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Bankruptcy and Financial Restructuring Law 2008

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Issues to Watch For—From Retail to Real Estate

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The Current Bankruptcy Landscape

The largest change to bankruptcy law recently has been the amendments to the Bankruptcy Code in 2005 and the various resulting constraints placed on Chapter 11 debtors. These amendments put changes into the law that people have yet to appreciate, as since 2005 the level of filings has decreased such that many of the changes that were put in by Congress in 2005 remain untested.

In 2007, the changes have been more dramatic because of the larger economic factors relating to sub-prime real estate and the credit crunch that is now sweeping through the economy. Over the last few years, employing the amendments to the Bankruptcy Code has been somewhat slow and challenging. For example, the amendments created a new priority type of claims for goods delivered in the twenty days before a bankruptcy filing that has affected some debtors and has caused people to file certain motions to define when people will get paid.

The largest issue that has yet to be fully realized is the affect of the shortening of the time period for the assumption or rejection of non-residential real property leases. There is now a hard and fast deadline for a debtor to assume or reject a lease. Yet since 2005 there has not been a great deal of retail or other cases that have had an asset being their non-residential real property leases. Therefore, debtors, their financial advisors, or their real estate advisors are starting to get around the lease issue right at the inception of the bankruptcy case. There has also been an acceleration relating to the time period allowed to complete analysis relating to leases.

Areas of Bankruptcy Law

Real Estate

As far as the real estate industry, I believe we are on the precipice of a number of real estate issues that are going to start to affect bankruptcy professionals and restructuring advisors. Real estate developers are beginning to have difficulty getting access to capital, which is causing them to have their own internal issues and to try to reorganize or restructure. Recently we had a real estate developer in a joint venture with a larger real estate developer who was asking for a time period all the way through 2011 to start to restructure and reorganize their debt.

Private Equity and Hedge Funds

The effect of private equity and hedge funds has changed the practice of bankruptcy law in the sense that previously banks would own a credit and would have to maintain the credit because there was no real market for that credit. However, with the evolution of private equity and hedge funds coming into the distressed world, every asset and loan can be sold in the secondary market. Therefore, if a bank or lender doesn't want to hold on to the credit, there is always a way to move it around to someone who wants it. This practice is becoming part of the bankruptcy landscape—the creation of a whole tertiary market for debt. For example, if you are a debtor and working with a lender and think the lender actually cares or has done some diligence relating to your company because they have decided to issue the loan, you are potentially mistaken. Now that the lender can just flip the credit to someone else, there is probably less diligence than was done previously, as well as less concern about what happens when there is a default. Instead of carrying the default and looking to restructure the debt, the lender can just sell it to someone else. This is a difficult situation to deal with from a debtors' perspective, as negotiations with lenders become more complex if the lender is not even going to hold on to the debt. There isn't the back and forth or give and take debtors used to have with a lender. Where previously there would be some kind of working relationship to keep the credit, the tightening credit markets mean the lender will simply flip the debt. From a debtors' perspective, this also makes it more difficult to restructure, as debtors can't control who their lender will be.

Case Studies

I think there are two recent decisions that are most prominent right now. One is the *Enron* claims trading decision by Judge Arthur J. Gonzalez in 2006 that held a transferee's claim against a bankrupt's estate can be subordinated or disallowed solely because of the transferor's misconduct or failure to return avoidable transfers even when there is no finding of wrongdoing or receipt of avoidable transfers by the transferee. *Enron Corp. v. Avenue Special Situations Fund, II, LP (In re Enron Corp.)*, 340 B.R. 180

(Bankr. S.D.N.Y. 2006); *In re Enron Corp.*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005). Under these rulings, a purchaser of a claim is subject to later attack and subordination of the claim, regardless of whether that transferee had any knowledge of the transferor's inequitable conduct or purchased the claim in good faith for value. In 2007, U.S. District Judge Shira Scheindlin reversed that decision for a number of reasons, including the fact that the Gonzalez decision created havoc in the distressed debt market. Claims traders and distressed debt traders had significant concerns, because if they were buying a claim there was no way for them to do diligence or become comfortable with the problems the claims seller had. Judge Scheindlin, in her reversal of Judge Gonzalez's decision, ruled that equitable subordination under Section 510(c) and disallowance under Section 502(d) are personal to the individual claimants that do not, without more, encumber the claim when the claim is transferred by way of a sale. However, equitable subordination and disallowance can be applied to claims held by a transferee when such claim is transferred by way of assignment. Judge Scheindlin remanded the case to the bankruptcy court to determine whether the transfers, documented by purchase and sale agreements and assignment agreements, constitute true sales or assignments, and therefore whether the conduct of a prior transferor can be imputed to a subsequent transferee. In effect, the district court created a sale versus an assignment distinction—if there was an actual sale of the claim, in her opinion the purchaser of the claim may not be liable for the problems of the seller. However, if it was an assignment of the claim, it would be consistent with state law and the assignee would take subject to the defenses or problems by the assignor. Referring to the effect on the debt markets, Judge Scheindlin noted, "It is proper to consider the effect that the court's interpretation would have on the markets. The unnecessary breadth of the bankruptcy court's decisions threatened to wreak havoc on the markets for distressed debt. That result has now been avoided."

