WORKING THROUGH THE WORKOUT: COMMON ISSUES WITH DISTRESSED PROPERTIES

David A. Weissmann
Weissmann Zucker Euster P.C.
3490 Piedmont Road
Suite 650
Atlanta, Georgia 30305
david@wzlegal.com

I. CONSTRUCTION ISSUES IN THE WORKOUT ENVIRONMENT

A. Monetary default is usually accompanied by a host of related defaults

1. The failure to pay the lender is usually preceded by a failure to pay contractors, or by the contractor's failure to pay subcontractors or materialmen.

i. Disbursements to the borrower may not find their way to the contractor, and there may be multiple liens representing the same work (the borrower does not pay the contractor, who in turn does not pay the subcontractor/materialman). Deciphering the actual claimed amount, and to whom it is owed is a time consuming, burdensome process.

2. Defects in construction may arise because unpaid subcontractors are unwilling to return to the job to complete their job or to remedy defects.

3. Mortgage priority over lien rights must be reviewed on a state by state basis. Junior liens can be avoided by foreclosure. In some states, the failure to obtain a date-down title check and endorsement can be fatal with regard to monies advanced after intervening lines. However, even if lien holders do not have priority, as a practical matter, the assistance of the lien holder may be required to complete the project.

B. Completing the job is a high priority. The lender must get control of the job, either through foreclosure, receivership, or other process before it can take over construction.

1. Timing may be crucial to meet deadlines in sales contracts or leases

2. Delay generally results in additional costs associated with remobilization or even weather (depending on if construction is at

a stage whereby weather will impact the construction schedule and if the upcoming season is rainy).

3. The contractor's consent to assignment and continuation agreement comes into play. At the outset of construction, the contractor should be asked to sign this agreement, giving the lender the following protections:

    a. Contractor to provide notice of borrower defaults

    b. Contractor to not make material modifications in the plans and specifications (i.e. change orders) without the lender's prior written consent. These may be based on pre-negotiated allowed amounts in each instance and in the aggregate (i.e. $25,000 in each instance and $100,000 in the aggregate).

    c. Contractor agreeing to provide continuous performance of the work provided that the contractor is compensated at the rate provided for in the construction contract.

        i. Although some lenders refuse to provide upfront assurance that borrower defaults will be remedied prior to the contractor being required to provide performance, most contractors will not be compliant without payment of all outstanding invoices. The lender's risk is for those amounts which have been disbursed to the borrower but not paid to the contractor. Disbursing additional amounts will cause the construction budget to balloon.

        ii. It is imperative for the loan officer to be adept at spotting problems before the default stage. Work slowdowns and liens are a sure sign of a pending problem and justify increased use of title checkdowns, inspections, and perhaps even joint checks.

    d. Changing contractors will increase cost and delay the project. A new contractor will need to familiarize itself with the project and the plans and specifications. Some subcontractors may be discarded and others retained. If the borrower is an alter-ego of the contractor, it is wise to try to keep the subcontractors on the job

i. A review of job status with the subcontractors, of the subcontracts, pay applications and remaining amounts due will give the lender a good indication of the current job status and amounts needed to complete construction. The lender's involvement demonstrates to the subs that there is a source of funds for completion of the work and keeps the subs involved and eager to finish the job.

e. A review of hard cost construction funds needed for completion is necessary. Equally crucial and often overlooked is the soft cost budget for completion. Include additional funds for attorneys fees, permit fees, water and sewer tap fees.

f. Payment and performance bonds are useful but do not provide a complete shield from construction related problems. Many projects require that the contractor be "bonded," and require as a condition to closing that a bond be issued in favor of the lender, usually pursuant to a so-called "dual obligee" rider to a payment/performance bond.

i. The payment bond guaranties the payment of sums due under the construction contract to potential lien claimants. State lien law should be reviewed with the terms of the payment bond to make sure that the owner is covered (and lender, as "dual obligee") as well as second and third-tier subcontractors who may not have direct privity of contract with the contractor.

