Dealing with a Perfect Storm: The Impact of a Down Economy and Natural Disasters on Bankruptcy Law

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Introduction

The past few years have brought significant economic changes to our country that, in their own way, have affected the bankruptcy arena. While many would say a bad economy should be good for bankruptcy lawyers, that is simply not the truth. With a down economy comes a shortage in available funding and lending options, thereby restricting traditional workout paths and reorganization game plans. Given the overall reduction in the value of real estate and other hard assets that flows from the turn in the economy, borrowers have less to offer a new lender as collateral. Further, given the failure of so many other businesses, there is a wealth of recovered hard assets and other collateral already in the marketplace that also serves in turn to devalue similar assets. For the obligor, finding a new lender to take out the old is simply not so easy, nor is it easy securing a lender to finance the not inconsiderable cost of a bankruptcy filing or a turnaround.

Yet, while the lack of available funding leaves the borrower with fewer options, this also affects the lender in that there is no white knight to take them out of a bad deal. Further, if the lender pushes to foreclose on the assets, there may be no one there to buy them from the collateral pool; given the recent years of increased real estate and lending foreclosures, the marketplace is flooded with readily available real estate choices. It also means a further sale of hard assets is equally challenged by lack of available buyers who have many other options open to them.

In the end, what this means is that each party on their own respective side of the table needs to evaluate how hard to push their traditional options (and the proverbial envelope) when employing negotiation and litigation strategies. Further, the restriction on choices and options means that, at times, parties need to work together more creatively and perhaps patiently in advancing claims to avoid being in possession of just another foreclosed asset or another entity with no refinancing options. In fact, the recognition of the need to turn to other means of resolving problems, less expensive means, has also led to the increase in mediation as a means to an end by many courts and litigators.

For those of us in the East Coast marketplace, add to this the confluence of events surrounding Hurricane Sandy and you have the perfect storm that has taken an already troubled market and ravaged it further. Businesses that

were struggling before may have lost what little they had, and in the months it will take to rebuild and recover, valuable lost time may never be regained to allow these companies to survive. The impact on all of these is not lost on our court system, which in turn is equally impacted in many ways by these troubled times.

Decisions and Developments Affecting Bankruptcy and Financial Restructuring Law

Practitioners in the bankruptcy/financial restructuring law area are seeing a continuing impact from the *Stern v. Marshall* decision.[1] In this case, the Supreme Court attempted to render a narrow decision related to the facts of that case and avoid any attempt to challenge the role of the bankruptcy courts and district courts in resolving bankruptcy-related matters. Notwithstanding that prognostication, many courts have responded in more expansive ways, and many litigants have attempted to utilize this decision to their tactical advantage.

The case law addressing the jurisdictional limits of the Bankruptcy Court is at times seemingly conflicting and often difficult to reconcile. For example, the Second Circuit upheld the constitutionality of the bankruptcy court's authority to enjoin lawsuits against non-debtors on the grounds that this type of injunctive relief is often necessary to best preserve assets of the estate.[2] In *Quigley*, the Second Circuit distinguished the narrow nature of the *Stern* holding and concluded that *Stern* was not applicable because the requested injunctions concerned the stay of litigation during the bankruptcy case as contrasted with the entry of a final tort judgment, which was at issue in *Stern*.[3] Other courts, however, such as the Sixth Circuit, have held that while the bankruptcy court could enter a final order of disallowance of claims against the debtor's estate, it could not enter a final judgment on a debtor's affirmative claims against a creditor on the basis that the debtor's affirmative claims were not within the bankruptcy court's constitutional authority.[4] The Sixth Circuit in *Waldman* also rejected the notion of waiver articulated by many bankruptcy courts and district courts and, in doing so,

[1] *Stern v. Marshall*, 131 S.Ct. 2594 (2011).
[2] *See In re Quigley Co., Inc.*, 676 F.3d 45, 53 (2d Cir. 2012).
[3] *See id.*
[4] *See Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012).

