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BANKRUPTCY AND FINANCIAL RESTRUCTURING LAW 2012

Top Lawyers on Trends and Key Strategies for the Upcoming Year

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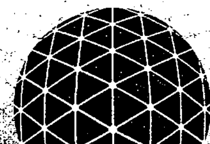

The Impact of the Overall Economic Climate on Middle Market Real Estate

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Introduction

The past year has shown some interesting developments in the bankruptcy arena. The overall continuing economic downturn has had a significant impact on both individuals and companies nationwide. As a result, there has remained a steady stream of bankruptcy filings, especially for individuals and companies that own or operate single asset commercial properties or small businesses. The average commercial property carries a mortgage that has a term of perhaps five to ten years, accompanied by a large balloon payment due at the end. Recently, with many owners defaulting on these loan obligations, in order to stave off foreclosure, owners have filed for bankruptcy in the misguided hope that they will be able to either cram down a plan over the objection of the lender or obtain refinancing for the property. Unfortunately, the continuing concomitant downturn in the real estate market has caused lenders to be guarded in advancing money in instances where the primary collateral is real estate. As a result, there is little hope on the horizon for many of these debtors, and while they may perhaps hold the lender from enforcing its rights for a period of time, eventually, after some delay, the case crumbles. Remarkably, the reality of these facts has not stopped the influx of filings in a multitude of situations cutting across a variety of businesses. The factual permutations of these cases have led to some interesting procedural issues, but in the end, we have found great success for our clients.

The Economic Climate Impacts the Bankruptcy Filings

My practice is primarily a creditor-based practice with a concentration in both traditional asset-based lending and equipment financing. My asset-based lenders are seeing an increasing flow of filings by operators of either small businesses or what would qualify as single asset real estate cases under Title 11 of the United States Code (the "Bankruptcy Code"). Several years ago, before the fall of Lehman Brothers or the subprime mortgage crisis, the general stability of the real estate market facilitated some level of consistency of advancing funds in traditional asset-based transactions. At this time, with the benefit of hindsight, many companies overleveraged themselves with balloon loans, hoping that they would continue to benefit from new funding sources when they came due. These borrowers who overleveraged years ago believing that real estate prices would continue to soar and they could pay off

these loans at the time of their balloons were sadly mistaken. With the balloon loans that companies entered into five to ten years ago now coming due, these companies do not have the wherewithal to pay the balloon from cash or refinance the debt with new money.

Moreover, lenders are no longer prepared to advance funds on existing real estate deals. The recent downturn in the real estate market and resultant volume of vacant real estate space have choked the coffers of many lenders, resulting in an unwillingness to make advances in the same manner and fashion as some lenders had done several years ago. The trust previously placed upon the stability and security afforded by a real estate-based deal has changed and is no longer there. The consequence is that there is less money available to companies to implement a traditional reorganization. The inability to refinance or pay the balloons has led to filings at various stages of the foreclosure process and/or other enforcement processes. Desperate to hold on to their properties, some of these entities are filing for bankruptcy to gain the protection of the automatic stay in the absence of an honest intent to reorganize and without a clearly defined exit strategy. Those filings, whether they are single asset cases or small business cases, are further constrained by the time limitations implemented under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 enacted on April 20, 2005 ("BAPCPA").

The enactment of BAPCPA, and the expedited timeframes and requirements implemented therein, were done prior to the more recent drastic downturn in the real estate market. Inherent in the provisions of BAPCPA is the recognition that some of these cases "might" have a purpose or be able to truly reorganize, but timeframes were to be tight and constraints were there. Today, with new money less available, the ability of these cases to achieve confirmation in such shortened timeframes has been significantly hampered. While I am not advocating that these restrictions and controls should be loosened, I submit that the confluence of the market downturn, lack of new funding, and shortened deadlines highlight the imperfect fit of these cases in Chapter 11.