ii. The performance bond guarantees performance of the work. If issued separately from the payment bond, for the full contract sum, it should provide coverage for full performance regardless of cost (if both are written on the same document as a "payment and performance" bond, effective coverage may be less).

x. The performance bond does not guaranty the completion date or payment of delay damages, or penalties or claims by third parties. Therefore, it should specify how much time the surety has in which to respond to a default by the owner.

iii. Be careful of circumstances that might cause an inadvertent waiver of the surety's obligations. Under some states' law, a change in circumstances that increases a surety's risk can release the surety. The bond should contain an express waiver of notice of these changes, which include changes in material terms of the contract, changes in payment terms, extensions of time and changes in developer's ownership entity.

C. The lender should conduct a review of insurance policies and make certain they continue following the takeover. A loss of builder's risk insurance could lead to a catastrophe.

D. A lender may incur liability for construction defects once it assumes the job. Warranty work on leases or contracts also will fall to the lender to complete.

II. **BANKRUPTCY CONCEPTS AND ISSUES INVOLVING REAL PROPERTY WORKOUTS** – The following are key concepts and issues involved in real estate bankruptcies. An effort has been made to retain "plain English" or "natural language" which may result in oversimplification of these concepts. Review of actual statutes is essential. Courts have wide discretion on many issues, and decisions vary widely from jurisdiction to jurisdiction. Familiarity with your jurisdiction's decision and individual judicial preferences is important to formulate strategy and to predict the outcome of a case.

A. Most know that Section 362 of the Bankruptcy Code (11 USC §101, et. seq.) "stays" all remedies against a defaulted borrower, including litigation, lien enforcement (i.e. foreclosure) and related collection efforts.

1. Section 362(d)(1) gives the court discretion to terminate or otherwise modify or abate the automatic stay "for cause, including the lack of *adequate protection*."

2. As a general principal, the filing of a petition in bankruptcy will cause all enforcement activities to cease for a minimum of 120 days because during this period, the debtor has the exclusive right to develop and propose a plan of reorganization.

a. If the debtor files a plan of reorganization within 120 days, the debtor has an additional 60 days to obtain confirmation.

B. A creditor may seek relief from the automatic stay (i) if the debtor has no equity in the property **and** the property is not needed for an effective reorganization, or (ii) for "cause," which is not defined by the Bankruptcy

Code, but courts have held it includes bad faith filing, fraud, prepetition mismanagement, and lack of **adequate protection** (which is specifically enumerated in the Bankruptcy Code as being "cause"). Section 362(d). There are also grounds if the filing was part of a scheme to "delay, hinder and defraud" creditors that involved either a transfer of the property without consent or multiple bankruptcy filings.

1. Adequate protection is not precisely defined. Different courts provide various meanings. It includes periodic payments, additional liens or other means that preserve the value of lender's interest in the collateral. The purpose of adequate protection is to insure that the creditor is not harmed by the automatic stay. The primary issue generally is whether a creditor can obtain payments of interest, or otherwise accrue interest, pending the outcome of the case.

    a. In the seminal case *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1988), the Supreme Court affirmed the basic principal codified by Section 506 that oversecured creditors can receive interest on their claim (at the non-default contract rate, unless modified by the court), to the extent of the equity cushion in the property.

    b. Conversely, *Timbers* specifically held that an undersecured creditor cannot claim the right to interest based on a claim that it is not adequately protected and thereby obtain relief from the bankruptcy stay unless payments of interest are made. The Court explicitly held that the "immediate right to foreclose," which is frustrated by the bankruptcy stay, is not an "interest" in property for which adequate protection can be obtained.

    c. Section 361 authorizes payments or granting of additional liens in a market where property values are declining, which does in fact compensate a secured creditor for loss of immediate use of property which would have occurred following foreclosure. The *Timbers* involved a market in which property values were improving.

2. Some jurisdictions allow actual payments of interest, even at default rates, while others allow accrual of interest until the equity cushion is exhausted.

