

**HEADED FOR THE ABYSS:
TOP 10 THINGS FOR THE REAL ESTATE PRACTITIONER
TO KNOW ABOUT BANKRUPTCY**

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TOP 10 THINGS FOR THE REAL ESTATE PRACTITIONER TO KNOW ABOUT BANKRUPTCY

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Introduction

Has the DFW area dodged the real estate bubble bullet? Some would say it has,² but it may still be too soon to tell. One thing is clear, there was certainly a noticeable softening in the residential real estate market in the second half of 2006.³ And while some have suggested that a bit of moderation is long overdue and healthy,⁴ it is hard to ignore the significant spike in home foreclosures that took place during the year.⁵ In this regard, according to at least one report Texas experienced a 20% increase in foreclosure postings in 2006.⁶ In Collin County, alone, there was a 61% increase in comparison to 2005.⁷ Nationally, the picture looks worse. In the third quarter of 2006, for example, nearly 5% of all U.S. mortgage payments were delinquent.⁸ And at least one analyst has projected that median sales prices for existing homes will decline nationally in 2007, which if proven to be correct, will be the first such decline since the Great Depression.⁹

With these statistics in mind, it is likely that the day will come when every real estate client will have to face the problem of dealing with a bankruptcy issue. Given the inevitable journey into the bankruptcy abyss, it is important for the real estate practitioner to have a general understanding of certain basic bankruptcy principles and certain provisions of the Bankruptcy Code (the “Code”)¹⁰ to be in a position to protect and provide some baseline advice to the client.

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² See Steve Brown, *Area Avoids Bubble Trouble*, The Dallas Morning News, Jul. 3, 2006 (citing report by PMI Group, one of the nation’s largest mortgage insurers, which ranked the DFW area as one of the markets least likely to experience home price decreases through the middle of 2008).

³ Included within this category is the condominium market, in which the rate of development outpaced demand and led to the cancellation of at least a couple downtown Dallas conversion projects. See Brown, *Fisher Detects No Housing Bubble in Texas*, The Dallas Morning News, Aug. 31, 2006 (citing comments of Federal Reserve Bank of Dallas President Richard Fisher).

⁴ See *id.*

⁵ See, e.g., *Foreclosures.com: Southwest Foreclosures Lead the Nation in 2006*, Business Wire, Jan. 8, 2007 (Texas, California and Colorado had the highest foreclosure rates in 2006 according to an analysis prepared by Foreclosures.com); Payton Oldham, *Foreclosures Peak in 2006 in Some States; Continued Growth Expected in 2007*, DSNews.com, Jan. 5, 2007 (projecting further increase in number of foreclosures in 2007).

⁶ Steve Brown, *Foreclosures Hold Steady*, The Dallas Morning News, Dec. 15, 2006.

⁷ *Id.* (also reflecting an increase of 24% in Dallas County and an increase of 15% in Denton County).

⁸ *Id.*

⁹ See Rachel Konrad, *Real Estate Expected to Flounder in 2007*, ABCNews Internet Ventures, Dec. 15, 2006 (citing forecast by Moody’s Economy.com).

¹⁰ The Bankruptcy Code is contained in Title 11 of the United States Code, 11 U.S.C. § 101, *et seq.*

The purpose of this paper is to provide the author's top ten things to know about bankruptcy to prepare the real estate practitioner for the trip.¹¹

10 – Bankruptcy Professionals Speak In Tongues

One of the first things that a real estate lawyer is likely to encounter is the seemingly foreign language used by bankruptcy professionals in their discussions about the bankruptcy case. To assist the outsider in the process, the following table lists some of the more common lingo and translations:

Bankruptcy Lingo	Meaning
341 Meeting	The initial meeting of creditors required pursuant to Section 341 of the Code. The 341 meeting is normally conducted at the U.S. Trustee's Office, where the debtor (or representative of the debtor) is placed under oath and asked certain basic questions regarding the bankruptcy filing, the debtor's schedules of assets and liabilities, and the debtor's statement of financial affairs, by a representative of the U.S. Trustee's Office. Creditors are invited to attend and to also ask questions (generally limited to overall case issues, as opposed to creditor-specific issues).
341 Notice	The notice sent to creditors shortly after the bankruptcy filing. Importantly, in addition to specifying the date/time/place of the 341 meeting, it also specifies the deadline for the filing of proofs of claim in the case.
2004 Exam	An examination (deposition) conducted pursuant to Bankruptcy Rule 2004. Generally, it is a means to formally obtain information relating to administration of the estate/case, but is not a means to fish for information relating to pending litigation.
Adequate Protection	The protection provided/required in relation to a non-debtor party's interest in property of the estate (<i>e.g.</i> , lien, reversionary interest in realty, etc.) to ensure that the value of such interest is protected during the course of the bankruptcy case.
Automatic Stay	The stay automatically imposed pursuant to Section 362 of the Code immediately upon the bankruptcy filing, which precludes the taking of most actions against the debtor and property of the estate unless and until the stay is lifted or terminates. Further discussion regarding the automatic stay and exceptions thereto are set out below.
BAPCPA	Most commonly pronounced "bap-see-pah." This is the short-hand reference to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the most significant overhaul of the U.S. Bankruptcy Code since the Code's enactment in 1978.
Bar Date	The deadline for the filing of proofs of claim in the case.
Chapter 5 Actions	Specific causes of action set out in Chapter 5 of the Code which enable the avoidance and recovery of certain transfers of property by the debtor.
Chapter 7	Chapter 7 of the Code, which consists of the provisions for straight liquidation.
Chapter 11	Chapter 11 of the Code, which consists of the provisions for reorganization. With a few exceptions, both businesses and individuals are eligible for relief under Chapter 11.
Chapter 12	Chapter 12 of the Code, which consists of the provisions for reorganization by family farmers and family fishermen.
Chapter 13	Chapter 13 of the Code, which consists of the provisions for reorganization by individuals with regular income.

¹¹ One word of caution. The presentation set forth herein is by no means a comprehensive description of the numerous intricacies associated with the bankruptcy process; it is merely an overview of some of the more significant issues likely to be faced in a bankruptcy case.

Bankruptcy Lingo	Meaning
Class	In a Chapter 11 case, the grouping into which claims of a particular nature are placed for purposes of voting and treatment under a plan of reorganization.
Committee	The Official Committee of Unsecured Creditors appointed in a Chapter 11 case by the U.S. Trustee's Office. The Committee is charged with the responsibility of representing the common interests of all unsecured creditors in the case.
Confirmation	In a Chapter 11 case, the Court's approval of the proposed plan of reorganization under the provisions of Section 1129 of the Code.
Cramdown	In a Chapter 11 case, the pursuit of confirmation of a plan when the plan has been rejected by a class of creditors or equity interests.
CRO	Chief Restructuring Officer (often a member of a turnaround firm specially engaged by the debtor in a large Chapter 11 case).
DIP	Short for debtor in possession. In a Chapter 11 case, the debtor (as the debtor in possession or DIP) remains in control and possession of estate assets, continues to have the authority to operate the business, and obtains most of the rights and powers of a trustee under the Code.
DIP Financing	Short for financing obtained by a debtor in a Chapter 11 case after the bankruptcy case has been filed.
EBITDAR	A variation of EBITDA (earnings before interest, taxes, depreciation and amortization) which includes reorganization expenses (the "R") as an excluded item in analyzing financial performance given the potential for such expenses to skew an analysis of past v. present performance during a bankruptcy case.
Estate	The bankruptcy estate, consisting all of the debtor's legal and equitable interests in property pursuant to Section 541 of the Code.
Examiner	In a Chapter 11 case, the individual/entity appointed to examine certain aspects of the debtor's operations/management if cause for the appointment is established under Section 1104 of the Code.
Exclusivity	In a Chapter 11 case, the initial period of time during which only the debtor has the right to file a proposed reorganization plan. Once exclusivity expires, any party in interest may file a proposed plan.
Petition Date	The date of the bankruptcy filing.
POC	Short for proof of claim, the claim form used by creditors to assert a claim in the bankruptcy case.
Post-Petition	Time period following the date of the bankruptcy filing.
Preference	A payment or other transfer made by the debtor to a creditor within 90 days (or within a year for insiders of the debtor) of the bankruptcy filing that is avoidable under Section 547 of the Code under certain circumstances.
Pre-Petition	Time period preceding the date of the bankruptcy filing.
Schedules	The schedule of assets and liabilities which a debtor is required to file shortly after the bankruptcy filing.
SOFA	Short for the statement of financial affairs which a debtor is required to file shortly after the bankruptcy filing.
Strong-Arm Powers	The avoidance powers set out in Section 544 of the Code.
Trustee	The individual appointed to administer the bankruptcy estate. In Chapter 7, 12 and 13 cases, a trustee is automatically appointed. In Chapter 11 cases, a trustee is not automatically appointed (see DIP description above), but may be appointed for cause under Section 1104 of the Code.

