

BANKRUPTCY AND CREDITORS' RIGHTS - FAQ

As the economic downturn continues, bankruptcy filings continue to raise. Sterns & Weinroth's Bankruptcy and Creditors' Rights practice has the breadth and depth of knowledge to advise clients in this uncertain financial time. What follows below is some guidance to the most common questions that arise when faced with a bankruptcy petition or financial crisis.

1. How do I buy real estate from other developers who file bankruptcy?

First of all, it is important to understand that not all bankruptcy proceedings result in the sale of assets. Chapter 11 proceedings are generally used to reorganize a business operation and, thus, may include the restructuring of debt or the refinancing of debt, as opposed to the sale of the underlying collateral. Conversely, most believe that Chapter 7 bankruptcies all result in the sale of assets and that is also not true. Sometimes the bankrupt debtor allows the bank to foreclose on its mortgage, leaving the bank to sell the property through its REO process. However, in those instances (becoming increasingly more frequent) when the Debtor sells its property, it is done in one of two ways – public sale or private sale, both of which are governed by section 363 of the Bankruptcy Code.

In a public sale context, the Debtor retains an auctioneer and there is a public forum for bidding. The terms of the auction are set out in advance and strict compliance is required. The key to participating is becoming known to the auctioneer and/or the Debtor and its counsel to be certain that you receive the “auction package” and to get the necessary professional advice to be able to comply with the terms of the auction. Then, go and bid.

The trickier scenario is in the case of a “private sale”. In that case, either with or without a real estate broker, the Debtor solicits bids for its real estate. Frequently the first bidder is given the label “stalking horse” because, as is also the case in auctions, no party wants to make the first offer and thereby set the “floor” for bidding. In some situations a Debtor will agree to reimburse the stalking horse for the costs associated with doing the necessary due diligence and negotiating the sale contract.

With only limited exceptions, bankruptcy sales are “as is where is”, so the time commitment and costs associated with due diligence may be significant and a right of reimbursement valuable. Once the sale is fully negotiated and contracts signed, the Debtor will seek court approval. All private sales in bankruptcy are subject to higher and better offers. Until the Order is entered, any person may submit a “competing bid” as long as the terms are better than the terms submitted by the stalking horse. Sometimes a “better” bid may not be “higher” if, for example, the stalking horse bid has a contingency that may not be fulfilled and the competing bid is fully non-contingent.

Finally, potential bidders should be “warned” against trying to get a deal that is “too good to be true”. In this region, the approval of sales is governed by the Third Circuit opinion in *In re Abbott's Diaries of Penna., Inc.*, 788 F.2d 143 (3d Cir. 1986) which, among other things, requires that the property be sold for “fair value” and by parties acting in good faith (i.e., with no undisclosed side agreements). In a private sale process this usually involves either extensive marketing of the property and/or the presentation of an appraisal. Understand that this process is not necessarily intuitive and is best undertaken with the assistance of knowledgeable bankruptcy advisors.

2. I am worried that my tenant (a corporation) is going to file a bankruptcy petition. Can I evict them if they do?

If they file a Chapter 11, you will have the right to receive rent going forward from the date the petition is filed. Why would you want to evict them? The company will retain the right to assume or reject the lease until they confirm a Chapter 11 Plan of Reorganization. “Assumption” means that the lease is reinstated; “rejection” means that the Debtor has decided to breach the lease and must now vacate. If you want to hasten that decision (e.g., if you have another tenant interested), you can file a motion to compel assumption or rejection, but realize that the Debtor has the right to take its time before making this type of decision (although recent amendments have tightened this timeframe). If the Debtor decides to stay in the property, it will be required to assume the lease and pay any pre-petition past due rent. In the event of rejection (that will force the Debtor to move out), the pre-petition rent will be a general unsecured claim paid on par with all other claims.

3. I am worried that my landlord is going to file a bankruptcy petition. Can it evict me?

a. In the event that the landlord files a Chapter 11 or Chapter 7 and your lease is rejected, you need not move out. The rejection simply relieves the landlord of the obligation to perform its obligations under the lease, 11 U.S.C. § 365(i) means you get to stay for the term of the lease, paying the rent, deducting the costs of non-performance by the landlord. Of course, under these circumstances, moving out may be preferable. If the lease is assumed, there is no reason to move.

b. In the event that the mortgage on the property goes into default and foreclosure is started (either during a bankruptcy proceeding or instead of one), one of two things will happen: (i) you will be named in the foreclosure (giving you ample time to vacate) and eventually judgment will be entered terminating your lease; or (ii) you will not be named in the foreclosure and any buyer at a sheriff's sale will take the property subject to the terms of your lease. In the event that you have concerns about this, you may want to contact the lender directly and get the lender to agree that it will not name you in the foreclosure, so your lease will remain pending.

4. Can I continue to provide services to a Chapter 11 Debtor post petition? What are my rights if I do?

The only way that Chapter 11 Debtors are able to truly reorganize (and pay creditors what they are owed) is if companies continue to do business with them. For that reason, the Bankruptcy Code provides protection for companies that do business with Chapter 11 Debtors. Anyone who continues to do business with a Debtor and ends up unpaid because the case fails to reorganize holds a Chapter 11 administrative claim. This claim would be about as high a priority as comes in a bankruptcy proceeding — paid on par with the lawyers (accountants and other professionals) for the Chapter 11 Debtor. As always there is a reason to be wary of doing business with any troubled business. Be certain to keep a close eye on the extension of credit, but at least you can take comfort in knowing that there is some protection.

