasonable and prudent business person would expect to generate substantial revenues from activities separate from the real estate operations.

Impact of Classification as a Single-Asset Real Estate Debtor

In a single-asset real estate case, the restriction on foreclosing on the debtor's property during a bankruptcy proceeding is eased. In such a case, the bankruptcy court is required to grant a secured creditor relief from the automatic stay unless, within 90 days after the commencement of the bankruptcy case or 30 days after the bankruptcy court determines that the debtor is a single-asset real estate debtor, whichever is later, the debtor

either files a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time or begins to make monthly payments to the secured creditor in an amount equal to interest at the current fair-market rate on the value of the secured creditor's interest in the real estate. The debtor may seek an extension of this 90-day grace period for cause.

With respect to the debtor's ability to make monthly payments to prevent a secured creditor from lifting the automatic stay, the debtor has the discretion to make monthly payments from rents or other income generated from the property and may do so without prior bankruptcy court approval or notice to the secured creditor, even if the creditor has a valid security interest in such rents or income. This allows the debtor to use such cash subject to a security interest (defined as "cash collateral" by the bankruptcy code) over the secured creditor's objection by demonstrating adequate protection of such security interest. A secured creditor may be unable to prevent a debtor from using the income generated from the property to make monthly payments, even if scheduled maintenance or improvement projects are delayed as a result. In such a case, the secured creditor may consider asserting a claim that its security interest in the real property is not being adequately protected, as the value of the collateral may be declining due to, among other things, the debtor's devoting insufficient financial resources to properly maintain the property.

SALES

Sales Free and Clear

As previously mentioned, a debtor can sell encumbered property either subject to or free and clear of any lien on it. In many circumstances, purchasers are unwilling to acquire property subject to a lien, and the debtor may seek bankruptcy court approval to sell the property free and clear of liens. In order for the debtor to obtain such approval, it must provide any

secured creditor whose lien would be eliminated by the sale “adequate protection.” Generally, this requirement is satisfied by allowing the lien to attach to the proceeds of the sale. Without adequate protection a secured creditor will be able to block the sale. As described above, a secured creditor is entitled to “credit bid” its claim in a sale of assets over which it has a lien. Further, in addition to the requirement of adequate protection for the secured creditor, the debtor will only obtain bankruptcy court approval to sell free and clear of a lien in one of five scenarios:

- applicable non-bankruptcy law permits the sale of property free and clear of the lien
- the secured creditor consents to the sale
- the price of the property to be sold is greater than the aggregate value of all the liens encumbering the property
- the lien was in *bona fide* dispute
- the secured creditor could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of the lien.

Interests of a Lessee in Real Property

The debtor’s ability to sell property free and clear of liens should not extend to leases to which the debtor’s property is subject. If a debtor-lessor rejects an unexpired lease and the lessee retains rights under the lease, the lease should remain in full force and effect for the balance of its term (including any renewal or extension period) even after the sale of the property.

Environmental Liabilities

A debtor’s ability to sell its assets free and clear of environmental liabilities depends on the nature of those liabilities — specifically whether they are obligations to pay penalties or reimburse cleanup costs or obligations to comply with the terms of certain environmental regulations such as prohibitions on specified activities. Determination of whether property with environmental liabilities can be sold free and clear of liability relies heavily on the specific facts.

Obligations to pay penalties or to reimburse cleanup costs give rise to a claim for payment to environmental authorities. Many environmental statutes allow environmental authorities that hold such obligations against the debtor to become secured creditors by placing liens on the debtor’s property. However, these liens do not cover future cleanup obligations and do not take priority over other existing liens. They must be recorded to be perfected and must be filed before the bankruptcy case is commenced. If these liens are recorded and perfected, the bankruptcy court could approve a sale of the debtor’s property free and clear of environmental and other liens (in which event the authority’s liens would attach to the sale proceeds), but the bankruptcy court cannot preclude any future environmental claims from being asserted against the purchaser.

Conversely, ongoing obligations to comply with environmental laws do not give the environmental authorities a right to payment. Because such obligations are not monetary in nature, they cannot be converted to liens upon the subject property. In such cases, the obligations remain with the subject property, and subsequent owners can be held liable for violations. Bankruptcy is not an excuse for the debtor or a subsequent owner to not comply with environmental laws.