9 – The Automatic Stay Is Automatic And Potent

The automatic stay, set forth in Section 362 of the Code,¹² is the cornerstone of bankruptcy and is present in every bankruptcy case. Generally speaking, the stay serves two purposes: (a) to prevent a race to the courthouse by creditors; and (b) to provide a short “breathing spell” for a debtor attempting to reorganize its business affairs.¹³

While statutory in nature, courts treat the automatic stay as an automatically imposed injunction against the taking of certain actions against the debtor and property of the estate.¹⁴ Among the actions prohibited are the following: (a) the commencement or continuation of any judicial, administrative, or other action or proceeding against the debtor; (b) the enforcement against the debtor or property of the estate of any judgment obtained prior to the bankruptcy filing; (c) any act to obtain possession of property of the estate or to exercise control over property of the estate; (d) any act to create, perfect or enforce a lien against property of the estate; (e) any act to collect, assess or recover a pre-petition claim against the debtor; and (f) the setoff of a pre-petition debt owing to the debtor against a pre-petition claim against the debtor.¹⁵

Actions taken in violation of the stay, even in situations where the violator is unaware of the bankruptcy filing and the stay, are typically determined to be void or voidable.¹⁶ The following examples are illustrative of same:

- ◆ Post-petition foreclosures have been invalidated.¹⁷
- ◆ Post-petition sheriff’s sales of real property, even if to innocent purchasers without knowledge of the bankruptcy case, have been voided.¹⁸
- ◆ Post-petition recordation of liens have been determined to be void.¹⁹

Importantly, a party’s violation of the automatic stay may subject the party to sanctions and other adverse consequences. Where a violation is shown to have occurred with the violator’s knowledge of the stay, for example, the violator may be subject to contempt of court and an award of damages, attorney’s fees and costs.²⁰ Accordingly, the significance of the automatic stay cannot be understated.

¹² 11 U.S.C. § 362(a).

¹³ The “breathing spell” objective is only applicable to reorganization cases – namely, those proceeding under Chapter 11 (mostly business cases, but occasionally individual cases), Chapter 12 (family farmer and family fishermen cases) and Chapter 13 (individual cases). It is not implicated in Chapter 7 liquidation cases.

¹⁴ *Gruntz v. County of Los Angeles (In re Gruntz)*, 202 F.3d 1074, 1082 (5th Cir. 2000) (“[t]he automatic stay is an injunction issuing from the authority of the bankruptcy court”); see also *In re Wilson*, 336 B.R. 338 (Bankr. E.D. Tenn. 2005).

¹⁵ See 11 U.S.C. § 362(a)(1)-(7).

¹⁶ See, e.g., *Ozonne v. Bendon (In re Ozonne)*, 337 B.R. 214 (B.A.P. 9th Cir. 2006) (actual knowledge of the presence of the automatic stay is irrelevant).

¹⁷ See, e.g., *Phoenix Bond & Indem. Co. v. Shamblin (In re Shamblin)*, 890 F.2d 123, 125 (9th Cir. 1989); *In re Ward*, 837 F.2d 124, 126 (3rd Cir. 1988).

¹⁸ See, e.g., *Singleton v. Abussad (In re Abussad)*, 309 B.R. 895 (Bankr. N.D. Tex. 2004).

¹⁹ See, e.g., *Field v. Fifth Third Bank (In re Nasr)*, 191 B.R. 689, 693 (Bankr. S.D. Ohio 1996).

²⁰ See 11 U.S.C. § 362(k); *Pettitt v. Baker*, 876 F.2d 456, 457-58 (5th Cir. 1989); *Jove Eng’g, Inc. v. IRS*, 92 F.3d 1539 (11th Cir. 1996); *Homer Nat’l Bank v. Namie*, 96 B.R. 652, 654 (W.D. La. 1989).

8 – There Are Numerous Exceptions To The Automatic Stay Affecting Real Property Interests

Prior to enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “BAPCPA”), which provided for the most sweeping modification to the Code since its enactment in 1978, the exceptions to the automatic stay relating to real property interests were limited. The BAPCPA, however, significantly expanded the exceptions in an effort to address perceived abuses of the bankruptcy process by dilatory debtors. Including the amendments, the following exceptions to the automatic stay exist under the Code:²¹

- ◆ Expired Lease Exception. A lessor of *nonresidential* real property may take any action to obtain possession of the property after the lease has terminated by virtue of the expiration of its stated term.²²
- ◆ Fraudulent Conduct Exception. A creditor may take any act to enforce its lien against or security interest in real property if:
 - (a) the creditor, in a prior bankruptcy case, obtained an order for relief from the automatic stay under Section 362(d)(4) of the Code in relation to the property (*i.e.* as a result of the fraudulent transfer of the property and/or multiple bankruptcy filings);
 - (b) the debtor has not obtained relief from the order based upon changed circumstances or other good cause; and
 - (c) the act is taken *within 2 years* of the entry of the order in the prior case.²³
- ◆ Ineligible Debtor Exception. A creditor may take any act to enforce its lien against or security interest in real property if:
 - (a) the debtor is an individual or family farmer²⁴ who is not eligible to be a debtor as a result of Section 109(g) of the Code (*i.e.* because the case was filed within 180 days of the dismissal of a prior case in which the court ordered the dismissal of the case based on the debtor’s willful failure to abide by orders of the court, or the debtor’s request for such dismissal after the filing of a motion for relief from the stay); or
 - (b) the debtor filed the bankruptcy case in violation of an order entered in a prior case prohibiting the filing.²⁵

²¹ Given the complexity of certain of the exceptions and the implications of violating the automatic stay, in those situations in which it is believed that a stay exception exists but it is a close call, the more prudent course of action may be to formally request relief from the automatic stay, specifying the exception that is believed to exist but noting that the motion has been filed out of an abundance of caution.

²² See 11 U.S.C. § 362(b)(10). Note, however, that this provision presumes that the term of the lease has not been shortened by virtue of an ipso facto clause in the lease. Ipso facto clauses are generally unenforceable. See *id.* § 365(e)(1).

²³ See *id.* § 362(b)(20).

²⁴ “Family farmer” is a defined term within the Code. See *id.* § 101(18).

²⁵ See *id.* § 362(b)(21).

- ◆ Eviction Judgment Exception. Pursuant to one set of amendments under BAPCPA, if an *individual* debtor is a lessee of *residential* real property under a lease or rental agreement (and resides at the property), then the debtor must now indicate on his/her bankruptcy petition whether a judgment for possession of the property was obtained by the lessor prior to the bankruptcy filing.²⁶ If such a judgment was obtained, then the debtor must also (a) provide the name and address of the lessor, and (b) certify whether the debtor is claiming, under applicable non-bankruptcy law, a right to cure the entire monetary default that gave rise to the judgment (hereafter referred to as a “Cure Right”). If claiming a Cure Right, then the debtor must also certify whether the debtor (or an adult dependent of the debtor) has made a deposit with the clerk of the court for the rent that would be due under the lease (but for the judgment) during the 30-day period following the bankruptcy filing (hereafter referred to as the “Short-Term Deposit”).²⁷

If the debtor fails to certify that a Cure Right exists or that the Short-Term Deposit has been made, then the lessor may immediately continue any eviction, unlawful detainer action, or similar proceeding against the debtor to regain possession of the leasehold.²⁸

If the debtor certifies that a Cure Right exists and that he/she (or an adult dependent) has made the Short-Term Deposit,²⁹ on the other hand, then the lessor may not proceed with such action *for a period of 30 days*. Prior to the expiration of the 30-day period, the debtor may eliminate the stay exception by filing (and serving on the lessor) a separate certification reflecting that the debtor (or an adult dependent of the debtor) has cured the entire monetary default leading to the judgment.³⁰ If the debtor fails to do so within the 30-day period, however, then upon expiration of the 30-day period the lessor may immediately continue any eviction, unlawful detainer action, or similar proceeding against the debtor to regain possession of the leasehold.³¹

There is also a procedure for the lessor to contest the certifications made by the debtor.³²

- ◆ Endangered Property Eviction Exception. Pursuant to another set of amendments under BAPCPA, if an *individual* debtor is a lessee of *residential* real property under a lease or rental agreement (and resides at the property), and the property is endangered or an illegal controlled substance is being used on the property, then the lessor may proceed with an eviction action based upon such facts if certain steps are taken in the bankruptcy case.