C. Valuation of the property is crucial to determining relative rights of creditors. A secured creditor is deemed "secured" only to the extent that

the real property has value. If the amount of the debt exceeds the value, the secured creditor is considered **undersecured** and has a secured claim to the extent of the value of the real property and is unsecured for the remainder of its claim. If the amount of debt is less than the value of the real property, then the secured creditor is considered **oversecured**, and the entire claim is a secured claim. Section 506(a). As stated above, secured creditors (those with claims that are deemed "secured" under Section 506(a)) are entitled to accrue interest or obtain payments for interest, to the extent that there is an equity cushion.

1. There are issues as to the timing and the method of valuation. Should the property be valued at the time of the filing, at the time of needed determination of value, at the time of reorganization, or other time? Is the proper value liquidation value, replacement value or otherwise derived market value? What is the purpose for valuation – to determine if a creditor is entitled to adequate protection (i.e. use of cash) or to determine the value at the time of confirmation of the plan of reorganization (in a "cramdown," each secured lien claimant must retain their lien or receive discounted present value payments equal to the allowed amount (i.e. value) of its secured claim – hence, lower value means lower payments).

2. Courts are divided on the proper date to determine value of property for adequate protection purposes. However, cash receipts create a powerful incentive to resolve the issue of their use early in a case and therefore, valuation may invariably occur at the commencement of a case.

3. Most courts use on their fair market value, as a going concern, and not a fire sale or liquidation value. A few courts use liquidation value.

4. In *Assoc. Commercial Corp. v. Rash*, 520 U.S. 953 (1997), involving non-real estate collateral in a Chapter 13 case, the Supreme Court held that the proper value for "cram down" (whereby the creditor's allowed claim in the collateral is lowered to the "value" of the collateral at such time) is "replacement cost" – something less than the value of brand new collateral, but more than liquidation collateral. The Court stated "we mean the price a willing buyer in the debtor's trade, business, or situation would pay a willing seller to obtain property of like age and condition." The Court rejected a definition of value based on repossession followed by sale (i.e. fire sale or liquidation value).

5. Several courts have applied *Rash* to both Chapter 11 cases and for purposes of valuation. In terms of valuation, that has meant using

the current use of the property rather than highest and best use (current use as a ranch instead of a proposed residential subdivision), or using a current capitalization rate based on current income, which can lower the value in a down market.

D. Post- petition rents are cash collateral which are generally subject to a security interest in favor of the lender. If the debtor is able to use the cash, it can continue operating, hoard cash to pay attorneys or other expenses, and then seek to "cram down" the lender's secured interest.

1. In the usual real estate bankruptcy, the "assignment of leases and rents" is the security vehicle giving the lender a security interest in post-petition rents.

a. Under bankruptcy law prior to 1994, courts would look to state law to determine whether or not the security interest was perfected prior to the filing of the petition. If the security interest was not perfected, then the creditor had no interest in post-petition rents. Perfection under state law may have required affirmative action by the creditor, such as appointing a receiver, prior to the bankruptcy filing.

b. The 1994 Bankruptcy Reform Act amendment to Section 552(b) makes it clear that a properly executed and filed security agreement extends to rents (including hotel revenues) arising post-petition if provided for in the security agreement, *unless* the court otherwise orders based on the facts, equities and circumstances of the case.

i. There is still some uncertainty as to the perfection of a security interest in post-petition rents, even with a security agreement that purports to grant an interest in after-acquired rent. Jurisdictions may differ on the requirement of additional, aggressive action by the lender to perfect or to "activate" the security interest. Furthermore, a lender that does take all such action can argue that the borrower has no interest in rents, and that they belong exclusively to the lender and no longer constitute cash collateral.

ii. Quick action by a lender upon a default has added the benefit of preventing hoarding of cash by the default borrower, which cash can be used as a retainer for bankruptcy counsel.

c. A typical motions practice at the beginning of a case is the filing of a motion for use of cash collateral by the debtor, and the filing of a motion to sequester rents or for adequate protection by the creditor. A settlement may ensue, or the judge may allow the use of some cash collateral, and require some "adequate protection" payments.

