WHEN THE BUBBLE BURSTS:
THE NEXT REAL ESTATE DOWNTURN AND
HOW IT WILL AFFECT COMMERCIAL REAL ESTATE

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A. Expected Amendments to the Bankruptcy Code (Proposed by Bankruptcy Reform Act of 2001)

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I. <u>INTRODUCTION</u>

Many of us remember the real estate downturn of the early 1990's: it sparked Single Asset Real Estate ("SARE") cases in Bankruptcy Courts nationwide. Commercial landlords nervously awaited their debtor/tenant's decision to assume or reject a lease.

This Homeward Bound Seminar was planned during the greatest bull market in recent memory. However, the cyclical nature of our economy and the long-term nature of commercial real estate investments requires that lawyers and businesspeople continue to be aware of the impact of bankruptcy upon commercial real estate. The anticipated Bankruptcy Reform Act of 2001, and the Revised Article 9 of the UCC (which takes effect on July 1, 2001 in Michigan) put a new spin on these issues.

II. <u>State Law Remedies for Mortgage Default</u>

1. <u>Mortgage as Lien</u>

Under Michigan law, a real estate mortgage grants the mortgagee a lien against the mortgaged property. The mortgagor has an equity of redemption, which is the right to redeem the property from the lien of the mortgage by making payment of the indebtedness owed under the mortgage.[1]

As a general rule, the mortgagee does not become entitled to possession of the mortgaged property until after a foreclosure sale and expiration of a statutory redemption period. Nusbaum v Shapero, 249 Mich. 252, 228 NW2d 785 {1930).

2. Right to Rents

As a general rule the mortgagor is entitled to possession, and the right to collect any rents from the mortgaged property, until expiration of the statutory redemption period following the foreclosure sale. There is an exception to the general rule where the mortgagee acquires an assignment of rents pursuant to Michigan's Assignment of Rents Statute MCLA 554.231.

A mortgagee may, in conjunction with a mortgage on certain commercial or industrial property (other than an apartment building of less than six apartments or any family residence) obtain an assignment of rents from the mortgaged property as additional security. MCLA 554.231. In order to be enforceable, the assignment must be recorded. MCLA 554.232.

The nature of the mortgagee's rights under an assignment of rents and the ability to obtain the appointment of a receiver to aid in its enforcement was set forth by the Michigan Supreme Court in Smith v Mutual Benefit Life Insurance Company 362 Mich. 114, 106 N.W.2d 515 (1960). The collection of rents is not merely an incident to the right of possession of the mortgaged property, but is a distinct remedy and additional security held by the mortgagee. While the right to collect rents is security, the right is a direct assignment of rents and not a mortgage of the rents.

The right of the mortgagee to collect rents from the tenants of the property will be triggered upon the existence of an event of default under the terms of the mortgage or the assignment, and compliance with any notice or other requirements in the mortgage or assignment. The assignment becomes binding upon the occupants of the mortgaged property from the date that the mortgagee files a notice of default with the register of deeds and serves the notice and a copy of the assignment upon the occupants of the property. MCLA 554.231(2).

The security interest afforded to a mortgagee by an assignment of rents will take priority over any garnishment of the rents by a judgment creditor of the mortgagor, upon recording of the statutory notice of default, even in the absence of service of the notice on tenants of the mortgaged premises. Otis Elevator Co. v Mid-America Realty Investors, 206 Mich. App. 710, 522 N.W.2d 732 (1994). Once the notice of default is recorded, the mortgagee becomes entitled to collect the rents and the assignment

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[1] These principles are well recognized as set forth, in Wager v Stone, 36 Mich 364, 366 (1877):

"It has become the well settled doctrine in this state that a mortgage conveys no title to the mortgagee. It is but a security for the debt, and until the title passes upon a foreclosure and sale of the property, the mortgagee has no legal interest in the land, and is not entitled to possession. (citations omitted)

becomes operative, such that the mortgagor no longer has an interest in the rents which is subject to a garnishment.

The court in Otis Elevator, 206 Mich. App. at 713-714 held as follows:

> [T]he statutory language states that such an "assignment of rents shall be binding upon such assignor only in the event of default..." Thus, the mortgagor's default is sufficient to finalize the mortgagee's interest in the rents as against the mortgagor. The additional language requiring service of notice of default upon the 'occupiers" or tenants concerns the operation of the assignment as against the tenants, not against the assignor.