Specifically, the lessor must file with the court (and serve on the debtor) a certification under penalty of perjury which states (a) that such an eviction action was initiated prior to the bankruptcy filing, or (b) that, during the 30-day period preceding the filing

²⁶ See *id.* § 362(l)(5).

²⁷ See *id.*

²⁸ See *id.* § 362(b)(22), (l)(1), (l)(4).

²⁹ Following deposit of the Short-Term Deposit, the clerk of court is directed to remit the deposit to the lessor. See *id.* § 362(l)(5)(D).

³⁰ See *id.* § 362(l)(2).

³¹ See *id.* § 362(b)(22), (l)(4).

³² See *id.* § 362(l)(3).

of the certification, the debtor has endangered the property or illegally used or allowed to be used a controlled substance on the property.³³

If the debtor does not contest the lessor's certification *within 15 days* of its filing/service, then the lessor may immediately thereafter move forward with the eviction action notwithstanding the automatic stay.³⁴

If, on the other hand, the debtor files (and serves on the lessor) an objection to the certification within the 15-day period, then the court is required to hold a hearing within 10 days after the filing/service of the objection to determine if the situation giving rise to the lessor's filing of the certification really existed and, if so, whether it has been remedied.³⁵ If the court determines that either the situation never existed, or that the situation has been remedied, then the stay exception will not apply.³⁶ If, however, the court determines that the debtor has failed to satisfactorily demonstrate that the situation did not exist or that the debtor has failed to satisfactorily demonstrate that the situation has been remedied, then the stay exception will apply immediately upon the court's ruling to allow the eviction action to proceed.³⁷

- ◆ **Repeat Filing Exception.** Pursuant to another set of amendments under BAPCPA, if a single or joint bankruptcy case is filed by or against an *individual* debtor, and a single or joint bankruptcy case of the debtor was pending *within the preceding year* but was dismissed (excluding a dismissal for failure of the debtor to meet the means test for Chapter 7 relief),³⁸ then *effective as of the 30th day* following the filing of the current case the stay will terminate to allow any act to be taken with respect to (a) a debt or property securing such debt, or (b) any lease.³⁹

However, on motion of any party in interest (including the debtor) for the stay to continue (provided the motion is filed in sufficient time to enable a hearing to be concluded before expiration of the 30-day period), the court may extend the stay as to any or all creditors, subject to any conditions or limitations that the court may impose,

³³ See *id.* § 362(b)(23).

³⁴ See *id.* § 362(m)(1),(3).

³⁵ See *id.* § 362(m)(2)(A)-(B).

³⁶ See *id.* § 362(m)(2)(C).

³⁷ See *id.* § 362(m)(2)(D).

³⁸ The Code was substantially modified by BAPCPA to impose certain limitations designed to limit the availability of Chapter 7 relief to individuals who are statutorily deemed capable of satisfying the payment obligations under a Chapter 11 or 13 plan. Among other things, Section 707(b) of the Code now provides that a Chapter 7 case may be dismissed if the debtor fails to satisfy a complicated "means test" set out in the section. See *id.* § 707(b). The "means test" is a statutorily-prescribed calculation designed to determine whether the debtor has the means to satisfy a repayment plan. See *id.* § 707(b)(2).

³⁹ See *id.* § 362(c)(3)(A). Significantly, the stay termination language also includes the phrase "with respect to the debtor." Read in its entirety, § 362(c)(3)(A) simply seems to say that the stay will terminate, with respect to the debtor, as to any actions involving a debt or property securing such debt, or involving a lease. Interestingly, however, there are already strained interpretations of § 362(c)(3)(A) emerging from the courts which focus on the "with respect to the debtor" language. At least one court, for example, has opined that such language means that the stay terminates as to actions against the debtor and actions against property of the debtor, but not as to actions against property of the estate. See *Jumpp v. Chase Home Finance, LLC (In re Jumpp)*, No. MW 06-031, 2006 WL 3802702 (B.A.P. 1st Cir. Dec. 28, 2006).

if the moving party demonstrates that the current bankruptcy filing is in good faith as to the creditors to be stayed.⁴⁰

In determining “good faith,” a case is presumed to have not been filed in good faith (subject to rebuttal by “clear and convincing” evidence to the contrary) if:

(a) the debtor had more than 1 bankruptcy case pending within the preceding 1-year period;⁴¹

(b) a prior bankruptcy case was dismissed within the preceding 1-year period after the debtor failed to (i) file or amend, without “substantial excuse,”⁴² the bankruptcy petition or other documents required by the Code or by the court, (ii) provide adequate protection as ordered by the court, or (iii) perform the terms of a plan confirmed by the court;⁴³

(c) there has not been a “substantial” change in the financial or personal affairs of the debtor since the dismissal of the most recently dismissed case, or any other reason to conclude that the current case will be concluded with a discharge (if Chapter 7) or with a confirmed plan that will be fully performed (if Chapter 11 or 13);⁴⁴ or

(d) as to a creditor that moved for relief from the automatic stay in a prior case of the debtor, the motion was still pending at the time of dismissal or the motion had been granted.⁴⁵

Notwithstanding the foregoing bases for the presumption against “good faith,” if a prior case was dismissed due to the creation of a debt repayment plan (*i.e.* a plan for repayment of the debtor’s debts outside of bankruptcy), then the presumption does not apply.⁴⁶

- ◆ **Multiple Repeat Filing Exception.** Pursuant to another set of amendments under BAPCPA, if a single or joint bankruptcy case is filed by or against an *individual* debtor, and if 2 or more single or joint cases of the debtor were pending *within the preceding year* but were dismissed (excluding a dismissal for failure of the debtor to meet the means test for Chapter 7 relief),⁴⁷ then the automatic stay will not apply in the current case.⁴⁸

However, on motion of any party in interest (including the debtor), filed within 30 days of the current bankruptcy filing, the court may (but is not required to) order the stay to take effect as to any or all creditors, subject to any conditions or limitations that

⁴⁰ See *id.* § 362(c)(3)(B).

⁴¹ See *id.* § 362(c)(3)(C)(i)(I).

⁴² In this regard, “mere inadvertence or negligence shall not be a substantial excuse unless the dismissal was caused by the negligence of the debtor’s attorney.” *Id.* § 362(c)(3)(C)(i)(II)(aa).

⁴³ See *id.* § 362(c)(3)(C)(i)(II).

⁴⁴ See *id.* § 362(c)(3)(C)(i)(III).

⁴⁵ See *id.* § 362(c)(3)(C)(ii). Note that this particular presumption is only applicable to the creditor that moved for relief from the stay in the prior case; it does not apply generally in relation to all creditors.

⁴⁶ See *id.* § 362(i).

⁴⁷ See footnote 37, *supra*.

⁴⁸ See 11 U.S.C. § 362(c)(4)(A).

the court may impose, only if the moving party demonstrates that the current bankruptcy filing is in good faith as to the creditors to be stayed.⁴⁹ If so ordered, the stay is effective as of the date of entry of the order (*i.e.* it is not retroactive and therefore does not invalidate any actions taken prior to entry of the order).⁵⁰

In determining “good faith,” a case is presumed to have not been filed in good faith (subject to rebuttal by “clear and convincing” evidence to the contrary) if:

(a) the debtor had 2 or more bankruptcy case pending within the preceding 1-year period;⁵¹

(b) a prior bankruptcy case was dismissed within the preceding 1-year period after the debtor failed to (i) file or amend, without “substantial excuse,”⁵² the bankruptcy petition or other documents required by the Code or by the court, (ii) provide adequate protection as ordered by the court, or (iii) perform the terms of a plan confirmed by the court;⁵³

(c) there has not been a “substantial” change in the financial or personal affairs of the debtor since the dismissal of the most recently dismissed case, or any other reason to conclude that the current case will be concluded with a discharge (if Chapter 7) or with a confirmed plan that will be fully performed (if Chapter 11 or 13);⁵⁴ or

(d) as to a creditor that moved for relief from the automatic stay in a prior case of the debtor, the motion was still pending at the time of dismissal or the motion had been granted.⁵⁵

- ◆ **Small Business Case Exception.** Another set of amendments under BAPCPA relates to small business cases.⁵⁶ In particular, the automatic stay does not apply if:

(a) the debtor was already a debtor in a small business case pending at the time of the bankruptcy filing;⁵⁷

⁴⁹ See *id.* § 362(c)(4)(B).