5. What Happens to Construction Liens When the Owner Files for Bankruptcy?

In these unfortunate economic times, the possibility of an owner bankruptcy is all too real. When an owner becomes the subject of a bankruptcy petition, voluntarily or involuntarily, Section 362(a)(4) of the Bankruptcy Code generally stays "any act to create, perfect or enforce any lien against property of the [debtor's] estate." 11 U.S.C. 362(a)(4). Section 362(b)(3) creates an exception to such automatic stay, permitting any act to perfect, or to maintain or to continue the perfection of an interest in the debtor's property to the extent that the trustee's rights and powers, including its avoidance powers under Section 545, are subject to such perfection under Section 546(b). 11 U.S.C. 362(b)(3). Under Section 545, the trustee may avoid the fixing of a statutory lien on the debtor's property to the extent that such lien "is not perfected or enforceable at the time of commencement of the case." 11 U.S.C. 545(2). However, such avoidance powers are subject to Section 546(b), which allows a creditor to continue post-petition perfection of an interest in property that attached pre-petition notwithstanding the automatic stay provisions of Section 362(a)(4). 11 U.S.C. 546(b). In short, the Bankruptcy Code draws a distinction between the post-petition perfection of a lien that attached to the debtor's property pre-petition, which is permitted, and the post-petition creation or attachment of a lien, which is not permitted. In the case of residential construction, if the claimant filed the NUB and obtained a favorable decision from the arbitrator fixing the amount of a valid lien claim pre-petition, then a post-petition filing of the lien claim will be allowed because its attachment is deemed to relate back to the pre-petition filing of the NUB; otherwise, the lien claim will be subject to avoidance by the trustee. See, *In re Kara Homes*, 374 B.R. 542 (Bkrcty, D.N.J. 2007).

6. My customer says that he is "teetering on the financial brink;" he may be filing a bankruptcy petition. Should I ship to him and under what terms?

Many vendors live in fear of receiving a preference – it is unfounded. Receiving a preference is not a crime – it only means that a creditor has been paid on an outstanding invoice within 90 days of a bankruptcy filing and as a result received more than it would have received on this obligation had it not received that payment. What is important to know is that a "preference" only exists *if* a bankruptcy petition is filed (and frequently it is not). Take the money, but beware that there may be a claim asserted down the road. The *best* terms on which to ship goods to avoid a preference is COD. Payments received for goods shipped COD *are immune to preference attack*. If you must extend credit, do so on terms that mirror the terms that you had generally given previously. Remember, even if you receive a demand for a preference, you will probably not be required to give *all* of the money back, so you will be ahead of the game. In other words, always take the payment.

7. Last week, I delivered a huge shipment of goods to my best customer and I just learned that they filed a Chapter 11 bankruptcy petition today. What can I do about this last shipment?

Assuming that you shipped on credit, your remedy is to demand "reclamation". Reclamation is, in theory, return of the items shipped. To be entitled to reclamation, you must make the demand (i) in writing; (ii) within 20 days of the bankruptcy filing; (iii) for goods delivered within the "last" 45 days¹. The reclamation claim will fail if the goods have already left the Debtor's possession (i.e., been resold) or have been modified (i.e., raw materials used in manufacturing). If you prove a right to reclamation, you may have the choice to recover your goods or be allowed a Chapter 11 administrative expense claim (instead of the usual pre-petition claim) which you may then request be paid immediately – with varying levels of success.

8. I have leased equipment to a company hovering on the brink of bankruptcy. I am protected, right?

There are two things to be aware of:

a. The fact that you may have called your transaction a "lease" does not necessarily mean that you have a lease and have retained title to the property that is covered. Courts will consider the "financial realities" of the transaction before deciding what the transaction should be called. If the lease term extends for the "useful life" of the leased property and if there is a mandatory buyout for a nominal amount – these are all terms that a court considers.

b. Since a Court may consider the transaction to be a secured transaction (and not a lease), make certain that you have filed a UCC financing statement to "perfect" your lien. Make sure that any filed UCC has not expired. Double check (and triple check) the status of your perfection! Secured creditors with properly perfected liens have rights in a bankruptcy proceeding that are very valuable.

9. Should I file a proof of claim?

Yes. Filing a Proof of Claim is not always required, but since there is little harm in filing one (unless, for some reason, you are trying to avoid being subject to the jurisdiction of the bankruptcy court) *do it*. It ensures that your claim is properly recorded, that your address is correct and that you will get the notices that you are entitled to receive. It is a very simple process, so there is no downside.

10. Why is my neighbor driving around in a brand new car, just returned from a European vacation and living in a big house after just having filed bankruptcy?

a. *It's not hard to explain:* the car is leased; the house is lien up to the extent of its value; the trip was paid on credit cards before they filed for bankruptcy. Your neighbors don't really own anything, so they have nothing to lose in a bankruptcy filing.

b. The Bankruptcy Code only requires the sale of assets of Debtors that will result in money for distribution to unsecured creditors. The neighbors will keep these assets and their debts (secured debts are not discharged in a bankruptcy proceeding) if they can pay for them.

¹ This is the general rule, but there are intricacies to the "counting of days" that need to be applied on a case-specific basis.

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