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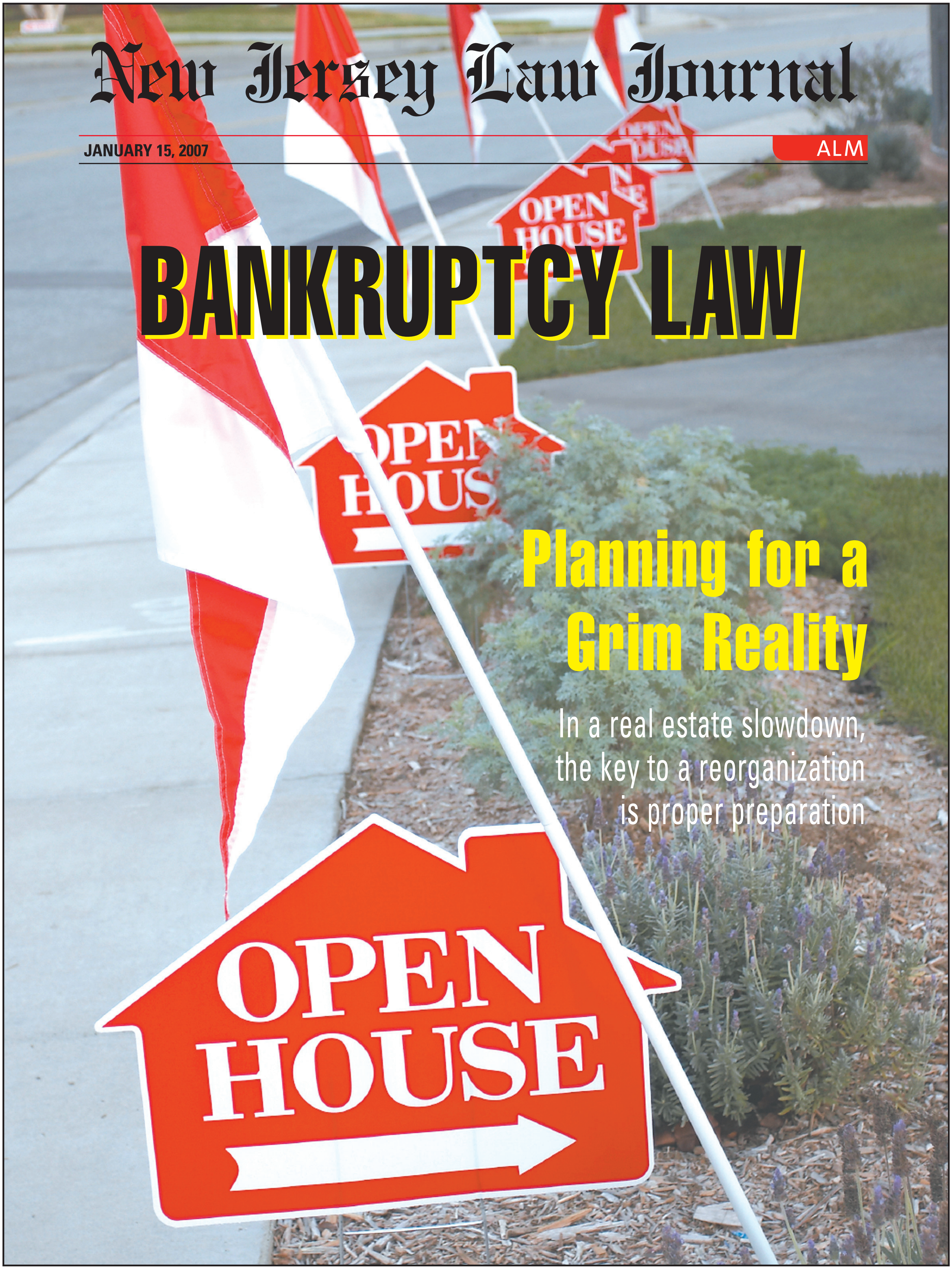

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Planning for a Grim Reality

In a real estate slowdown, the key to a reorganization is proper preparation

By Andrew H. Sherman

As the real estate market begins the inevitable slowdown, the possibility of restructuring and insolvency for developers is also becoming a grim reality. The developers who begin to consider bankruptcy issues at the early stages of a slowdown are best served in case the need to seek bankruptcy protection arises down the road. Even if the developer never needs the protection of a bankruptcy court or can avoid a bankruptcy filing, the consideration of bankruptcy issues will only help and could strengthen the business operations.

Certain of the highly leveraged real estate developers have already sought bankruptcy protection without proper planning and those entities face an uphill road during their bankruptcy cases. Even though a developer can file a bankruptcy petition with a simple board resolution and a filing fee, filing a bankruptcy case by developers which is not properly planned and coordinated can lead to ever greater problems than the slow real estate market. Prior to filing, the developer should know the risks inherent in the bankruptcy arena and have a strategy going into a bankruptcy case so that the developer will be able to emerge as a successful entity. This article touches upon certain of the significant issues which should be considered prior to the commencement of a bankruptcy case by a real estate developer to foster a successful reorganization.