⁵⁰ See *id.* § 362(c)(4)(C).

⁵¹ See *id.* § 362(c)(4)(D)(i)(I).

⁵² In this regard, “mere inadvertence or negligence shall not be a substantial excuse unless the dismissal was caused by the negligence of the debtor’s attorney.” *Id.* § 362(c)(4)(D)(i)(II).

⁵³ See *id.*

⁵⁴ See *id.* § 362(c)(4)(D)(i)(III).

⁵⁵ See *id.* § 362(c)(4)(D)(ii). Note that this particular presumption is only applicable to the creditor that moved for relief from the stay in the prior case; it does not apply generally in relation to all creditors.

⁵⁶ A “small business debtor” is a person (individual/entity) engaged in commercial or business activities (including any affiliate of such person that is also a debtor in a bankruptcy case, but excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the bankruptcy filing in an amount not more than \$2 million (excluding debts owed to affiliates or insiders) for a case in which an official committee of unsecured creditors has not been appointed or the court has determined that such committee is not sufficiently active and representative to provide effective oversight of the debtor, but does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$2 million (excluding debts owed to affiliates or insiders). *Id.* § 101(51D).

⁵⁷ See *id.* § 362(n)(1)(A).

(b) the debtor was a debtor in a small business case that was dismissed for any reason by an order that became final *within 2 years* of the date of the order for relief⁵⁸ in the current case;

(c) the debtor was a debtor in a small business case in which a plan was confirmed *within 2 years* of the date of the order for relief in the current case; or

(d) the debtor is an entity that acquired substantially all of the assets or business of a small business debtor described in (a),(b) or (c) above, unless the entity establishes by a preponderance of the evidence that it acquired substantially all of the assets or business of such small business debtor in good faith and not for the purpose of evading the exceptions of (a),(b) or (c) above.

However, the automatic stay will apply (and is not subject to the foregoing exceptions), if:

(a) the current case was commenced by the filing of an involuntary bankruptcy petition involving no collusion by the debtor with creditors;⁵⁹
or

(b) the debtor proves by a preponderance of the evidence that (i) the current filing resulted from circumstances beyond the debtor's control which were not foreseeable at the time the case then pending was filed, and (ii) it is more likely than not that the court will confirm a feasible plan (other than a liquidating plan) within a reasonable period of time.⁶⁰

If none of the foregoing exceptions apply, then an order for relief from the stay must be obtained from the Bankruptcy Court. To obtain such an order, the party seeking such relief must file and serve a motion. The Code provides four possible grounds:

- ◆ For Cause, Including Lack of Adequate Protection. First, the stay may be lifted “for cause.”⁶¹ “Cause” is purposefully not defined by the Code so as to provide the court with wide latitude in assessing the particular circumstances at issue. Nevertheless, the Code does specify at least one such basis for cause – that being “lack of adequate protection.” In the context of real property interests, a party's interest in property is generally not adequately protected if the value of such interest is being adversely impacted without any substitution of value to protect against, or compensate the party for, the loss in such value.⁶²

⁵⁸ The filing of a voluntary bankruptcy case is deemed to constitute an “order for relief” under the Code. *See id.* § 301(b). If an involuntary bankruptcy case is filed against a debtor, then the “order for relief” will be the date on which the bankruptcy court enters an order determining that the bankruptcy case has been properly filed. *See id.* §§ 102(6), 303.

⁵⁹ *See id.* § 362(n)(2)(A).

⁶⁰ *See id.* § 362(n)(2)(B).

⁶¹ *See* 11 U.S.C. § 362(d)(1).

⁶² *Security Leasing Partners L.P. v. Proalert LLC (In re Proalert LLC)*, 314 B.R. 436, 441 (B.A.P. 9th Cir. 2004) (“[t]he secured creditor has an entitlement to the value of its lien. Adequate protection protects that entitlement”); *see also* 11 U.S.C. § 361 (providing statutory examples of how “adequate protection” may be provided).

- ◆ No Equity and Not Necessary. Second, the stay may be lifted in relation to property of the estate where it is established that (a) the estate has no equity in the property, and (b) the property is not necessary to an effective reorganization.⁶³ The first prong of the test is necessarily valuation driven and, therefore, highly fact intensive. With respect to the second prong, if the case is proceeding under Chapter 7, then there is obviously no reorganization taking place and the prong is satisfied. If, however, the case is proceeding under Chapter 11, 12 or 13, then the court will need to determine the necessity of the property to an “effective” reorganization.
- ◆ Single Asset Real Estate Cases. Third, in a single asset real estate case,⁶⁴ a creditor whose claim is secured by an interest in the real estate may obtain relief from the stay in relation to the real estate unless, by no later than the later of **90 days of the order for relief** (or such longer period as the court may order for cause within the 90-day period) **or 30 days after the court determines that the case qualifies as a single real estate case**, the debtor has (a) filed a reorganization plan that has a reasonable possibility of being confirmed within a reasonable time, or (b) commenced making monthly payments to the creditor in an amount equal to interest at the then applicable non-default contract rate of interest on the value of the creditor’s interest in the real estate.⁶⁵
- ◆ Fraudulent/Bad Faith Filings. Finally, a creditor whose claim is secured by an interest in the real estate may obtain relief from the stay in relation to the real estate if the creditor establishes that the filing of the bankruptcy case was part of a scheme to delay, hinder, and defraud creditors that involved either (a) transfer of all or part ownership of, or other interest in, such real property without the consent of the creditor or court approval, or (b) multiple bankruptcy filings affecting the real property.⁶⁶

7 – **Ipsa Facto Lease Termination/Expiration Clauses Are Unenforceable**

Pursuant to the Code, *ipso facto* lease termination or expiration clauses are generally unenforceable against the debtor or property of the estate. To put this protection in context, it is first important to understand how the Code treats the rights of parties to a terminated or expired lease.

First, as noted above, one of the exceptions to the automatic stay is the retaking of possession of nonresidential real property leased to the debtor after the lease has terminated by the expiration of its stated term.⁶⁷ Here, the Code simply recognizes that because the debtor/estate no longer holds any legal interest in the property following the end of the lease

⁶³ See 11 U.S.C. § 362(d)(2).

⁶⁴ See *id.* § 101(51B) (defining “single asset real estate” 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 (other than a family farmer) and on which no substantial business is being conducted by the debtor other than the business of operating the real property and activities incidental thereto).

⁶⁵ See *id.* § 362(d)(3).

⁶⁶ See *id.* § 362(d)(4). Section 362(d)(4) also provides that an order for relief from the stay on such basis may be recorded as part of the real property records for the property to ensure that any subsequent transferees of the property are on notice of debtor’s prior fraudulent conduct and the implications of the order. See *id.*

⁶⁷ See *id.* § 362(b)(10); see also *In re Moore*, 290 B.R. 851 (Bankr. N.D. Ala. 2003).

term, there is no entitlement to the stay's protection after such point in time.⁶⁸ There are, however, two important distinctions to make here: (a) the exception only applies to leases of *nonresidential* real property; and (b) the exception, literally construed, only applies to leases that have terminated by virtue of the expiration of their stated term (as opposed to being terminated by a default, for example).⁶⁹

Second, Section 365 of the Code, which grants the trustee the right to assume and assign unexpired leases under certain circumstances, provides that a trustee may not assume or assign a lease of *nonresidential* real property that terminated under applicable nonbankruptcy law prior to the filing.⁷⁰ In order for this prohibition to apply, however, all of the preconditions to termination must have occurred prior to the filing.⁷¹ (See also discussion below regarding assumption and rejection of unexpired leases).