E. Single Asset Real Estate Bankruptcies: single asset real estate is defined "as real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating real property and activities incidental thereto." Section 101 (51A)

1. A creditor can obtain relief from the bankruptcy stay after the later of (a) 90 days of the filing (unless extended by the court) and (b) 30 days after court determines that the case concerns single asset real property, if the debtor has not presented a plan of reorganization that has a reasonable possibility of being confirmed or, in the alternative, commenced monthly payments in amounts equal to non-default interest on the "value" of the creditor's interest in the real property. Section 362(d)(3).

2. A $4,000,000 cap on value was eliminated in 2005, thereby greatly expanding the definition of single asset real estate.

3. In a market where property values are declining or have declined, and there is little equity remaining in property at the time of bankruptcy, a single asset real estate bankruptcy debtor will usually not be successful in reorganization. First, a filing on the eve of foreclosure is subject to a motion for relief of stay based on claim that filing was merely an effort to delay and hinder creditors. Second, with no other significant creditors, and no real equity to play with, the property is not needed for an effective reorganization.

F. Preference and fraudulent transfer claims are primary tools used by the court to avoid outright transfers or grants of security interest occurring prior to the bankruptcy.

1. A preference is a transfer of interest in property, to or for the benefit of a creditor, for or on account of a pre-existing debt, made when the debtor was insolvent, and made within 90 days of the filing of the petition generally, or within 1 year of the filing of the petition by insiders, whereby the creditor obtains property valued

in excess of what would have been received in a Chapter 7 bankruptcy. Section 547.

a. *In re V.N. De Prizio Constr. Co.*, 874 F.2d 1186 (7th Cir. 1989) applied preference avoidance powers to payments made to outside creditors (i.e. banks) to a full year because the payments to these creditors "benefited" other insider parties liable, secondarily, for the debt, since payments reduced these insiders potential liability to the creditors. These insiders were deemed "creditors" because they held rights of reimbursement or contribution from the debtor-borrower. Various amendments to the Bankruptcy Code have ostensibly limited the period to 90 days. Some commentators feel that *De Prizio* still has potential to cause harm and waivers of contribution and indemnity are still applicable.

b. There are some exceptions to preference avoidance powers, including when new value was given contemporaneously for the transfer, and when the transfer was made in the ordinary course of business.

2. A fraudulent transfer is one made, voluntarily or involuntarily, within 2 years of filing that is made "with actual intent to hinder, delay, or defraud any entity which the debtor was or became, on or after the date of transfer, indebted. Section 548.

a. State law may provide additional fraudulent transfer protection.

3. If any such transfers are avoided, the property will be restored to the estate in bankruptcy or the lien will be removed, as the case may be.

G. Classes, Plan of Reorganization, Confirmation and "Cram Down"

1. The primary goal of Chapter 11 is the development of a plan of reorganization that will allow the debtor to continue to operate its business. The debtor has the exclusive right to present a plan for the first 120 days of the bankruptcy. Thereafter, any party in interest can file a plan. Additionally, if the debtor presents a plan which is not accepted by each "impaired" class within 180 days of the petition filing, any party in interest can file a plan.

2. The plan places the creditors into categories or "classes" and describes how each class will be affected by the plan. The classes are segregated by priority of payment or other consideration.

    a. Voting for or against the plan is by classes. Unimpaired classes are not entitled to vote. However, a class is deemed "impaired" unless one of the following standards applies:

        i. The plan must not alter the legal, equitable or contractual rights of the holders of the class; or

        ii. Notwithstanding any right of acceleration on the part of the claim holder, the debtor cures all defaults (pre- and post bankruptcy), reinstates the original maturity date, compensates the holder for any damages arising from reasonable reliance on their contractual provisions.

    b. Impaired classes may vote to accept or reject the plan. Explanations are not required. A class is deemed to have accepted the plan if it is approved by at least 2/3^{rds} in amount and by more than 1/2 in number.

        i. If all impaired classes do not approve the plan, it may nevertheless be "crammed down" with the approval of at least 1 impaired class, provided that the court considers the plan fair and equitable and does not think the plan discriminates against those who voted against the plan.