The court in Otis Elevator cited with approval the holding of the bankruptcy court in the case of In re Mount Pleasant Limited Partnership, 144 B.R. 727, 733-734 (Bankr. W.D. Mich 1992) as follows:

> Under section 1 of Michigan's statute, giving "binding effect" to the assignment is conditioned only upon default. Therefore, at the point of default the mortgagor becomes obligated as contractually provided in the assignment.
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> ******
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> ...Once default occurs, ...the assignment becomes binding, and the mortgagee has a "choate", or present vested right in the rents… [T]he service requirement only determines which party has the initial right to collect the rents, and is intended as a protection for the tenants. It does not affect the rights between mortgagor and mortgagee.

The court in Otis Elevator also cited with approval the holding of the bankruptcy court in the case of In re Coventry Commons Associates, 143 B.R. 837, 838 (E.D. Mich. 1992) as follows:

> In Michigan, the assignment of rents is governed by statute - M.C.L.A. §§ 554.231 and 554.232 These provisions, this Court concludes, permit a mortgagor to grant an assignment of rents as additional security and the assignee/mortgagee's rights are perfected and binding against the assignor/mortgagor when such assignment is recorded and a default occurs in the terms and conditions of the mortgage.

The right of a mortgagor during a bankruptcy proceeding to make use of rents is discussed, infra, at pages 14-16 and 26-27.

3. Procedures for Foreclosure

Michigan law provides two methods of foreclosing a mortgage: judicial foreclosure and foreclosure by advertisement. Judicial foreclosure, involves the filing a complaint in a court having jurisdiction. MCLA 600.3101. Foreclosure by advertisement may be used if the mortgage includes a power of sale, MCLA 600.3201, and the mortgage and all assignments of the mortgage have been recorded. MCLJA 600.3204(3).

By statute a mortgage may include a power of sale which permits the property to be sold by public auction in the event of a default by the mortgagor in the terms and conditions of the mortgage. MCLA 600.3201. The procedure for foreclosure by advertisement has withstood constitutional challenge. Cheff v Edwards, 203 Mich. App. 557, 560-561, 513 N.W.2d 439 (1994)[2]

Foreclosure by advertisement is not available if there is any lawsuit pending for recovery of the debt which is secured by the mortgage, unless the suit is discontinued or a judgment entered and a writ of execution returned unsatisfied in whole or in part. MCLA 600.3204(1)(b). An action on the debt which will prohibit foreclosure by advertisement includes, "proceedings in which judgment may be rendered and execution issued against a debtor's property." Michigan Land Title Standard 16.13. An action for recovery on a guaranty is not an action for recovery of the debt. United States v Leslie, 421 F.2d 763 (6th Cir. 1970). An action for appointment of a receiver does not constitute an action for recovery of the debt. Calvert Associates v Harris, 469 F. Supp. 922 (ED Mich 1979).

Once an action has been filed to foreclose a mortgage, the mortgagee may not pursue a separate action against the mortgagor to recover the indebtedness unless authorized to do so by the court. This is required by the "one action" rule set forth in MCLA 600.3105(2).[3]

If a judgment has been obtained for the debt which is secured by the mortgage, it is necessary to obtain issuance of a writ of execution which is returned unsatisfied prior to proceeding for foreclosure of the real estate mortgage, MCLA 600.3105(1). If the mortgagee obtains a money judgment for the amount of the indebtedness, the mortgagee has a duty to seek collection of the judgment from assets of the mortgagor other than the mortgaged property prior to proceeding with foreclosure of the mortgage. Stegeman v Fraser, 161 Mich. 35, 125 N.W. 769 (1910).

A mortgagor can prevent a mortgage foreclosure sale by filing bankruptcy. The bankruptcy filing invokes the automatic stay which is embodied in 11 U.S.C. § 362. 11 U.S.C. § 362(a)(5) operates to prevent the foreclosure sale until the stay is lifted.