The second decision of note was the *Manhattan Investment Fund* decision in the Southern District of New York regarding fraudulent conveyance context. This decision determined that Bear Stearns Securities Corp. was required to return more than $125 million in margin payments that Bear Stearns had received from the fund before the fund had ceased operations, because such payments were fraudulent conveyances. The bankruptcy court also required Bear Stearns to pay an additional $34 million in pre-judgment interest. The court concluded that all payments made in a ponzi scheme are "fraudulent" by nature, and that the margin debt payments to Bear Stearns were with actual intent to hinder, delay, or defraud its creditors. The court further held that Bear Stearns was on "inquiry notice" that the hedge fund might be engaged in fraud and that Bear Stearns had not acted with sufficient "diligence" to satisfy the good faith. Basically, Bear Stearns received payments from a debtor that was engaged in a ponzi scheme and should have, according to the judge, noticed there were problems with the debtor or with the person making payments to Bear Stearns. Some of the allegations in the complaint state there was certain cocktail party talk indicating that Bear Stearns was aware of problems and, had they done further diligence, would have discovered the problems with Manhattan Investment. The allegations continue that the problems were so evident that Bear Stearns could have uncovered them after about ten minutes worth of diligence. Therefore, the judge held that Bear Stearns was liable for $125 million and had to repay that in margin payments, plus $34 million in judgment interest. This decision may change the landscape in fraudulent conveyance law, creating this inquiry notice type of concept.

Another interesting decision was one I was involved with in the real estate world about defining who could be a single-asset real estate debtor. In *Kara Homes, Inc. v. National City Bank (In re Kara Homes, Inc.)*, the U.S. Bankruptcy Court for the District of New Jersey found that thirty-three affiliated debtors, each of which owned a separate real estate development project for the construction of single-family homes, constituted "single asset real estate" debtors under the Bankruptcy Code. When the debtors commenced their Chapter 11 cases, each had indicated on the face of its voluntary petition that it was a "single-asset real estate" debtor. In addition, many of the debtors identified themselves as single-asset real estate entities on their respective statements of financial affairs filed with the court. Subsequently, however, each debtor amended its respective voluntary petition and statement of financial affairs to indicate it was not a single-asset real estate debtor. In representing a secured lender, we argued that each of the debtors owned a single real estate project, which constituted each debtor's sole asset, that the debtors conducted no business operations other than the sale of real estate, and that the debtors derived all their revenue from improving and selling the property. Accordingly, the lenders argued, the debtors were single-asset real estate debtors as contemplated in the Bankruptcy Code. The bankruptcy court agreed with our position and held that the debtors' business activities, such as researching and purchasing developable land, planning and constructing homes, marketing and selling homes, and maintaining developments, were insufficient to constitute "substantial business" other than operation of the real property. Accordingly, the court concluded that the debtors were single-asset real estate debtors for purposes of the Bankruptcy Code.

This decision is important for two reasons. First, it is important because, as I mentioned previously, the Bankruptcy Code was amended in 2005, expanding who could be considered a single-asset real estate debtor. The amendment removed some of the debt limitations that were imposed by Congress pre-2005. This decision was probably one of the few decisions dealing with the real estate developer that went bankrupt in 2007, and it is important because it will likely set the landscape for many of the real estate cases in 2008 and 2009. Essentially, the gist of the decision is many developers that set up their own individual corporations to own real estate developments will be subject to the single-asset real estate limitations as a debtor under the Bankruptcy Code or have shortened time periods to be in bankruptcy, creating a responsibility to try to get out of bankruptcy quicker. There will likely be more of these types of cases in the future.

Implications

In the claims trading world, because of the *Enron* decision, purchasers of claims have tried to bolster the type of representations and warranties in claims trades so a claims purchaser isn't caught off guard or, if the claims purchaser does have difficulties there is a way to put the claim back to the original holder of the claim. This can be accomplished by further representations and warranties and/or broader indemnification clauses.

I have also changed my approach to some lending/forbearance documents in a real estate setting to try to make sure a debtor pre-bankruptcy tries to admit or make representations and warranties relating to the single-asset cases because of the *Kara Homes* decision. If the entities admit they are actually single-asset real estate developers in either a loan or a forbearance agreement, it makes it a little easier to litigate the issue in bankruptcy court based on the admissions.

Additionally, I probably put more emphasis to try to preference-proof some problems because of the potential for upcoming financial difficulty. When dealing with any type of debtor/creditor relationship, it is necessary to be a bit more aware of potential avoidance actions and preference problems. This requires taking another look at documents and trying to set up defenses to preference problems in advance.

Hurdles

Given the above discussion, the major hurdles my clients will face include the availability of lending, whether debtors will continue to be able to access money, if there will be constraints on that money, and what happens in the decreasing real estate market and in the retail world. Retailers may face a constriction in consumer spending, perhaps leading to increased retail-related filings. This will be important because of the restrictions on non-residential real property leases, meaning retailers will have to pick what stores they are going to want to keep without the benefit of a Christmas season. Most retailers will always want the following Christmas season to see how they do. However, based upon the changes to the law, those retailers are not going to get the benefit of the Christmas season if they file in early 2008.

Andrew H. Sherman is vice chair of the firm's creditors' rights and bankruptcy reorganization practice group. He has represented clients in a broad range of complex business reorganizations, debt restructurings, and insolvency matters. He advises companies experiencing financial difficulties, creditors of such entities, as well as investors and acquirers of substantial assets in bankruptcy cases and workouts. Over the past few years, he has focused his practice on representing incumbent local exchange carriers and competitive local exchange carriers in telecommunications and construction bankruptcy cases across the nation. He has also recently represented large multinational corporations in construction and energy bankruptcy cases. In addition to his bankruptcy experience, he has represented parties in significant commercial litigation in the New York federal and state courts.

Mr. Sherman is listed in The Best Lawyers in America *and was named by* New Jersey Super Lawyers *magazine as being among the top 5 percent of lawyers in the state. He earned his A.B. from Cornell University and his J.D. from the Yeshiva University Benjamin N. Cardozo School of Law. He is a member of the American Bar Association, the New York State Bar Association, the Essex County Bar Association, the American Bankruptcy Institute, and the Bankruptcy Inns of Court.*

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