Repercussions of the Lack of Funding on the Current Filings

The timing of many of these filings occurs *after* the horse has left the barn (e.g., the foreclosure completed, the deed in lieu granted, the strict

foreclosure of the ownership interest in the entity completed). Perhaps it is the same lack of funding precluding the traditional reorganization, or the refinancing of debt outside of bankruptcy, that has led so many debtors to utilize unsophisticated and/or unknowledgeable counsel when filing bankruptcy. Alternatively, maybe it is because this is an act of desperation that led them to the "only" counsel that will take a case; this is unclear. However, many of these recent "too little, too late" "desperate filings" serve to clog our judicial system and delay a lender's ability to recover and/or realize upon its collateral in accordance with bargained-for state law remedies. Our prized judicial resources are being distracted with cases that do not truly belong in bankruptcy. While the Bankruptcy Code, and BAPCPA, make clear that some types of single asset cases could be viable, even these shortened time limits do not put an end to the agony caused by these cases quickly enough.

The nuisance caused by these filings extends to the bankruptcy bar, many of whom (including myself) have been practicing exclusively in the area of bankruptcy and creditor's rights for many years. Often we are fighting with adversaries who neither know, nor appear to care about, bankruptcy procedure, but who also make it more difficult to get the right issue before the court timely and properly for adjudication. While more often than not we ultimately get the right result for the client, the lag time and resultant cost in getting there are remarkable. We respect and understand that in bankruptcy court, a court of equity, the judge carefully balances a debtor's desire for a fresh start with a lender's competing interest in obtaining its collateral, with the scales often tilting in the debtor's favor at the outset. However, the lender, having already "lived" with this debtor for however long outside of bankruptcy through the state court process or forbearance process, is usually jaded by the time of the bankruptcy filing. The lender knows that if no white knight has come out before the filing, these kinds of cases (unlike others where the bankruptcy filing can create opportunities that would not otherwise have existed) offer little to no incentive for a new lender to come in and refinance the debtor.

Legal Strategies for Bankruptcy Lawyers in These Cases

The influx of these types of cases, and the anticipation that you will be dealing with unsophisticated bankruptcy counsel on the other side, often

warrants trying to move expeditiously in recovering collateral. Obviously the deals in crisis are several years old and thus you cannot change the deal as drafted and documented originally. Many financial institutions are making decisions regarding whether they should push for collection of the debt, enter into forbearance agreements, take a deed in lieu of foreclosure, or see if there is some deal (however unpalatable it may be) to be worked out with the borrower. If the opportunity to enter into forbearance agreements arises, consideration should be given for building in short notice periods, as well clearly defined and aggressive remedies following a default. These can be useful tools in trying to protect the lender's rights and interests in collateral. There are many variables in this area that can impact the length of bankruptcies and opportunities for new financing, and those variables come into play with respect to how I counsel a client.

Jurisdictional/Venue Issues in Bankruptcy Filings

In the year to come, I believe that there will be some impact from *Stern v. Marshall*, 131 S. Ct. 2594 (U.S. 2011). Essentially, legal experts are debating the practical and legal impact of the Supreme Court's decision in *Stern v. Marshall*. The holding of *Stern v. Marshall* does not limit a bankruptcy court's power to hear certain matters, but rather simply limits the bankruptcy court's power to enter final judgments in state law counterclaims, even if they are court proceedings. The reach of the *Stern v. Marshall* holding remains to be seen; however, it is certain to be injected in the claims objection, plan rejection, and avoidance action stages of a bankruptcy case.

On a related note, the House Judiciary Committee recently introduced a bill known as the Chapter 11 Bankruptcy Venue Reform Act of 2011 (H.R. 2533) largely because there is growing perception that parent corporations of corporate bankruptcy debtors are engaged in the practice of forum shopping. Enron is a company whose assets and operations are located in Texas, but it decided to file its bankruptcy case in New York. Winn-Dixie attempted to file in New York, but was forced to move its case to Florida. Essentially, many companies are filing in jurisdictions where neither they nor their creditors are located, but rather where they are incorporated, despite that they may have absolutely no other ties to that jurisdiction. From a corporate perspective, New York and Delaware tend to be frequently used districts for incorporation, due to state rules that govern

how a company is operated and various other advantages. For example, corporations are routinely formed in Delaware and New York due to the well-developed body of commercial law in these jurisdictions relative to security, ownership, and management of a company.