Transfer Taxes

Transfer or stamp taxes are imposed by many state and local jurisdictions on transfers of interests in real estate, including the mortgaging of real property. Such taxes are imposed only at the time of the transfer, in amounts typically determined in relation to the consideration or value of the property, and are imposed irrespective whether the transferor enjoyed a gain or suffered a loss on the transfer. The party responsible for paying the tax (seller or purchaser) varies by jurisdiction and can ordinarily be determined by agreement of the parties.

Under the bankruptcy code, transfers of real property pursuant to a confirmed plan of reorganization under Chapter 11 are exempt from state or local transfer taxes. Transfers of a debtor's real property in a sale conducted outside of a Chapter 11 plan, or prior to plan confirmation, are subject to state or local transfer taxes, including mortgage-recording taxes.

A purchaser responsible for all or a portion of the transfer tax may wish to stipulate a sale pursuant to a confirmed Chapter 11 plan in order to avoid the tax. However, the risk of future depreciation or the cost of maintaining the property prior to sale may persuade the parties to consummate a sale prior to plan confirmation, thereby forcing the parties to incur potentially significant transfer taxes.

REAL ESTATE-RELATED ASPECTS OF CHAPTER 11

Debtor as Borrower

Over the past several years, real estate-secured loans have been made to special-purpose vehicles (SPVs) — newly established entities created to hold title to the real estate collateral, often in the form of a single-member limited liability company wholly owned by the loan applicant. This structure, which resulted from lessons learned by lenders in the significant downturn of the early 1990s, is designed to limit the number of claimants and the amount of claims against the collateral and its owner, as well as the opportunities for the borrower to voluntarily file under Chapter 11. For these reasons, the borrower SPV will typically covenant to hold no assets other than the loan collateral, to engage in no unrelated business, and not to declare bankruptcy without approval of one or more independent members or directors appointed with the approval of the lender.

The efficacy of these covenants has not been fully established but, at least outside the bankruptcy context, they have rendered less meaningful the distinction between recourse and non-recourse debt. When the borrower SPV is permitted to have

no assets other than the loan collateral, the lender has no meaningful deficiency claim against it. Yet, lenders have remained concerned about the possibility that, whether through action or neglect, the collateral may be impaired. Thus, lenders typically require a “bad-boy” guaranty, pursuant to which a party other than the borrower becomes responsible for repayment of the loan or for damages suffered if the collateral value is impaired through misappropriation of funds, neglect or other specified occurrences.

Despite these developments, there remains the possibility that a borrower will file for bankruptcy. Thus, it is important to understand the basic principles as applied to secured and undersecured creditors.

As previously discussed, the bankruptcy code permits a debtor to grant, in favor of “DIP” lenders (those providing additional financing to a debtor during bankruptcy), a lien that is senior, equal or junior in priority to any lien granted to its pre-petition secured creditors. As such a step may significantly affect a secured creditor's interest in its collateral, the debtor cannot take it without first providing “adequate protection” to the affected pre-petition secured creditor and obtaining bankruptcy court approval.

Moreover, in the Chapter 11 case commenced by General Growth Properties, a number of its SPV subsidiaries also filed voluntary Chapter 11 proceedings. GGP is one of the largest owners/operators of shopping centers in the United States. It was also one of the most significant borrowers in the commercial mortgage backed securities market — with aggregate debt in excess of \$27 billion. GGP owned many of its shopping center properties through CMBS approved SPV structures. GGP's decision to file the SPVs was and continues to be controversial because many of the SPVs were cash flow positive, with significant net worth. Even more surprising (and controversial) was GGP's request (and the bankruptcy court's approval) to

use the SPVs excess cash flow to fund its global Chapter 11 process, in addition to its approved \$375 million debtor-in-possession credit facility. This excess cash was otherwise the SPV lender's cash collateral. Although the bankruptcy court granted the SPV lenders extraordinary adequate protection rights, many viewed the court's ruling as a departure from the perceived separateness of the SPV structure and potentially disruptive to the future of the commercial real estate lending market.