With these provisions in mind, a creative real estate practitioner might naturally consider including a clause in his/her client's lease providing for an automatic reduction of the stated lease term and/or for termination of the lease upon the lessee's bankruptcy filing, the lessee's insolvency, and/or the appointment of a trustee in the lessee's bankruptcy case. In short, the Code renders such clauses unenforceable in bankruptcy. Specifically, Section 365 of the Code provides that "[n]otwithstanding a provision in an ... unexpired lease, or in applicable law, an ... unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such ... lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such ... lease that is conditioned on – (A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a [bankruptcy] case []; or (C) the appointment of or taking of possession by a trustee in a [bankruptcy] case...."⁷²

6 – There Are Now More Definite Time Limits For The Assumption Of Unexpired Commercial Real Estate Leases

Section 365 of the Code sets out provisions relating to "executory" contracts and unexpired leases. An "executory contract" is a contract under which each of the parties continues to have material unfulfilled obligations, such that the failure of one of the parties to perform will excuse the other party's obligation to perform.⁷³ While Section 365 separately

⁶⁸ See 11 U.S.C. § 541(b)(2) (recognizing that property of the estate (a) does not include "any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease before the commencement of the [bankruptcy] case" and "ceases to include any interest of the debtor as a lessee under a lease of nonresidential real property that has terminated at the expiration of the stated term of such lease during the case"); see also *id.* § 362(c)(1) ("the stay of an act against property of the estate ... continues until such property is no longer property of the estate").

⁶⁹ But see *In re Southcoast Express, Inc.*, 337 B.R. 739, 742-43 (Bankr. D. Mass. 2006) (construing exception to be broad enough to include terminations caused by acceleration under express terms of lease).

⁷⁰ See 11 U.S.C. § 365(c)(3).

⁷¹ See, e.g., *Hart Environmental Mngt. Corp. v. Sanshoe Worldwide Corp. (In re Sandhoe Worldwide Corp.)*, 993 F.2d 300, 304-05 (2nd Cir. 1993) (explaining that termination is not effectuated under New York law by providing notice of eviction alone); *Vanderpark Props., Inc. v. Buchbinder (In re Windmill Farms, Inc.)*, 841 F.2d 1467 (9th Cir. 1988) (analysis of applicability of § 365(c)(3) requires consideration of whether forfeiture could be avoided under applicable state law).

⁷² 11 U.S.C. § 365(e)(1).

⁷³ See *In re Smith*, 269 B.R. 629, 631 (Bankr. E.D. Tex. 2001).

refers to unexpired leases, unexpired leases are simply a type of executory contract.⁷⁴ Pursuant to Section 365, the trustee has the option of “assuming” or “rejecting” unexpired lease.⁷⁵

Rejection embraces the economic concept of “efficient breach,” in that it provides an opportunity for the trustee to get the estate out of a burdensome lease and convert outstanding defaults and post-petition, unperformed obligations into a pre-petition damages claim subject to satisfaction through the bankruptcy process (*i.e.* often for cents on the dollar).⁷⁶ The resulting damages claim, if asserted, is also subject to a maximum claim cap equal to (a) unpaid rent as of the bankruptcy filing (or as of the date of surrender of possession of the property, if earlier), plus (b) the rent reserved under the lease for the greater of (i) 1 year or (ii) 15% (but not to exceed 3 years) of the remaining term of the lease.⁷⁷ Assume, for example, that the debtor is the lessee under a 30-year office lease (having a remaining term of 20 years) and that the rental terms are substantially above market. Assume further that the debtor (acting as the DIP in a Chapter 11 case) is current on the existing lease, but has located a comparable office lease on terms that are significantly more favorable. Depending upon the cost differential between the two leases, the debtor (exercising its rights as the DIP) may determine that its best option is to reject the existing lease and enter into the lease for the new location, noting that the existing lessor’s rejection damages claim will be limited to the rent reserved under the lease for 3 years (*i.e.* 15% x 20 years = 3 years) and may even be limited further based on the lessor’s obligation to mitigate its damages.

Assumption, on the other hand, is the equivalent of reaffirmation. However, there are certain requirements that must be met before the bankruptcy court will authorize the trustee’s assumption of an unexpired lease. Specifically, the trustee must: (a) cure all defaults under the lease (or provide adequate assurance of prompt cure); (b) compensate the lessor for pecuniary losses resulting from defaults under the lease (or provide adequate assurance of prompt compensation); and (c) provide adequate assurance of future performance under the lease.⁷⁸ This can be a costly, and sometimes impractical, option for the trustee (or debtor exercising its rights as the DIP) depending upon the outstanding defaults, the extent and magnitude of future lease obligations, the size of the estate and the debtor’s financial wherewithal. Consequently, trustees are often reluctant to make a prompt decision regarding assumption/rejection. While the trustee is required to make payments under a **nonresidential** real property lease until the assumption/rejection decision is made,⁷⁹ the delay can be detrimental to the lessor who is eager to find a new tenant or simply take back the property.⁸⁰

⁷⁴ See *Kent’s Run Partnership, Ltd. v. Glosser*, 323 B.R. 408, 424 (W.D. Pa. 2005), *aff’d sub nom. Glosser v. Marysville Regional Water Dist.*, 174 Fed. Appx. 34 (3rd Cir. 2006).

⁷⁵ See *id.* § 365(a).

⁷⁶ See *id.* § 365(g)(1) (damage claim treated as arising pre-petition); see *Miller v. Chateau Communities, Inc. (In re Miller)*, 282 F.3d 874, 877 (6th Cir. 2002).

⁷⁷ See 11 U.S.C. § 502(b)(6).

⁷⁸ See *id.* § 365(b)(1).

⁷⁹ See *id.* § 365(d)(3).

⁸⁰ Moreover, the obligation to perform only relates to post-petition obligations. Most courts hold that a trustee/DIP is not required to timely pay rent that came due prior to the bankruptcy filing, even where the rent is for post-petition possession of the leasehold premises. See, e.g., *In re Appletree Markets Inc.*, 139 B.R. 417 (Bankr. S.D. Tex. 1992) (rent came due pre-petition; therefore, 365(d)(3) not applicable). Some courts have nevertheless allowed a lessor an administrative claim for the value of the lessor’s post-petition possession and use of the premises. See, e.g., *In re Garden Ridge Corp.*, 323 B.R. 136, 140-43 (Bankr. D. Del. 2005).

Prior to enactment of the BAPCPA amendments, the deadline for the trustee to assume an unexpired lease of *nonresidential* real property was 60 days.⁸¹ In the absence of the lease's assumption by such deadline, it was automatically deemed rejected whereupon the trustee was required to immediately surrender the property to the lessor.⁸² However, Section 365 further provided that the 60-day period could be extended for cause shown.⁸³ Significantly, it did not establish a limit on the length of the extension available, or the number of extensions that could be sought. Thus, in many cases filed prior to the BAPCPA, particularly larger, more complex cases, courts would grant multiple extensions pushing out the deadline for months, if not years. Moreover, some courts had ruled that notwithstanding Section 365's mandate that post-petition obligations be timely performed pending assumption or rejection, claims for unpaid amounts coming due post-petition were subject to analysis as to whether and to what extent they should be entitled to administrative priority, as opposed to general unsecured priority, if the lease was ultimately rejected.⁸⁴

Recognizing the potential for abuse, Congress amended Section 365 in several respects as part of the BAPCPA. First, in an effort to be more realistic on timing, Congress modified the section to extend the initial time limit for assumption/rejection to 120 days from the bankruptcy filing.⁸⁵ Second, to avoid unending extensions, it modified the section to allow for a 90-day extension of the period for cause, but eliminated the possibility of any further extensions in the absence of prior written consent of the lessor.⁸⁶ Hence, the amendments place lessors in a much stronger bargaining position in relation to extensions sought beyond 210 days from the filing.