        ii. Each impaired class must either accept the plan, or receive property equal in value to what it would receive in Chapter 7 liquidation, valued as of the effective date of the plan.

        iii. In a cram down, the debtor can reduce the principal amount of the secured claim to the value of the property, and modify all or some of the payment terms (maturity date, interest rate, schedule of payments).

        iv. Regardless of the debtor's sincere intentions, the court must rule that a cram down is "feasible" (i.e. will it likely not be following by a liquidation or need for further reorganization), taking into consideration all factors: the general state of the

economy, the condition of the collateral, market conditions, management, availability of credit, capital requirements and ability of debtor to obtain credit.

H. The "absolute priority" rule does not allow a claim to be crammed down if the principals in the debtor retain equity interests in the debtor unless all senior creditor classes are paid in full. This is sensible because it would be unjust for the lender to be forced to take a hit while the debtor retains upside potential. The new value exception, which some courts will apply, allows the principals to maintain an interest in the debtor to the extent of "new value" given to the debtor as part of the reorganization.

III. TAKING OVER DISTRESSED PROPERTIES: PITS AND PITFALLS

A. There are two basic takeover methods:

1. Purchase of loan documents with intent to foreclose: subjects the purchaser to any offsets or defenses the borrower may have and to the bankruptcy risk. Large discounts, sometimes more than 50% or 60% are available.

2. Purchase the property at or after foreclosure, which is most typical. These materials focus on this method.

B. The purchase of new properties either in the midst of construction or recently completed construction contains its own set of unique risks.

1. Residential or mixed use developments usually are subject to declarations of covenants, conditions and restrictions. It is highly desirable that the purchaser obtain "control" of the declarant's rights, which rights may include the following:

a. Architectural approval;
b. Right to appoint directors and voting control over the association;
c. Right to create budgets and assessments; and
d. Easement rights for sales trailers or construction access.

2. The purchase should determine if mortgage and/or foreclosure deed included declarant's rights as part of the definition of security property.

3. Owners of even vacant lots will usually be required to pay assessments toward the property owners association, or perhaps, shortfalls in operating expenses.

4. There may be hidden costs associated with the project

a. Incomplete or defective infrastructure;
b. Maintenance requirements for governmental approval and/or dedication and acceptance;
c. Bonding or letter of credit requirements for dedication and acceptance;
d. Construction of promised amenities, such as swimming pools, tennis courts or cabanas; and
e. Warranty work associated with common areas and amenities and warranty work associated with individual property improvements (either legal warranty requirements,

or requirements "imposed" by the need to satisfy recalcitrant pre-foreclosure purchasers of lots or properties)

i. In most default scenarios, the foreclosing lender is not the only one who has not been paid. Usually contractors, subcontractors and materialmen have outstanding invoices. Since their cooperation may be needed to complete improvements or do warranty work, they may require payment over and above the cost of purchasing the project

5. Condominiums have particular state-by-state requirements. Be certain that the condominium was properly formed and that the plat, floor plans and declaration are in compliance with at least the minimum legal requirements.

a. Well drafted condominium documents can protect the successor declarant by containing certain hold harmless and indemnity provisions which might be absent:

i. Indemnities of officers and directors of the Association;
ii. Indemnities and hold harmless provisions for criminal activity of third-parties at the project; and
iii. Restraining the Association from instituting legal action against anyone on behalf of any or all of the owners which is based on any alleged defects in any unit or the common element

b. There may be a desire to turn the condominium into an apartment project. The condominium documents generally will contain restrictions on leasing. Leasing is generally less desirable in condominium developments because of the transient nature of the occupant of the unit.

i. The restriction might reduce the units available for "lease" to a fixed percentage (i.e. 25%) except in the case of hardship.

ii. Modifying the condominium documents to be more flexible on leasing is problematic.

iii. Terminating the condominium will require the consent of each owner and this may necessitate a buyout at a prohibitive cost.

6. Problems can arise from pre-foreclosure purchasers when they realize that the value of their respective properties have declined and that the quality of new improvements, or of the character of post-foreclosure purchasers, have declined.