The mortgagee can file a motion with the bankruptcy court seeking to lift the automatic stay. The court will lift the stay if it determines that 1) there exists sufficient cause to lift the stay, including lack of adequate protection, or 2) the mortgagor lacks equity in the mortgaged property *and* the property is not necessary for an effective reorganization. 11 USC § 362(d). (11 U.S.C. § 362(d)(3), discussed *infra* at pages 23-26, contains another basis for relief from the automatic stay in the context of single asset real estate cases.) In a proceeding by the mortgagee to lift the automatic stay, the mortgagee has the burden to

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[2] The constitutionality of foreclosure by advertisement has been reviewed and held valid. Nat'l. Airport Corp. v. Wayne Bank, 73 Mich. App. 572, 576, 252 N.W.2d 519 (1977); Cramer v. Metropolitan Savings & Loan Ass'n, 401 Mich. 252, 258 N.W.2d 20 (1977), cert. denied, 436 U.S. 958, 98 S.Ct. 3072, 57 L.Ed.2d 1123 (1978); Northrip v. Federal Nat'l. Mortgage Ass'n, 527 F.2d 23 (6th Cir. 1975).

[3] MCL 600.3105(2), MSA 27A.3105 provides that:

> "After a complaint has been filed to foreclose a mortgage on real estate or land contract, while it is pending, and after a judgment has been rendered upon it, no separate proceedings shall be had for the recovery of the debt, secured by the mortgage, or any part of it, unless authorized by the court."

prove that the mortgagor does not have equity in the mortgaged property. Once this has been established, the mortgagor carries the burden of proof on all other issues. 11 U.S.C. § 362(g).

If the bankruptcy filing occurred subsequent to the foreclosure sale, but prior to the completion of the redemption period, then the redemption period will not be tolled by the filing. See In re Glenn, 760 F. 2d 1428 (6th Cir. Mich. 1985), cert. denied, 474 U.S. 849 (1985); Byrne, Sean P., *For Whom the Stay Tolls,* Mich. Real Prop. Rev. 21 (Spring 2001).

4. Use of Receivership.

The use of a receivership over real property is available in state circuit court where "allowed by law." MCLA 600.2926-.2927. The mortgagee may seek the court appointment of a receiver to aid in the enforcement of the assignment of rents. MCLA 600.2927 permits the parties to a mortgage to provide that the failure of the mortgagor to pay real property taxes or insurance premiums will be deemed waste and that a receiver may be appointed to prevent waste. MCLA 600.2927(2).

As a general rule, a receiver is available only as ancillary relief: there is no independent remedy of the right to a receiver. National Lumberman v Lake Shore Machinery Co., 260 Mich. 440; 245 N.W.494 (1932). A request for appointment of a receiver may be sought as ancillary relief in a pending judicial foreclosure action. The remedy of a receiver should also be available where the mortgagee seeks to foreclose by advertisement if the appointment is necessary to aid in the enforcement of an assignment of rents or to prevent waste.

If a receiver is appointed over the mortgaged property prior to a foreclosure sale, it will be necessary to obtain the approval of the court before proceeding to sale. Kuschinski v Equitable & Central Trust Co., 277 Mich. 23,268 N.W.2d797 (1936), citing In re Petition of Chaffee, 262 Mich 291, 247 N.W. 186 (1933). Michigan Land Title Standard 16.10.

In the event of the filing of a bankruptcy proceeding, a state court receiver will be deemed a custodian under 11 U.S.C. § 101(11) and the receiver will be required to transfer assets to the Debtor in Possession under 11 U.S.C. § 543 and Bankruptcy Rule 6002. One court has found that the "turnover provisions of § 543 are part of the statutory expression of the Congressional preference that a Chapter 11 debtor be permitted to operate and control its business during the reorganization process." In re Northgate Terrace Apartments. Ltd., 117 B.R. 328, 332-33 (Bankr. SD Ohio 1990).

III. BANKRUPTCY OVERVIEW

The Federal Bankruptcy Code is designed to provide a comprehensive nationwide scheme for two different insolvency procedures: **liquidation and reorganization**.

A. Chapter 7 Bankruptcies (Liquidations)

In Chapter 7 bankruptcies, an independent trustee is appointed to conduct an orderly liquidation of the assets of an individual or business.