5 – Cure Requirements For The Assumption Of Unexpired Leases Have Been Clarified

As indicated above, in order for a trustee to assume an unexpired lease, the trustee must cure all outstanding defaults. Certain types of defaults, however, may appear to be incurable by their nature. Assume, for example, that the lease contains the following 2 requirements: (a) the lessee must maintain continuous operations on the leasehold during the entire term of the lease (Term A); and (b) the lessee must update the landscaping at the leasehold location (Term B). Assume further that (a) shortly before the bankruptcy filing, the lessee shut down its operations at the location (Term A default); and (b) the debtor failed to update the landscaping (Term B default). Can the trustee cure these defaults? As to the landscaping, yes, but absent time travel, there is no way for the trustee to cure the continuous operations provision, even if the trustee is prepared to resume operations on the leasehold. So, is the trustee precluded from assuming the lease because of the inability to cure both of the defaults?

⁸¹ See 11 U.S.C. § 365(d)(4) (1984).

⁸² *Id.*

⁸³ *Id.*

⁸⁴ See, e.g., *In re Mr. Gatti's, Inc.*, 164 B.R. 929, 937 (Bankr. W.D. Tex. 1994) (finding that it would be unfair to accord the claim priority where the landlord simply sat by idly as rent continued to accrue post-petition which was not paid); *In re Joseph C. Spiess Co.*, 145 B.R. 597, 603 (Bankr. N.D. Ill. 1992) ("It is difficult to fathom why Congress would have intended an unwarranted windfall, like payment of rental expenses as an administrative expense when the debtor had abandoned use of same"); *In re Tammey Jewels*, 116 B.R. 292, 294 (Bankr. M.D. Fla. 1990).

⁸⁵ See 11 U.S.C. § 365(d)(4)(A) (2005).

⁸⁶ See *id.* § 365(d)(4)(B).

Prior to the BAPCPA, Section 365 included the following provision: “Paragraph (1) of [Section 365(b)] [requiring the cure of outstanding defaults] does not apply to a default that is a breach of a provision relating to ... (D) the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the ... unexpired lease.”⁸⁷ Applying this provision to our hypothetical above, clearly the Term A and Term B defaults relate to nonmonetary obligations. But the answer to whether the cure exception applies to both of the defaults depends upon how the modifiers in the provision are applied. Specifically, the provision is susceptible to the following two interpretations:

Option 1. Cure is not required as to any provision relating to “the satisfaction of **any ... provision** relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the ... unexpired lease;” or

Option 2. Cure is not required as to any provision relating to “the satisfaction of **any penalty ... provision** relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the ... unexpired lease.”

Application of Option 1 would suggest that the trustee is not required to cure either of the Term A or Term B defaults in our hypothetical. Application of Option 2, on the other hand, would suggest that the cure exception is inapplicable to both of the defaults (making assumption impossible by virtue of the Term A default). Prior to the BAPCPA, courts were split in their interpretation of the provision.⁸⁸

As part of the BAPCPA, Congress sought to resolve the dispute in two ways. First, it adopted the Option 2 reading of the cure exception by inserting the word “penalty” before “provision” in the exception.⁸⁹ To avoid the impossibility scenario, however, it substantially modified the underlying cure provision to now preclude assumption unless the trustee:

Cures, or provides adequate assurance that the trustee will promptly cure, such default *other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under [the] unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of [Section 365 requiring compensation for pecuniary losses resulting from defaults].*⁹⁰

⁸⁷ See 11 U.S.C. § 365(b)(2)(D) (1994).

⁸⁸ Compare, e.g., *Eagle Ins. Co. v. Bankvest Capital Corp. (In re Bankvest Capital Corp.)*, 360 F.3d 291 (1st Cir.) (applying Option 1 interpretation), cert. denied, 542 U.S. 919 (2004), with *Worthington v. General Motors Corp. (In re Claremont Acquisition Corp.)*, 113 F.3d 1029 (9th Cir. 1997) (applying Option 2 interpretation).

⁸⁹ See 11 U.S.C. § 365(b)(2)(D) (2005).

⁹⁰ See *id.* § 365(b)(1)(A) (added language italicized).

4 – Lessors Should Carefully Structure Third-Party Financial Accommodations and Carefully Consider Their Options Upon Lease Rejection if Lease Obligations Are Secured By A Letter of Credit

As indicated above, a lessor's damage claim resulting from a trustee's rejection of the lessor's lease is subject to an allowance cap under Section 502 of the Code equal to (a) unpaid rent as of the bankruptcy filing (or as of the date of surrender of possession of the property, if earlier), plus (b) the rent reserved under the lease for the greater of (i) 1 year or (ii) 15% (but not to exceed 3 years) of the remaining term of the lease.⁹¹ While some might question the reasoning, Congress imposed the cap to ensure that other general unsecured creditors are not deprived of a dividend in the case by virtue of large landlord claims.⁹² But how do third-party financial accommodations affect the cap? For example, what happens to a guaranty obtained from the debtor's president, or a letter of credit obtained from the debtor's bank?

For the most part, the Code preserves the rights of creditors against non-debtor third parties. Landlords that have obtained guarantees, for example, retain their rights against the guarantors and, absent a supplemental stay order or injunction, may pursue recovery from the guarantors notwithstanding the bankruptcy of the accommodated debtor.⁹³ Provided the guaranty is structured properly – *i.e.* guaranteeing performance of the terms of the lease as opposed to guaranteeing payment of amounts that the debtor may owe – the rejection damage cap will not impact the amount recoverable from the guarantor.⁹⁴

When it comes to letters of credit, however, while a lessor is still generally free to pursue recovery of amounts owing by the debtor to the lessor through the presentment of draw requests on the letter of credit,⁹⁵ letters of credit are fundamentally different from guarantees. While a guaranty may effectively make the guarantor a co-obligor in relation to the performance obligations under the lease itself, a letter of credit does not do so. Instead, a letter of credit is an independent agreement to pay a sum certain to the beneficiary in the event certain conditions precedent to the payment have occurred. In most cases, the payment obligation is, in turn, limited to the amount owed by the letter of credit applicant (*e.g.*, the debtor) to the beneficiary (*e.g.*, the lessor) under the terms of an underlying agreement (*e.g.*, the lease).⁹⁶ Thus, the rejection damage cap may, in fact, come into play in limiting a lessor's ability to recover the amount of its claim in excess of the cap from proceeds of the letter of credit.⁹⁷

⁹¹ See 11 U.S.C. § 502(b)(6).

⁹² S. Rep. No. 95-989, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5849; H.R. Rep. No. 95-595, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6309 (purpose of allowing rejection damage claim, but subject to a cap, is “to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend of the estate”).

⁹³ See *In re Moore*, 318 B.R. 679, 682 (Bankr. W.D. Wis. 2004) (“Bankruptcy does not affect third-party guarantees of a debtor's obligations. ‘The automatic stay does not apply to guarantors, sureties, insurers, partners, and other persons liable on the debt’”) (*quoting United States v. Wright*, 57 F.3d 561, 562 (7th Cir. 1995)).

⁹⁴ See, *e.g.*, *Redback Networks Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295, 300 (B.A.P. 9th Cir. 2004) (“the liability of a guarantor that is not in bankruptcy is not limited by section § 502(b)(6)”).

⁹⁵ See *Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.)*, 831 F.2d 586, 589 (5th Cir. 1987).

⁹⁶ See Tex. Bus. & Com. Code § 5.101 cmt (“A letter of credit is an idiosyncratic form of undertaking that supports performance of an obligation incurred in a separate financial, mercantile, or other transaction or arrangement”).

⁹⁷ See, *e.g.*, *Solow v. PPI Enters., Inc. (In re PPI Enters., Inc.)*, 324 F.3d 197 (3rd Cir. 2003) (because lessor's claim against debtor disallowed to the extent in excess of the rejection damage cap, lessor's recovery from letter of credit

Recently, however, the Fifth Circuit exposed a loophole for lessors in *EOP-Colonnade of Dallas Ltd. Partnership v. Faulkner (In re Stonebridge Technolgoies, Inc.)*.⁹⁸ In *Stonebridge*, the lessor obtained, among other things, an irrevocable letter of credit to secure the payment of amounts owing by the debtor under the lease. Following the debtor's Chapter 11 bankruptcy filing, the lessor and debtor submitted an agreed order for the debtor's rejection of the lease. Because the rejection constituted a breach of the lease under Section 365 of the Code,⁹⁹ the lessor obtained a claim for damages caused by the breach. Instead of filing a claim in the bankruptcy case to assert the rejection damage claim, however, the lessor submitted a draw request to the letter of credit issuer to recover the damages, ultimately receiving proceeds in excess of the amount that would be calculated under the rejection damage cap of Section 502 of the Code. Following confirmation of the plan in the case, and based upon the rejection claim cap, the plan trustee filed suit against the lessor to recover the difference between the amount of the proceeds received by the lessor under the letter of credit and the amount of the rejection damage cap. The Bankruptcy Court agreed with the trustee, awarding the difference, and the District Court affirmed. On further appeal, however, the Fifth Circuit reversed.