Unsecured lenders are entitled only to make a pre-petition claim against the debtor for sums owed, which will be treated as unsecured and subordinate to all secured, administrative and priority claims. If paid at all, an unsecured creditor will often receive only a fraction of its allowed claim. By contrast, lenders who have a valid perfected security interest in the debtor's property receive many forms of protection. In most Chapter 11 cases, secured creditors will retain their liens on the collateral (or substitute collateral) upon the debtor's emergence from bankruptcy, or else will be paid the entire value of their collateralized claim if the collateral is sold during the bankruptcy. Additionally, the bankruptcy code provides secured creditors certain advantages unavailable to other parties. For instance, in contrast to unsecured creditors who are not entitled to interest that accrues after the petition date, secured creditors are entitled to post-petition interest to the extent that the value of the collateral securing the claim exceeds the value of the creditor's allowed claim, though they may not be able to receive actual interest payments until after the plan of reorganization is confirmed. A secured creditor also is entitled to "credit bid" its claim in a sale of assets over which it has a lien.

The bankruptcy code also provides certain advantages to undersecured creditors (those whose allowed claim exceeds the value of the collateral

securing the claims), especially non-recourse secured creditors. Outside of bankruptcy, a non-recourse secured lender will be limited to the value of the collateral upon which it forecloses and would not be able to seek a judgment against the borrower for any deficiency. However, the bankruptcy code ordinarily treats non-recourse secured creditors as if they had recourse against the debtor on account of their claim. The claim is divided into a secured claim up to the value of the collateral and an unsecured claim for any deficiency. The unsecured deficiency claim will be given the same treatment as all other unsecured claims (and likely will be paid a fraction of its value). This treatment is unavailable to non-recourse secured creditors whose collateral is to be sold in the bankruptcy process or where the class of non-recourse secured creditors elects a certain different treatment (discussed below).

Regardless whether a secured creditor has recourse against the debtor outside of bankruptcy, the bankruptcy code allows a class of undersecured creditors to elect to be treated as fully secured up to the allowed amount of their claims.⁸ In a class that elects this treatment, an undersecured creditor waives its deficiency claim, betting in essence that the debtor will be able to continue to make payments after its emergence from bankruptcy and, in case the debtor later defaults on its payments and the creditor forecloses on the collateral, that the value of the collateral will have increased. If the value of the collateral increases sufficiently, the creditor will be able to realize the full value of its outstanding loan upon foreclosure. If the value of the collateral remains the same or decreases, the creditor will again have a deficiency which, if non-recourse, it will be unable to pursue. Before making this election, an undersecured creditor must carefully assess the likelihood of recovery under each scenario. If the creditor expects the value of the collateral to significantly

⁸ This is referred to as an "1111(b)" election because it derives from Section 1111(b) of the bankruptcy code.

increase over time, it is likely to receive a greater recovery by electing fully-secured treatment. If it expects the value of the collateral to remain the same or decrease, the creditor might be better off asserting an unsecured deficiency claim and receiving whatever payout is available during the bankruptcy. An undersecured creditor may not elect 1111(b) treatment if the underlying collateral is to be sold during the course of the bankruptcy or if its lien is of inconsequential value.

Lease Issues — Assumption, Assignment, Rejection, etc.

Debtor as Lessee — Time Period for Assumption or Rejection

A debtor has 120 days after the commencement of the bankruptcy proceeding to assume or reject unexpired non-residential real property leases. The bankruptcy court may extend this period only for cause for an additional 90 days. Any further extensions are granted on a lease-by-lease basis with prior written consent of each lessor. This time constraint requires a debtor to quickly analyze its operations and develop a business plan for reorganization, but often results in numerous lease rejections when the debtor cannot develop such a plan within the 210-day period.

For residential real property leases, the debtor has more leeway and may assume or reject unexpired leases at any time prior to the confirmation of the reorganization plan. At the request of any party to such a lease, the bankruptcy court may, however, order the debtor to assume or reject the lease before the debtor has indicated its willingness to do so.