allowed a party to object to a bankruptcy court's constitutional authority for the first time on appeal.[5]

In an effort to wind their way through the impact of *Stern v. Marshall*, some courts have enacted specific orders in an effort to clarify that cases will be handled by the bankruptcy courts in some respects similar to the magistrate judge structure, entering "decisions" as requests for reports and recommendation subject to approval or blessing by the district court. The attempts by litigants to raise *Stern v. Marshall* as a litigation tactic have been gravely frowned upon and at times have had the wind taken out of them by the impact of these orders.[6] Others who have pursued these claims aggressively have been taken to task for raising them as stalling tactics versus truly meritorious pursuits.

Many would say that not much has truly changed since this decision, which is similar to the court's earlier decision in *Granfinanciera, SA v. Norberg*; while it addressed the structural and statutory framework of the bankruptcy courts, in the twenty years since, the system has still worked with some bumps.[7] It remains to be seen what the ultimate impact of *Stern v. Marshall* will be over time as more courts address it in a variety of contexts.[8]

Another significant event in 2011 was the enactment of "Obama Care."[9] Many believed the Patient Protection and Affordable Care Act (PPACA) was going to have a significant impact on the bankruptcy arena. In fact, some time ago I edited a manual on healthcare bankruptcy[10] that we held

[5] *Id.*

[6] *See Stern*, 131 S.Ct. 2594.

[7] *See Granfinanciera, S.A. v. Norberg*, 492 U.S. 33 (1989).

[8] *See Stern*, 131 S.Ct. 2594.

[9] On March 23, 2010, President Barack Obama signed the Patient Protection and Affordable Care Act (PPACA), Pub. L. No. 111-148, 124 Stat. 119-1025 (2010), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029. Though the PPACA is known for its landmark provisions relating to healthcare access and delivery, it also added numerous provisions that amend the fraud and abuse statutes. For example, the law amends both the Anti-Kickback Statute and the False Claims Act, and in effect will make it easier for the government to prove violations of these laws. The PPACA also strengthens the government's enforcement mechanisms by broadening its ability to suspend Medicare payments and by increasing the penalties for healthcare fraud convictions. In turn, these PPACA provisions have the potential to create further ripple effects in bankruptcy proceedings.

[10] ABI HEALTH CARE INSOLVENCY MANUAL (Leslie A. Berkoff & Timothy Lupinacci eds., 3d ed. 2012).

off publishing, because we were waiting to see whether the Supreme Court was going to approve the PPACA. Once the Supreme Court upheld the law,[11] we published the manual with remarkably few changes. While PPACA may eventually, given President Obama's second term, have an impact on the healthcare arena and bankruptcy cases, as of yet there has not been a direct or tremendous impact. As the regulations are given effect and the companies are forced to address the economic realities of the requirements (once they are truly discerned), then it may be that an increase in health care-related filings will occur. The law is simply too new to have had any real impact on the bankruptcy law area as of yet.

However, any health care changes that are enacted nationwide in a non-bankruptcy construct may indeed effect or create bankruptcy filings by companies, doctors' offices, and other health service providers that are affected by those changes, either directly or indirectly. Looking ahead, I believe we are going to see more consequential bankruptcy filings by satellite services and other providers in the health care field, including MRI facilities, nuclear imaging facilities, and standalone position support practices. Given the fact that over the past few years this industry has been particularly affected by the downturn in the economy and other health care-related changes, many companies may now be out of options, having already attempted a reorganization one time in recent years. However, as we all know, many companies file multiple times and for different reasons, some even with success.