Under the current Bankruptcy Code venue rules, a corporation can file for bankruptcy where it incorporated, where its principal assets are located, or where its corporate headquarters are located.

Consequently, when determining where to file Chapter 11, lawyers that have been retained to handle a client's bankruptcy case will consider those three options. There is a concern that a lawyer may ultimately decide that they are going to file in a particular jurisdiction simply because they like its judges better, the consistency of their rulings or even the available local rules that would govern, and perhaps provide for ease in administering, the case. This situation is when a foreign corporation selects the county where its regular attorney in that state is for purposes of selecting a "principal place of business" in that state so that their attorney can commence and bring cases within their usual stomping grounds.

There has also been some insinuation in some of the articles that have been published that finding a means to file cases in New York, California, or Delaware makes sense because the lawyers in those states are more experienced in restructuring matters. While it may be true that, on average, there may be more significant and complex cases filed in those jurisdictions, it would be very egocentric to believe that only practitioners in those geographic areas are capable of handling sophisticated restructuring cases.

Opponents to the Venue Reform Act argue that major stakeholders in the cases (e.g., trade creditors) are located in the jurisdiction of the company's actual operations and not where the companies were incorporated, thereby precluding such entities from participating in the case. In my experience, however, these parties are seldom present in court themselves, but rather appear through counsel. Thus, their interests can be easily represented by retaining competent counsel in the jurisdiction where the cases are pending. Where, however, the attorney selected by the creditor is geographically located far from the venue of the bankruptcy case, the travel costs may be prohibitive and, in the end, cost the creditors far more dearly. Unlike

debtors' counsel, some of the key stakeholders who typically participate in the Chapter 11 process generally do not need to appear in court on a regular basis. Typically, only representatives of each of the lender and creditors' committee appear with regularity, and those creditor constituents likely will engage counsel in the jurisdiction of the bankruptcy case. On balance, the venue of a bankruptcy case should not preclude interested parties from being involved in the process.

Of course, some of the motivation, putting aside the advanced argument of the concern for stakeholders, is that these cases (large cases) generate money for that jurisdiction, the professionals, para professionals, and other parties related to the bankruptcy arena. In a day and age where the economy is not doing well and jobs are scarce, helping the local workforce in some way has value, especially political value.

While both political parties are sponsoring the proposed Bankruptcy Venue Reform Act, that does not necessarily mean that the bill will pass. There are some changes in the bill that appeal to both sides of the aisle, and there are some respected practitioners who are serving as proponents of the bill, but the hearing process is still in the very early stages. If the bill does pass, it could have a major impact on where bankruptcy cases are filed, as most filings would need to be made in a location where the principal parties are located so that they can participate in the process in a more meaningful way. The proposed Act would certainly have a major impact on my own practice, because although I practice nationwide, I handle many cases filed in New York, Delaware, and New Jersey. I do think that, where possible, creditors should participate in the process, but such direct participation is not necessary and may more effectively be done through engaging local counsel.

New Objectives in Bankruptcy Negotiations and Settlements

New trends have emerged in the area of bankruptcy negotiations and settlements, due to the limited availability of funding for reorganizations. In the past, lenders who wanted to get out of a distressed deal had a level of comfort in knowing that the debtor would be able to find a new lender in bankruptcy or, alternatively, the existing lender would provide post-petition financing pursuant to which it would extract certain fees and super-priority claims and liens. Even if a debtor had a systemic or industry-specific

problem, its creditors (both secured and unsecured) would normally be comfortable that the burn rate would not put them so far behind the eight-ball that they would have to be on heightened alert. These days, however, unless creditors are willing to continue to work with the debtor on liquidation strategies, they are finding that it is not easy to sustain these cases. As a result, many creditors now are choosing to fight harder to prevent a bankruptcy filing and are being more aggressive about liquidation and taking back control of their assets prior to any such filing.