The Fifth Circuit focused on the significance of the claims allowance process in bankruptcy. It explained, for example, that while the rejection of a lease constitutes a breach of the lease, the Code does not automatically recognize a claim in favor of the lessor for the damages caused by the breach. Instead, the lessor must file a claim for such damages in order for the claim to be included in the bankruptcy case for distribution purposes.¹⁰⁰ Where such a claim is filed, the claim is deemed allowed unless and until an objection to its allowance is lodged under Section 502(b) of the Code.¹⁰¹ Pursuant to Section 502(b)(6), a lease rejection damage claim must be disallowed to the extent that it exceeds the rejection damage cap.¹⁰² However the allowance/disallowance process, itself, is the event leading to a limitation of the debtor's liability to the lessor. Hence, according to the Fifth Circuit, such liability is not limited automatically. Based upon such analysis, the Fifth Circuit concluded that "the damages cap of § 502(b)(6) does not apply to limit the beneficiary's entitlement to the proceeds of the letter of credit unless and until the lessor makes a claim against the estate."¹⁰³

proceeds likewise limited); *Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.)*, 306 B.R. 295 (B.A.P. 9th Cir. 2004) (same).

⁹⁸ 430 F.3d 260 (5th Cir. 2005) [referred to herein as "*Stonebridge*"].

⁹⁹ See 11 U.S.C. § 365(g).

¹⁰⁰ See *Stonebridge*, 430 F.3d at 269; see also *Century Indem. Co. v. National Gypsum Co. Settlement Trust (In re National Gypsum Co.)*, 208 F.3d 498, 505 (5th Cir.) ("opportunity" to file a lease rejection claim arises after lease is rejected), *cert. denied*, 531 U.S. 871 (2000); *Eastover Bank for Savings v. Sowashee Venture (In re Austin Dev. Co.)*, 19 F.3d 1077, 1084 (5th Cir.) (rejection of lease simply entitles lessor to then file a proof of claim), *cert. denied sub nom. Sowashee Venture v. EB, Inc.*, 513 U.S. 874 (1994).

¹⁰¹ See 11 U.S.C. § 502(a).

¹⁰² *Id.* § 502(b)(6).

¹⁰³ *Stonebridge*, 430 F.3d at 270 (emphasis added); see also *id.* at 269 ("By its terms, § 502(b) applies only to claims against the bankruptcy estate"); *In re SKA! Design, Inc.*, 308 B.R. 777, 781 (Bankr. N.D. Tex. 2004) ("Section 502 deals only with allowance by a landlord of a claim, *if presented*, against the bankruptcy estate") (quoting *In re Mr. Gatti's, Inc.*, 162 B.R. 1004 (Bankr. W.D. Tex. 1994) (emphasis added)).

Thus, applying the holding of *Stonebridge*, a lessor who holds security in the form of a letter of credit should carefully analyze whether or not to file a claim in the bankruptcy case following the rejection of its lease. In particular, if (a) the damages caused by the rejection are in excess of the rejection damage cap, and (b) the amount of availability under the letter of credit is greater than the rejection damage cap, then the lessor should not file a rejection damages claim in the case because all the lessor will be accomplishing is limiting its recovery.

3 – Unperfected Interests In Real Property, and Untimely Perfected Interests in Real Property, May Be Subject To Avoidance

Critical to every real estate closing or financing is the timely filing of each of the documents necessary to perfect the interest transferred – whether it be a deed, deed of trust, financing statement, or otherwise. The failure to timely file such instruments can lead to disastrous results in a bankruptcy under at least three possible different scenarios.

Avoidance of Unperfected Interests. First, assume the requisite instrument for perfection was not filed by the time of the bankruptcy. In this situation, the transfer may be subject to avoidance under Section 544 of the Code, commonly referred to as the “strong-arm” provision. Pursuant to Section 544, the trustee has the rights and powers of (or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by) the following types of parties (whether or not such a party exists in the case):

- (a) a judicial lien creditor having a lien on all property on which a creditor to a simple contract could obtain a judicial lien;¹⁰⁴
- (b) a creditor who has obtained execution against the debtor that is returned unsatisfied;¹⁰⁵ and
- (c) a bona fide purchaser of real property (other than fixtures) from the debtor, against whom applicable law permits such transfer to be perfected, who has perfected the transfer of the real property.¹⁰⁶

Significantly, such rights and powers exist irrespective of whether the trustee or any creditors of the debtor had actual knowledge of the unrecorded instrument.¹⁰⁷ Using the strong-arm powers, trustee (or DIPs exercising the rights of a trustee) have avoided the following types of transfers:

- ◆ Fee interests under unrecorded quitclaim and warranty deeds.¹⁰⁸
- ◆ Equitable liens that are not recorded in any manner.¹⁰⁹
- ◆ Mortgages and deed of trust liens that are not recorded.¹¹⁰

¹⁰⁴ See 11 U.S.C. § 544(a)(1).

¹⁰⁵ See *id.* § 544(a)(2).

¹⁰⁶ See *id.* § 544(a)(3).

¹⁰⁷ See *id.* § 544(a) (specifying that that the rights/powers exist “without regard to any knowledge of the trustee or of any creditor”).

¹⁰⁸ See, e.g., *Cox v. Griffin (In re Griffin)*, 319 B.R. 609 (B.A.P. 8th Cir. 2005), *aff’d*, 178 Fed. Appx. 595 (8th Cir. 2006); *Wahlman v. Tardif (In re Kravec)*, 310 B.R. 655 (Bankr. M.D. Fla. 2004).

¹⁰⁹ See, e.g., *Gaffney v. United States Dep’t of Transp. (In re Premier Airways, Inc.)*, 303 B.R. 295 (Bankr. W.D.N.Y. 2003).

- ◆ Assignment of rents where assignment instrument not properly recorded.¹¹¹

Avoidance of Interests Untimely Perfected Shortly Before the Bankruptcy Filing. Next, assume the requisite instrument for perfection was not filed at the time of the closing 2 years ago, but instead was filed 30 days before the bankruptcy. In this instance, Section 547 of the Code (the “preference” provision) may come into play. Section 547 provides that the trustee may avoid any transfer of an interest of the debtor in property which (a) was made within 90 days (or within 1 year if to an insider) of the bankruptcy filing, (b) was made while the debtor was insolvent, (c) was made to or for the benefit of a creditor, for or on account of an antecedent debt, and (d) enabled the creditor to receive more than what the creditor would receive on account of the debt in a Chapter 7 liquidation case if the transfer were unwound.¹¹² For purposes of Section 547, “transfer” is defined broadly and includes the creation of a lien, the retention of title as a security interest, a foreclosure, and “each mode, direct or indirect, absolute or conditional, voluntary or involuntary, disposing of property or an interest in property.”¹¹³ Using the preference avoidance powers, trustees (or DIPs exercising the rights of a trustee) have avoided the following types of transfers:

- ◆ Fee interests under untimely recorded quitclaim deeds.¹¹⁴
- ◆ Interest in tenancy in common under untimely recorded deed.¹¹⁵
- ◆ Charge against real estate pursuant to *lis pendens*.¹¹⁶
- ◆ Mortgages and deed of trust liens granted under untimely filed mortgages and deeds of trust.¹¹⁷

Avoidance of Interests Untimely Perfected After the Bankruptcy Filing. Finally, assume that the requisite instrument for perfection was not filed until after the bankruptcy filing (without court approval). Here, Section 549 of the Code is applicable. Pursuant to Section 549, a trustee may avoid a post-petition transfer of property of the estate that is not authorized by the Code or by court order (with a few exceptions).¹¹⁸

¹¹⁰ See, e.g., *Simon v. Chase Manhattan Bank (In re Zaptocky)*, 250 F.3d 1020 (6th Cir. 2001); *Hearn v. Bank of New York (In re Hearn)*, 337 B.R. 603 (Bankr. E.D. Mich. 2006); *Stubbs v. Chase Manhattan Mortgage Corp. (In re Stubbs)*, 330 B.R. 717 (Bankr. N.D. Ind. 2005), *aff'd*, 2006 WL 2361814 (N.D. Ind. 2006); *Weisbart v. Sanger Bank (In re Tilton)*, 297 B.R. 478 (Bankr. E.D. Tex. 2003).

