Acquisition of Distressed Loans: Bankruptcy Considerations and the 363 Sale

*By Caroline A. Harcourt and Patrick E. Fitzmaurice**

In this article, the authors explore the bankruptcy considerations that must be understood by an incoming lender that acquires a distressed commercial real estate loan where the borrower shortly thereafter files for bankruptcy protection.

There are no shortage of bankruptcy considerations that must be understood by an incoming lender that acquires a distressed commercial real estate loan where the borrower shortly thereafter files for bankruptcy protection. For the purposes of this article, we imagine a hypothetical distressed debt buyer who has acquired the loan with the goal of eventually obtaining the underlying property and who may be distressed (pun intended!) by the bankruptcy filing. While often considered an impediment to acquisition efforts, we believe that bankruptcy presents significant benefits and opportunities for the strategic loan-to-own investor.

BUT FIRST, THE BAD NEWS

Section 362(a) of the Bankruptcy Code in general terms imposes an immediate, automatic and worldwide injunction against any collection or other enforcement efforts against property of the debtor, meaning that any pending foreclosure action is stayed and no new action may be commenced pending further order of the bankruptcy court. To obtain such an order, the foreclosing lender will ask the court to lift the automatic stay and must show either (i) that cause exists, including a lack of adequate protection (more on that below) of the lender's interest in the property, or (ii) that (a) the lender is under-secured, and (b) that the debtor is highly unlikely to obtain confirmation of a plan within a reasonable time.

It gets worse. To the extent that the property is cash flowing, that cash will generally be the lender's collateral and the borrower/debtor will want to use that cash collateral to fund its bankruptcy case (in plain English to pay its lawyers and other advisors to fight against the lender). The Bankruptcy Code preserves the

*Caroline A. Harcourt, a partner in the New York office of Pillsbury Winthrop Shaw Pittman LLP, is the head of the firm's Real Estate Finance Group and also leads the New York Real Estate Group. Ms. Harcourt represents lenders, owners, investors, developers and tenants in all aspects of commercial real estate. Patrick E. Fitzmaurice, a partner in the firm's New York office, focuses his practice on representing lenders and other creditors in workouts, restructurings, litigation and bankruptcy matters. The authors may be contacted at caroline.harcourt@pillsburylaw.com and patrick.fitzmaurice@pillsburylaw.com, respectively.

lender's interest in cash collateral and provides that the debtor may not use the lender's cash collateral without either the lender's consent or a court order. But, such an order can be obtained over the lender's objection so long as the lender receives "adequate protection."

A lender obtains adequate protection for its interest in collateral where it receives:

- Cash payments equal to the diminution (if any) of the lender's interest in the collateral (Section 361(1)) during the bankruptcy case;
- Additional or replacement liens (Section 361(2)); or
- Other relief sufficient to give the lender the "indubitable equivalent" of its interest in the collateral (Section 361(3)).

The general scope of what would constitute adequate protection in a given instance is beyond the scope of this article, but it suffices to say that the court's view and the lender's view of how the lender's interest in the collateral should be protected are likely not to be the same. This is one reason—and another is discussed below—a lender should consider consenting to the use of cash collateral and negotiating adequate protection with the borrower as that may yield more protections than may be awarded by the court after the issue is litigated.

The news gets a little better when we consider the timelines applicable in bankruptcy cases. In sum, the collateral and the cash it generates should be tied up and unavailable to the lender for a relatively short period, especially when compared to those in state court foreclosure actions in judicial foreclosure states. (Of course, foreclosure timelines in deed of trust states are much shorter.) Indeed, one can compare the impact that the Bankruptcy Code's cash collateral and adequate protection provisions have on the loan-to-own lender with a real property receiver in a state court foreclosure action—in both instances cash flow will be diverted away from the lender in order to, in part, maintain the property and ensure that it does not deteriorate and also to pay professional fees (of either the borrower/debtor or the receiver). And in both instances property-related expenses will need to be disclosed and accounted for in a court-supervised process.

Where the property is determined to be a Single-Asset Real Estate (SARE), essentially a term of art under the Code, the borrower's ability to delay the foreclosing lender may be particularly short-lived because of certain special provisions of the Code.

Under the Code, a debtor's case will be determined to be a SARE case where:

- The real property constitutes a single property or project;
- The real property generates substantially all of the debtor's gross income; and
- The debtor must not be involved in any substantial business other than the operation of the real property.

A business is not a SARE if a reasonable and prudent businessperson would expect to generate substantial revenues from activities that are separate and apart from the sale or lease of the underlying real estate such as the operation of a conference center or golf course at a resort hotel.

In a SARE case, the lender is entitled to relief from the automatic stay unless, within 90 days after the bankruptcy petition is filed, or 30 days after the court's determination that the debtor is a SARE debtor (whichever is later), the debtor has filed a reorganization plan with a reasonable possibility of being confirmed within a reasonable period of time; or the debtor has commenced payments to the lender (which can be from cash collateral), equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's secured claim.[1] But, note that "for cause" the time to file the plan or commence payment can be extended.

NOW, FOR THE GOOD NEWS

A real estate debtor, like any Chapter 11 debtor, will need cash to fund the payments it will make to creditors under its bankruptcy plan and may not have the ability to do so without selling assets, chiefly the property that the lender has had its eye on. Because the Bankruptcy Code generally preserves the lender's state law right to credit bid, it may be wise for the lender to consent to the use of cash collateral, and even agree to fund the debtor's bankruptcy case, in exchange for, among other things, the debtor's agreement to sell the property within a defined period of time.

The debtor's ability to sell property outside of the ordinary course of its business, and we assume that the sale of a real estate debtor's principal asset is outside the ordinary course of business, is provided for in Section 363(b) of the Bankruptcy Code. Section 363(f) allows the debtor, or a bankruptcy trustee, to sell property "free and clear of any interest in such property."

In other words, all liens and interests that have or would otherwise attach to the property are essentially stripped away (and attach instead to the sale proceeds) giving the buyer pristine title to the property. Additionally, the bankruptcy court's sale order will include good faith and fair value findings further insulating the purchaser, and the transaction generally, from attack.

Importantly for the loan-to-own lender, its right to credit bid at the "363 sale" is preserved to the same extent as it would be under state law and the lender will generally have the right to bid up to the entire amount of its debt. The 363 sale can either be stand-alone or pursuant to a plan and many lenders (and other transferees) may prefer a sale under a plan because such sales are exempt from transfer taxes while stand-alone sales are not.

Moreover, 363 sales are final and extremely difficult to overturn. For example, Section 363(m) provides that a sale to a good faith purchaser cannot be reserved or modified on appeal unless the sale was stayed pending appeal. This is true even if the purchaser knew of the existence of the appeal at the time the sale closed. The lender/purchaser should therefore ensure that the bankruptcy court has a robust record on which to determine that it is a good faith purchaser ensuring that such a finding will not be disturbed. (This may consist, among other things, of evidence that the purchaser has not colluded or conspired with the debtor or other prospective purchasers or the debtor's representatives.)

In sum, while a borrower bankruptcy filing is not exactly good news, it can present some opportunities and benefits to a lender hoping to acquire the underlying property.

NOTES:

[1]This is not the same thing as full interest payments under the note or loan agreement. To the extent the property's value has declined and the lender's claim is "underwater" and therefore, for bankruptcy purposes, may consist of a secured and unsecured portion, the payments a SARE debtor is required to make relate only to the secured portion of the claim.