While creditors need to focus on preservation and recovery of their collateral outside of bankruptcy, debtors increasingly need to consider the availability of funds when evaluating bankruptcy strategies. For instance, if an entity has a systemic problem that can be corrected by filing for bankruptcy, then it likely will be able to garner lender support for the right to use cash collateral. However, in most instances today, bankruptcy attorneys need to ask the key question: Is this business worth saving? If the company does not have an exit plan, then it should not waste everyone's time and effort by filing for bankruptcy—a process that can take two or three years. In some cases you file a well-developed strategy and end game but the outcome ultimately proves unsuccessful. In those cases, however, at least there was a clearly defined end goal at the outset of the process. All too often, however, debtors, and their practitioners file cases with *no* exit strategy in mind on day one.

Conclusion

During the upcoming year, bankruptcy attorneys will be looking at new ways of structuring certain documents related to the bankruptcy filing process, including cash collateral orders, DIP orders, or sale orders. Some of these changes will be based upon the concern for the ever-growing number of single real estate filings. The continuing downward trend in the economy and the depression of the real estate market will also have an impact on these cases. Creditors are worried about more corporate inventory being placed into stock that cannot be sold, and debtors are worried about being able to get good value for the assets that they currently have—values that tend to be depressed. They are also worried about the availability of funds; how to determine the value of their collateral; and whether their collateral will sustain its market value. Generally speaking,

debtors need to base their strategies on where they think the market for their particular collateral is heading, with respect to the pursuit of guaranteed and deficiency claims. All of these issues may result in more filings to be dealt with, as well as more creativity on the part of bankruptcy practitioners in how to get these cases resolved expeditiously and cost-effectively for their clients.

Key Takeaways

- Keep in mind that bankruptcy might not be the proper financial solution for certain types of entities. If a company has a good operating structure, then bankruptcy can give it a new life, but if an entity is internally flawed and money is scarce, bankruptcy may only prolong the inevitable.
- Help clients deal with the changing trends in this area by being prepared and ahead of the curve. There are many variables in this area that can impact the length of bankruptcies and opportunities for new financing, and those variables come into play when counseling an independent client.
- When dealing with venue selection issues, keep in mind that the major stakeholders need to be able to participate in the bankruptcy litigation process in a meaningful way.

Leslie A. Berkoff is a partner with Moritt Hock & Hamroff LLP and serves as co-chair of the firm's Litigation and Bankruptcy practice groups. Ms. Berkoff concentrates her practice in the area of bankruptcy and restructuring litigation and corporate workouts, and she represents a variety of corporate debtors, trustees, creditors, and creditors' committees both nationally and locally. Her practice also includes an emphasis on equipment leasing and health care law, and she has experience in commercial litigation and corporate transactions. In addition to her practice, Ms. Berkoff frequently serves as a mediator, and has also served as a court-appointed examiner and guardian ad litem in several bankruptcy cases.

Prior to joining Moritt Hock & Hamroff LLP, Ms. Berkoff served as a law clerk to the Honorable Jerome Feller, United States Bankruptcy Judge in the Eastern District of New York, from 1991 to 1993, and to the Honorable Allyne R. Ross, Federal Magistrate Judge in the Eastern District of New York, from 1990 to 1991.

Ms. Berkoff speaks and publishes extensively and is a recognized leader in her field. She is a graduate of Hofstra University School of Law, JD, 1990, and was editor-in-chief of Hofstra Labor Law Journal. *Ms. Berkoff is admitted to practice in New York and Connecticut.*

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Theresa A. Driscoll, an associate at Moritt Hock & Hamroff LLP, concentrates her practice in the representation of corporate debtors, trustees, creditors, and creditors' committees in all phases of large and complex bankruptcy proceedings. Prior to joining the firm, Ms. Driscoll was an associate at a prominent New York City law firm where she handled various bankruptcy litigation and transactional matters, Chapter 11 debtor and creditor matters, and represented creditors, commercial landlords, and indenture trustees in Chapter 11 and Chapter 7 cases.

Ms. Driscoll is a graduate of St. John's University School of Law, JD, 2000, cum laude, and was associate editor of St. John's Law Review. *Ms Driscoll is admitted to practice in New York. She is also admitted to the U.S. District Courts for the Southern and Eastern Districts of New York. Ms. Driscoll is a member of the International Women's Insolvency and Restructuring Confederation (IWIRC), the American Bankruptcy Institute (ABI), and the New York Women's Bar Association.*