In fact, this kind of trend occurred when the garment industry was particularly hard hit by the economy some years ago; we soon saw a wave of filings in the supporting industries, such as the packaging and shipping industries, following filings by companies such as the Federated Department Store. Going forward, in addition to healthcare, we are likely to see a similar bankruptcy filing trend in the real estate area. First, the owners of larger properties will file bankruptcy, and then the owners of smaller

[11] During the 2011–2012 term, the Supreme Court heard several constitutional challenges to the PPACA. On June 28, 2012, the court upheld the law, concluding that the PPACA's key provision, the individual mandate, is constitutional under Congress's taxing power. The court also held that while the Medicaid expansion provisions in the PPACA are constitutional, states can refuse to participate in the expansion without losing all Medicaid funding. Notably, none of the new fraud and abuse provisions were at issue. *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S.Ct. 2566 (2012).

properties will follow suit; afterwards, the vendors and support services to those properties—repairmen, sanitation and cleaning product suppliers, and ancillary service providers—will eventually be impacted as the properties they serve cannot meet their financial obligations to them. Simply put, when property owners are unable to pay the bills that are due to their ancillary suppliers, those suppliers will, in turn, suffer.

In addition, the ongoing economic downturn has led to a continued increase in single-asset real estate bankruptcy filings (known as SARE cases), as well as filings by companies and small businesses that predicate their cases upon real estate enterprises that have continued to survive in this economy. Unfortunately, the acts of desperation that some of these business owners have committed—sometimes in the form of numerous tag team filings—have only heightened the clogging of the court system and led to delays in getting these cases resolved. Also, in the wake of Hurricane Sandy, we are likely to see a further rise in bankruptcy filings as a result of people trying to deal with the storm's aftermath on their property—i.e., property damage, battles over insurance coverage or lack of coverage, and a sudden flood of damaged properties on the market that nobody wants to or can buy. Again, this situation will further clog the court system with additional cases that cannot be properly addressed in a bankruptcy construct.

Working with Debtor and Creditor Clients

My practice is currently split between debtor and creditor clients. When working with debtors, it is important to determine how the financial problems of the client came to exist. You need a hard check on reality. We do not file a case unless we believe there is a realistic possibility of succeeding and we have an exit strategy; while facts and circumstances will change over time, we do not go blindly into the abyss. Too many lawyers will simply take that retainer, file the case, and that is the end of it, and if success cannot be had then so be it. Bankruptcy is an option of last resort, but it must be an option utilized wisely.

When evaluating a case (whether it is an out-of-court workout or in-court filing), we also need to consider if they are looking for refinancing options, a new bank loan, or an extension on a loan. In this market, many banks are

simply not lending money, particularly in cases where real estate collateral is all a borrower has to offer. The flood in the marketplace, as discussed earlier, and the overall downturn in values play a vital role here. On the other side, banks generally do not want to take back real property, as there is already an excess of properties on the market. When a bank takes over a property, it generally has to consider the cost of protecting and preserving and insuring that property for a time, and the ability of a new buyer to come acquire that at a price that nets some funds to the bank, ideally in excess of debt.

Consequently, the aggressiveness with which creditors, such as banks, used to foreclose on properties is no longer a key factor in these cases. Likewise, the confidence borrowers had that they had a wealth of options to choose from and believed they could possibly force a reorganization down the bank's throat has been diminished. As a result, we often find that the parties on both sides of these situations are looking to (and if the right mindset is brought, are able to) work out some type of settlement.

Of course, let us be clear we represent many lending institutions that can bear the cost of carrying these properties and the debt until there is a turn in the marketplace or a willing buyer comes along. On the other hand, a smaller community-based lending practice is not as well situated to monitor and carry in their portfolio these foreclosed properties.

Bankruptcy Court Funding Challenges

The bankruptcy court system has its own financial issues that may ultimately have a major impact on the management of cases and the ability of parties to secure relief from the courts. At the present time, the federal government is dealing with a $240 million deficit level in terms of funding the court system; some of the remedies that are being considered include sequestration, shutting down certain courts, and instituting furloughs without pay, which would have a huge impact on the many people who work in the court system. Unfortunately, there seems to be a lack of recognition that the judiciary is a true third branch of the federal government. It is one thing to impose budget cuts on certain government agencies, such as the Post Office, which indeed have a day-to-day impact, but not devastating consequences. But the consequences of diminishing

or restricting access to, and the ability of our judiciary to function, could be catastrophic.