Debtor as Lessee — Special Provisions on Curing Non-Monetary Defaults

In order to assume an executory contract or unexpired lease, the debtor must cure certain defaults, compensate the counterparty for any actual pecuniary loss resulting from the default and provide adequate assurance of future

performance. However, the debtor is not required to cure any non-monetary defaults under a lease of real property if it is impossible for the debtor to cure the default at and after the time of assumption. For instance, commercial leases often contain “going dark” clauses, which require the lessee to continuously operate its business at that location or be in breach of the lease. In many bankruptcy cases, the debtor already has shut down operations so that, by the time it decides to assume its lease, it is already in breach because of its failure to maintain a continuous operation. In such a case, it would be impossible for the debtor to cure the default; it could not go back in time to continually operate its business. The bankruptcy code treats such a non-monetary default as being cured by performance in accordance with the lease terms at and after the time of assumption. In other words, it is sufficient that the debtor will restart its operations on the leased property at the time of assumption and will continue such operations thereafter. Nevertheless, the requirement of future performance can still be problematic in cases where the debtor wishes to assign its lease to a third party, but the third party will be unable to continually operate the premises because of required renovations.

Debtor as Lessee — Shopping Center Lease Provisions

Generally, a debtor only needs to provide adequate assurance to obtain the bankruptcy court’s permission to assume and assign a lease. The bankruptcy code imposes additional restrictions on assumptions and assignments of shopping center leases, however, enumerating specific requirements for adequate assurance of future performance for shopping center lease assignees, namely that the percentage of rent will not decline substantially; the tenant will be subject to the lease’s provisions, including those regarding radius, location, use or exclusivity; and the shopping center’s tenant mix or balance will not be disrupted. Ideally, the result of these

restrictions is that the assignee tenant will be one engaged in a substantially similar business with substantially similar revenue streams to those of the once-solvent debtor.

Debtor as Lessor

Where the debtor is a lessor of real property and chooses to reject an unexpired lease, the lessee has the option of either terminating the lease or retaining its rights under the lease. If a rejection amounts to a breach that would allow the lessee to treat the lease as terminated by virtue of its terms, applicable non-bankruptcy law (e.g., state law) or any other agreements, then the lessee may treat the lease as terminated by the rejection. The termination would be deemed to be effective immediately prior to the commencement of the bankruptcy case and the lessee would hold a pre-petition claim for any damages resulting from the termination. Alternatively, the lessee may retain the rights under the lease that are in or appurtenant to the real property for the balance of the lease term and for any renewal or extension, all to the extent that they otherwise are enforceable. These rights include, but are not limited to, the right to sublet, assign or hypothecate the lease and to use and possess the premises. The lessee can thus remain on the subject property despite any sale of the leased property to a third party.

Claims Issues

General Treatment of Letters of Credit

A standby letter of credit is a commercial instrument that obligates the issuer to pay the beneficiary upon presentation of agreed documentation. The issuer's obligation under the letter of credit is treated as independent of the underlying contract between the beneficiary of the letter of credit and the customer. Accordingly, if the customer files for bankruptcy, neither the letter of credit nor its proceeds are property of the customer's bankruptcy estate. Thus, the beneficiary's right to draw upon the letter of credit is not subject to the automatic stay, even though

the effect of the withdrawal will be a claim against the debtor customer by the letter of credit issuer.

Unpaid Rent

The treatment of unpaid rent depends on whether the debtor chooses to assume or reject the unexpired lease. In order to assume an unexpired lease, a debtor first must pay any existing unpaid rent. If the debtor chooses to reject the unexpired lease, the rejection is treated as a breach of the lease immediately prior to the commencement of the bankruptcy case. Thus, the counterparty to the rejected lease would hold a pre-petition claim in the amount of unpaid rent and any other damages.

Special Provisions Regarding Lease Termination Damages

Claims of a Lessor Against a Debtor-Lessee:

Statutory Cap on Pre-Petition Damages — General Application

Under the bankruptcy code, a lessor's claim for damages against a debtor-lessee resulting from termination of a lease of real estate is limited to the rent reserved by the lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease following the earlier of the commencement of the bankruptcy case or the date on which the lessor repossessed or the debtor lessee surrendered the property (this is commonly referred to as a "502(b)(6) cap," referring to the section of the bankruptcy code that limits the landlord's claim). The majority of bankruptcy courts finds that "15 percent" refers to 15 percent of the total rent due under the remainder of the lease, while a minority finds that it refers to 15 percent of the time remaining through the natural end of the lease. Any unpaid rent due prior to the commencement of the bankruptcy case or the repossession or surrender (whichever is earlier) will not be subject to this statutory limitation.