Many real estate developers organize their business using the following lines: parent/holding company which runs the business operations, and affiliate/subsidiary companies which own individual properties. Banks generally provide loans to the affiliate/subsidiary and obtain a mortgage on the real property, and the parent/holding company guarantees the underlying debt. The subsidiary/affiliate upstreams all of its cash after the payment of debt service to the parent/holding company to hold in a concentration account, and the parent/holding company pays the operating expenses of each of the properties.

Upon the filing of a bankruptcy case, there can be a question of who owns the cash in the concentration account. Even though individual subsidiaries may have generated the funds from the operation of their properties, if the funds are held by the parent, it can be argued that the money is actually owned by the parent. In general, it is presumed that deposits in a bank to the credit of a bankruptcy debtor belong to the entity in whose name the account is established and it becomes the burden of the subsidiary or the creditors of the subsidiary to demonstrate that the cash actually belongs to the subsidiary. This issue can and should be addressed prior to the filing of a bankruptcy case by performing due diligence or instituting proper controls to avoid this inequitable result and to avoid costly and time-consuming litigation.

When a real estate developer obtains financing from a bank to develop a project, the bank will usually be granted a mortgage on the real property, and a lien on all

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personal property, cash and cash equivalents. Upon the filing of a bankruptcy petition by operation of the Bankruptcy Code, a debtor is prohibited from using or selling the cash that is subject to the bank's lien without first obtaining consent from the secured lender or a court order approving the use or sale. A court will allow a debtor to use the cash if and only if a debtor is able to adequately protect the bank's interest — proving assurance that the bank's position will not deteriorate.

A real estate developer may have difficulty in providing adequate protection in a declining real estate market and may not have the ability to use its cash or rental income stream to pay for current expenses. The easiest way to demonstrate adequate protection is if there is an equity cushion for the real property, such that the value of the property exceeds the amounts due to the bank. As long as there remains a sufficient equity cushion and a debtor can show that the position of the bank is not eroding by the use of the cash, the developer may be able to convince a court to allow the developer to use the cash. However, in a declining market, when the value of the real estate drops, the developer may have difficulty demonstrating adequate protection. If the debtor is unable to demonstrate adequate protection, the bank may be in a position to force the debtor to shut its doors unless the debtor cooperates with the bank's demands. Cash collateral issues should be considered prior to the commencement of any bankruptcy case to determine whether the debtor can operate.

The Bankruptcy Code contains certain restrictions on the ability of a single asset real estate debtor to reorganize. In the 1994 amendments to the Bankruptcy Code, Congress defined a single asset real estate case to be real property constituting a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto.

Congress added this section to impose an expedited time frame for filing a plan in a single asset real estate case. The plan in such a case must be filed within the later of 90 days after the filing of the case or within 30 days after the Court determines that the case is a single asset real estate case. This requirement is noteworthy in two respects. First, it sets a time for filing a plan in this species of Chapter 11 case. There is no time requirement in the Bankruptcy Code for the filing of a plan for any other kind of Chapter 11 case. Second, the consequence of not meeting that requirement is that the automatic stay may be lifted without further ado to enable the bank to pursue a foreclosure of the property.

If a real estate developer has vacant land or no real operations on the property, there is a substantial risk that the case could be considered a single asset real estate case with expedited deadlines for the filing of a plan.

Assuming the developer overcomes the issues relating to the use of cash and formulates a plan to emerge from bankruptcy protection, the developer must convince a court that the plan is confirmable pursuant to the terms of the Bankruptcy Code. The Bankruptcy Code enables a debtor to confirm a plan through a consensual agreement with its creditors and, if an agreement can't be reached, through nonconsensual means. The plan must specify how the claim of each creditor (or class of creditors) is to be treated and paid by the debtor. A plan can provide for payment in full of a secured claim, surrender of the collateral to the secured creditor, or the restructuring of the loan with reduced or delayed debt-service payments.

If the plan provides for the cure of existing defaults, compensation to the creditor for losses caused by the breach and reinstatement of the debt in accordance with the pre-bankruptcy terms, the secured claim is classified as "unimpaired" such that the secured creditor is deemed to accept the plan and does not have the right to vote. If a Chapter 11 plan alters any of the creditor's legal rights and remedies, the claim is said to be "impaired," and the creditor has the right to vote to accept or reject the plan. If an impaired secured creditor votes to reject a Chapter 11 plan, the plan can be confirmed only if it satisfies the Bankruptcy Code's nonconsensual confirmation, or "cram-down," requirements. These complicated and often litigated requirements allow a plan to be confirmed over the objection of a secured creditor if the creditor retains its lien on the collateral and receives property on the effective date of the plan valued at (at least) the full allowed amount of the creditor's secured claim or the indubitable equivalent of the secured creditor's claim. Once again, prior to the filing of a bankruptcy case, these confirmation requirements should be considered to determine if there is a viable case or whether a viable case can be formulated.

Just like many aspects of a successful business, the key to a reorganization is proper planning and preparation. All too often, many companies will seek bankruptcy protection as a last resort after many other options have been exhausted. In this scenario, a company will limit or impair its ability to reorganize because it did not, or could not, consider all issues to foster a successful reorganization. Just like individuals have a will to protect against unanticipated events, it is never too early to consider bankruptcy issues, but sometimes, it is too late. ■