It is the court system that administers the operation of the government at the highest level, just as the executive and legislative branches are charged to do. Therefore, by implementing funding cuts in this area, you run the risk of adversely affecting the ability of the court system—not just the bankruptcy courts, but also the Article III courts—to operate and administer justice. Such cuts would clog up the court system and delay relief, thereby preventing those of us who work in this area from obtaining decisions. Further, these kinds of delays affect determinations on issues that reach everyone's day-to-day life and security, such as federal court trials involving terrorists and criminal trials that affect ongoing criminal enterprises. These delays thus not only impact day-to-day security, but also national security.

Further, what about the delay in seeking relief for our clients in a timely fashion? The judges in my arena work hard, for far less pay than their contemporaries in the open marketplace, and some work longer hours. Their decisions allow the commercial wheels of businesses to continue operating smoothly. Significant delays can have an economic impact on both the debtor who has filed a case and the creditor who is owed funds and depends on this for repayment of its own bills and obligations.

When you are involved in a bankruptcy case, your clients often include companies that need immediate relief from the court in order to get assistance. Simply stated, if you cannot get a bankruptcy case through the court system in a timely fashion, your client can wind up losing their company for a reason that is completely outside of their control, and that has nothing to do with the success or failure of their business or the parties involved—it involves access to justice.

Earlier I mentioned the impact of Hurricane Sandy. Like so much of New York, the Southern Bankruptcy District Court house was adversely impacted by this storm and effectively closed. Yet remarkably, the diligence of the court staff and personnel kept work moving even from remote locations. While general hearings have had to be pushed back out of necessity, emergent matters were addressed as required. This has delayed

some cases for a few weeks, which is manageable, but imagine being delayed for months in getting relief not because of an event of nature, but because there is simply inadequate funding to turn the wheels of justice. Delay is not always your friend in a bankruptcy case; you may lose out on a deal, such as the ability to close on financing or obtain access to collateral in a timely fashion.

New Bankruptcy Negotiation and Settlement Strategies

As noted, there are currently a large number of properties being held in the coffers of various banks and lending institutions, and at the same time, there is not an ability to readily access and refinance property debt. Therefore, regardless of which side you are on in bankruptcy negotiations, you tend to be more mindful these days that neither side is necessarily rushing to pull the trigger. For instance, some lenders are now more open and amenable to a modification in terms or other consideration in order to ensure a deal gets done. However, this is balanced by the fact that in uncertain economic times people are often loathe to extend the timeframe for payouts, simply because no one knows what is going to happen next—i.e., will the collateral or ancillary markets drop further and impact the ability of an obligor/creditor to make payments? Thus, while many lenders want to get the most they can in a deal, to do that often means a longer payout that has greater risk in a climate of uncertainty and turmoil.

For borrowers, the current economic climate hurts the debtors not only in that they cannot secure a white knight to take out the old lender or fund a reorganization, but also if they propose a deal, they cannot put together projections that are sustainable or provable over longer time frames.

Increased Use of ADR in Bankruptcy Cases

One factor that has certainly affected the practice of bankruptcy law over the past few years has been legal fee increases—a trend the courts and clients in these cases have become very cognizant of. Consequently, over the last few years we have seen a greater reliance on alternative dispute resolution (ADR) methods such as mediation or arbitration in these cases. Basically, the use of ADR has become more prevalent as judges look to coax the disputing parties in a bankruptcy case into trying to work out their

differences in a more consensual fashion, by using either an impartial arbitrator or a mediator.

I have been involved in more mediations in the last two years than I have in all of my previous years of practice; again, this is largely because judges now have turned a more favorable eye to mediation as an option, and are more likely to send out the parties in a bankruptcy case to engage in the process, whether or not they are amenable to it. In fact, some courts are setting mandatory mediation policies and procedures that go into effect at the operative point in a case where the parties are ready to commence their adversary proceedings or when adversary proceedings stall. In some of the "mega-cases," often, following the summons and complaint being filed and served, upon the filing of an answer and preliminary discussion, if the parties cannot independently resolve their differences, they are required to go to mediation.