In many US jurisdictions, damages for termination of a lease of residential real property are limited by statute. Any claim against a debtor for damages will thus be limited by applicable non-bankruptcy law.

*Claims of a Lessor Against a Debtor-Lessee:
Statutory Cap on Pre-Petition Damages —
Guaranty Issues*

The statutory cap on real estate lease-termination damages is intended to compensate the lessor fairly while limiting its claim for damages from consuming the debtor's entire estate at the expense of other creditors. This cap also limits both debtor-guarantors' and third-party guarantors' rights of reimbursement or contribution, but does not limit a lessor's claim against a non-bankrupt lease guarantor.

While the bankruptcy code is silent as to the applicability of the statutory cap, bankruptcy courts consistently have held that the statutory cap applies whether the debtor is the lessee or the guarantor. In situations where the tenant and the guarantor are both debtors, at least one court has determined that the landlord should have a single 502(b)(6) claim against the estates. This also should be the case where two affiliated debtors are co-tenants under a lease.

Similarly, a third-party guarantor's right of reimbursement or contribution against a debtor is statutorily capped. The bankruptcy code disallows any claim of reimbursement where the entity seeking reimbursement is liable with the debtor and the underlying creditor's claim against the debtor's estate is or would be disallowed. Since a guarantor is liable with the debtor and the creditor-lessor's claim is statutorily capped, a guarantor of the lease may only seek reimbursement from the debtor up to the statutory cap.

*Claims of a Lessor Against a Debtor-Lessee:
Statutory Cap on Pre-Petition Damages —
Security Deposit Issues*

Generally, a cash security deposit by a lessee is treated as part of the bankruptcy estate. Thus, any amount in excess of the lessor's allowed claim is refundable to the estate. If a lessee posts a security deposit in the form of a letter of credit in favor of the lessor and breaches its lease, the lessor is not restricted from drawing upon the letter of credit, nor does the bankruptcy court have the authority to prevent the lessor from doing so. However, any amounts that the lessor draws from the letter of credit will be applied to any claim by the lessor for damage resulting from the breach of the lease. As these claims are statutorily capped, the lessor's claim against the debtor for lease termination damages will be reduced by any amount drawn by the lessor from the letter of credit, but the lessor will not be liable for any amounts it drew from the letter of credit in excess of the statutorily capped damage claim. A creditor lessor may thus draw down in full on a letter of credit, but if the amount drawn down equals or exceeds the creditor's allowed termination damages under the statutory cap the creditor lessor may not also assert a claim for termination damages against the estate. Conversely, if the draw down is less than the allowed damages under the statutory cap, then the creditor may assert a claim for termination damages against the estate in the amount of the deficiency.

Lessees often choose the letter of credit alternative because of the availability of credit facilities and a potentially smaller cash outlay and lessors often permit lessees to choose the form in which a security deposit is posted. From the foregoing analysis, one would conclude that a lessor would benefit from a letter of credit and should consider requiring them (subject to credit considerations). Lessees, by contrast, should be indifferent to using a letter of credit or cash as a security deposit (subject to any costs of posting the letter of credit). Just as the lessor's claim for termination damages

is capped under the bankruptcy code, the letter of credit issuer's claim against the debtor upon the lessor's draw-down of the letter of credit may be capped as well.

Claims of a Lessor Against a Debtor-Lessee:

Statutory Cap on Administrative Expense Claims

If a debtor lessee assumes a lease in bankruptcy and subsequently rejects the lease or defaults under the lease, any arising damages constitute an administrative expense and are not subject to the bankruptcy code's statutory cap. These damages are subject to certain limitations in that they are limited to the obligations under the lease for the two-year period following the later of the rejection date and the date of repossession and they may not include any amounts arising under the lease

relating either to a failure to operate or any penalty amounts. However, these damages are not subject to reduction or setoff for any reason whatsoever except for sums actually received or to be received from an entity other than the debtor, such as a new tenant.

Claims of a Lessee Against a Debtor-Lessor

If a debtor-lessor rejects an unexpired lease of real property and the lessee retains rights under the lease, as discussed above, the lessee may offset against rent the value of any damage caused by the debtor-lessor's nonperformance after the date of rejection of any of the debtor-lessor's obligations under the lease. The lessee may only offset its rent, however, it does not have any other right to assert a claim against the debtor-lessor for its nonperformance.



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