¹¹¹ See, e.g., *In re Wheaton Oaks Office Partners Ltd. Partnership*, 27 F.3d 1234 (7th Cir. 1994).

¹¹² 11 U.S.C. § 547(b).

¹¹³ *Id.* § 101(54).

¹¹⁴ See, e.g., *Grandy v. Sanders (In re Smith)*, 336 B.R. 402 (Bankr. S.D. Ill. 2006); *Rice v. First Arkansas Valley Bank (In re May)*, 310 B.R. 405 (Bankr. E.D. Ark. 2004).

¹¹⁵ See, e.g., *Wallach v. Korniczky (In re Korniczky)*, 308 B.R. 153 (Bankr. W.D.N.Y. 2004).

¹¹⁶ See, e.g., *Rice v. First Arkansas Valley Bank (In re May)*, 310 B.R. 405 (Bankr. E.D. Ark. 2004).

¹¹⁷ See, e.g., *Superior Bank, FSB v. Boyd (In re Lewis)*, 398 F.3d 735 (6th Cir. 2005); *Anstine v. Centex Home Equity Co., LLC (In re Pepper)*, 339 B.R. 756 (B.A.P. 10th Cir. 2006).

¹¹⁸ 11 U.S.C. § 549(a). See, e.g., *Grandy v. Sanders (In re Smith)*, 336 B.R. 402 (Bankr. S.D. Ill. 2006) (transfer of property effectuated by recordation of quitclaim deed after bankruptcy case filed avoidable by trustee).

2 – The Bar Date Is Not An Invitation To A Happy Hour

Essential to the bankruptcy process is the determination of all pre-petition unsecured claims against the debtor. For this reason, Bankruptcy Rule 3002 provides, with a few exceptions, that “[a]n unsecured creditor ... must file a proof of claim ... for the claim ... to be allowed.”¹¹⁹ One of the key exceptions relates to Chapter 11 cases. In a Chapter 11 case, if the debtor lists the claim on its schedules and does not (a) identify it as unliquidated in amount, contingent or disputed, or (b) identify it with an incorrect priority, then the creditor is not required to file a proof of claim.¹²⁰ Of course, the more prudent course of action to take is to file a proof of claim anyway to avoid any questions down the road. Proof of claim forms are typically mailed to those creditors/potential creditors identified by the debtor in its mailing matrix filed with the Court. Most courts also have proof of claim forms available for download from their websites.¹²¹

Notably absent from Bankruptcy Rule 3002 is the requirement to file a proof of claim for a secured claim. Without going into the intricacies of property and constitutional law, the boiled down explanation is that because a lien against or security interest in property constitutes an interest in the property, such an interest is not eliminated solely because of the secured party’s failure to timely file a proof of claim.¹²² Nevertheless, the exception is limited to the *in rem* nature of the interest as opposed to the *in personam* nature of the underlying claim. As to the claim, itself, the *in personam* liability of the debtor remains susceptible to discharge through the bankruptcy process. Hence, a secured creditor’s failure to timely file a proof of claim will, in most cases, limit the creditor’s recourse to collection of the claim from any sales proceeds subsequently realized from a sale of the property (whenever that might occur) – not a particularly enviable outcome. To add a few more layers of complication, in a Chapter 11 context, Congress has expressly recognized any property dealt with in the plan will be free and clear of all claims and interests upon confirmation of the plan (except as otherwise provided in the plan or the court’s confirmation order).¹²³ And if there is any chance of a deficiency as a result of the value of the collateral, the deficiency (an unsecured claim) will be eliminated in the absence of a proof of claim to assert such deficiency.¹²⁴ Therefore, it is always advisable for secured creditors to timely file proofs of claim in the case unless there is certainty of collection from other sources.

¹¹⁹ Fed. R. Bankr. P. 3002(a) (emphasis added).

¹²⁰ See 11 U.S.C. § 1111(a); Fed. R. Bankr. P. 3003(b)(1).

¹²¹ For the Bankruptcy Court for the Northern District of Texas, for example, such forms may be accessed by going to www.txnb.uscourts.gov/forms/.

¹²² See *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992); *Stonebridge*, 430 F.3d at 269 n.6 (“[t]he filing of a proof of claim serves no purpose if the creditor is secured”); see also 11 U.S.C. § 506(d)(2).

¹²³ See 11 U.S.C. § 1141(c). But see *FDIC v. Union Entities (In re Be-Mac Transport Co.)*, 83 F.3d 1020, 1024-27 (8th Cir. 1996) (explaining that if secured creditor does not participate in the bankruptcy, then its lien is not “dealt with” through the plan) and *In re Simmons*, 765 F.2d 547 (5th Cir. 1985) (distinguishing lien from “claims and interests” for purposes of § 1141(c)).

¹²⁴ See, e.g., 11 U.S.C. § 506(a) (providing for bifurcation of claims secured by property of the estate into secured and unsecured claims based upon the value of the property).

The deadline for filing proofs of claim is commonly referred to as the “bar date.” In Chapter 7, 12 and 13 cases, the deadline is 90 days from the first date set for the 341 meeting.¹²⁵ In a Chapter 11 case, the deadline is established by the court.¹²⁶ By docket entry and/or local rule, certain courts have ordered that the same 90-day deadline will apply in Chapter 11 cases unless changed by separate order.¹²⁷ The 341 notice sent to those creditors/potential creditors listed on the debtor’s mailing matrix will specify the deadline. The failure to timely file a proof of claim can have disastrous effects for at least three reasons. First, distributions from the bankruptcy case will only be made on account of allowed claims timely evidenced in the bankruptcy case. Second, claims that are filed after the bar date has passed are subject to disallowance.¹²⁸ Finally, the debtor will normally obtain a discharge from all pre-petition claims. Therefore, failure to timely participate in the case may lead to the claim being forever barred.¹²⁹

1 – Avoid Getting In Over Your Head On Bankruptcy Issues With Which You Are Not Sufficiently Familiar

Finally, it is never advisable to feign an understanding of complex bankruptcy issues in front of a bankruptcy court. If there is ever any uncertainty about an issue, it is best to seek out assistance from an experienced bankruptcy practitioner. This will protect you from the following type of ruling that was handed down by Judge Clark from the Bankruptcy Court of the Western District of Texas in 2006:¹³⁰

The court cannot determine the substance, if any, of the Defendant’s legal argument, nor can the court even ascertain the relief that the Defendant is requesting. The Defendant’s motion is accordingly denied for being incomprehensible.¹

¹Or, in the words of the competition judge to Adam Sandler’s title character in the movie, “Billy Madison,” after Billy Madison had responded to a question with an answer that sounded superficially reasonable but lacked any substance,

Mr. Madison, what you’ve just said is one of the most insanely idiotic things I’ve ever heard. At no point in your rambling, incoherent response was there anything that could even be considered a rational thought. Everyone in this room is now dumber for having listened to it. I award you no points, and may God have mercy on your soul.

Deciphering motions like the one presented here wastes valuable chamber staff time, and invites this sort of footnote.

¹²⁵ See Fed. R. Bankr. P. 3002(c) (noting, however, certain exceptions including rejection damage claims where an executory contract or unexpired lease has been rejected, certain types of claims arising from post-petition judgments, and cases initially identified by the trustee as “no asset” cases).

¹²⁶ See Fed. R. Bankr. P. 3003(c)(3).

¹²⁷ See e.g., Bankruptcy Local Rule 3003(a) for the Bankruptcy Court of the Southern District of Texas.

¹²⁸ See 11 U.S.C. § 502(b)(9). But see also *id.* § 726(a)(3) (providing for subordinated treatment of tardily filed claims that are filed and allowed in a Chapter 7 case).

¹²⁹ See *id.* §§ 727, 1141(d)(1)(A), 1228, 1328; see also *id.* § 524(a).

¹³⁰ *Factac, Inc. v. King (In re King)*, Adversary No. 05-5171-C (Bankr. W.D. Tex. Feb. 21, 2006).