I believe this trend toward the use of ADR in the bankruptcy arena changes the playing field tremendously, as it has the potential for diminishing the cost of litigation; it increases the possibility that the parties will be able to settle their dispute more easily. In turn, this also helps unclog the court system, at least to a certain extent. Ultimately, the possibility that your client will be forced to engage in neutral arbitration or mediation is leading to changes in our litigation strategies, because the disputing parties know that at some point they may be pushed out of the court system to work their issues out on their own.

Conclusion

Going forward as a practitioner in the bankruptcy law area, it will be increasingly important to evaluate the impact of the economy and the needs of the parties when developing strategies. More so than at any previous time in my history as a bankruptcy lawyer, I realize I cannot simply presume that my client or the other party will take the most aggressive approach to get the highest award. Rather, you have to understand and recognize that there are independent factors and concerns that are affecting your adversaries and your clients that are outside the scope of the pending dispute. If you can understand and appreciate those factors and concerns, you may be better able to achieve a sound solution to the pending problem.

Looking ahead, lawyers and clients in this area will continue to deal with the impact of the economic downturn, the flood of properties on the real estate market, and the damaged economy, including those businesses affected by the recent storms. In the Northeast, we may have an incredibly harsh winter, and I think that is going to do further damage to real estate values, structures, roads, and the earning capabilities of everyone in the business sector—putting everyone in an increasingly hazardous condition, both financially and otherwise. I also foresee an expansion in the mediation and arbitration area to solve problems.

Key Takeaways

- Determine how the financial problems of a debtor client came to exist. Consider if they are looking for refinancing options, a new bank loan, or an extension on a loan. Keep in mind that many banks are not necessarily lending money, particularly in cases where real estate collateral is all a borrower has to offer.
- Understand that the aggressiveness with which creditors, such as banks, used to foreclose on properties is no longer a key factor in these cases. Likewise, it is much more difficult than it used to be for borrowers to go elsewhere to secure financing. As a result, we often find that the parties on both sides of these situations are able to work out some type of settlement.
- Advise clients that the use of ADR has become more prevalent as judges look to coax the disputing parties in a bankruptcy case into trying to work out their differences by using an impartial arbitrator or mediator. Essentially, following the summons and complaint stage, and the exchange of basic information, if the parties cannot independently resolve their differences, they are often required to go to a mediation process.
- Do not simply presume your client or the other party is looking to obtain the highest award. Recognize that there are independent factors and concerns that are affecting your adversaries and your clients that are outside the scope of the pending dispute. If you can understand and appreciate those factors and concerns, you may be better able to achieve a sound solution.

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Prior to joining Moritt Hock & Hamroff LLP, Ms. Berkoff served as a law clerk to the Honorable Jerome Feller, US 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. She speaks and publishes extensively and is a recognized leader in her field. She is a graduate of Hofstra University School of Law and was editor-in-chief of Hofstra Labor Law Journal *and president of Hofstra's Alumni Association for over ten years. She is admitted to practice in New York and Connecticut. She was chair of the International Women's Insolvency and Restructuring Confederation from 2004 to 2008 and has served on the board of directors of that organization for over ten years. She also served as co-chair of the American Bankruptcy Institute's Healthcare Insolvency Committee from 2008 to 2011 and is currently head of special projects for that committee, as well as co-editor of its* Healthcare Bankruptcy Manual, Second Edition. *She currently serves on the Strategic Planning Committee for the US Bankruptcy Court for the Eastern District of New York and is an active member of the Nassau County Bar Association and a past chair of its Bankruptcy Committee. She is also a member of the Long Island Fund for Women and Girls Circle of 99s. In addition, she serves on the board of editors of* Pratt's Journal of Bankruptcy Law *and is a past president and board member of Hofstra School of Law's Alumni Association.*