B. Chapter 11 Bankruptcies (Reorganizations)

In Chapter 11 bankruptcies the debtor is either a business or an individual seeking to reorganize. Chapter 11 provides relief from the pressure of creditors while the debtor attempts to restructure debt and propose and confirm a plan of reorganization in order to make a fresh start. The relief and protection afforded while restructuring comes in the form of an automatic stay of actions against the debtor. 11 U.S.C. § 362. The fresh start comes upon the discharge of a portion of the debtor's pre-petition debts, as provided in the plan of reorganization. 11 U.S.C. § 1141.

C. **Glossary of Terms**:

1. Automatic Stay: 11 U.S.C. § 362(a) and (d) Exhibit 1

2. Adequate Protection: 11 U.S.C. § 361 Exhibit 2

3. Cash Collateral: 11 U.S.C. § 363(a) Exhibit 3

4. Lien Stripping: 11 U.S.C. § 506(a) Exhibit 4

5. Absolute Priority Rule: 11 U.S.C. § 1129 Exhibit 5

6. Single Asset Real Estate: 11 U.S.C. § 101(52B) Exhibit 6

IV. **TREATMENT OF COMMERCIAL LEASES UNDER THE BANKRUPTCY CODE**

Section 365(d)(4) permits a debtor or a Trustee in a case under *any* chapter of the Bankruptcy Code to assume or reject an unexpired lease of non-residential real property under which the debtor is a lessee within 60 days after the order for relief is entered into the bankruptcy case. The order for relief is entered immediately if the bankruptcy case is filed voluntarily, but in involuntary bankruptcy proceedings the order for relief is entered somewhat after the bankruptcy filing date, either upon content of the parties or after the Bankruptcy Court conducts a hearing on the involuntary petition. 11 U.S.C. §365(d)(4) also permits the Bankruptcy Court to grant the debtor and the Trustee additional time to assume or reject non-residential real property leases *for cause,* so long as the motion seeking such extension is filed within the initial 160 day period to assume or reject these leases. If a lease of non-residential real estate is not assumed or rejected within the initial 60 day period, or any extended period set by Court order, then the non-residential real estate lease is deemed rejection and the debtor or Trustee "*shall* immediately surrender" the non-residential real property to the lessor.

In large business bankruptcies, the debtor often files a motion for a long extension of the 60-day time in which assume or reject non-residential real estate leases. Some debtors seek an extension of this deadline through and including the plan confirmation date. The purpose for such a long extension is to give the debtor a chance during the bankruptcy proceedings to carefully evaluate which of its locations are profitable, and which are not. Obviously, the debtor will try to assume the profitable locations, and will reject the unprofitable ones. The larger the bankruptcy case, the longer this analysis can take. With hundreds of bankruptcy courts throughout the country, there is wide variation from court to court with respect to how a judge will react to a motion to extend the time to assume or reject non-residential real estate leases. Generally, however, Courts tend to be receptive to an extension which is reasonable under

the circumstances in order to give the debtor the time (and information) which it needs in order to effectively reorganize.

V. SINGLE ASSET REAL ESTATE (SARE) CASES UNDER THE BANKRUPTCY CODE - PRE 1994

A. How It Was (pre-1994): An Examination of Four Important Issues

Generally, issues concerning SARE entities in bankruptcy arise in the context of Chapter 11 proceedings. The real estate might be an unimproved parcel of land, or a large urban office building. Before 1994, the Bankruptcy Code contained no provisions dealing specifically with SARE cases. Indeed, the pre-1994 version of the Bankruptcy Code lacked a definition of "single asset real estate," even though several important Chapter 11 cases in the early 1990's involved a partnership or corporation whose sole significant asset was an office building, apartment complex, warehouse, or similar real property. In those cases, the debtor was often current in paying the day-to-day expenses but was unable to make the payment owing on the mortgage. Consequently, the sole significant creditor was often the mortgagee, who might be oversecured (*i.e.* the value of the collateral exceeds the amount owing) or undersecured (*i.e.* the value of the collateral in less than the amount owing: in this scenario the gap between the collateral value and the amount owing is an unsecured claim). Other creditors were often owed small sums for minor maintenance costs, etc. Often the SARE bankruptcy occurred when the debtor suffered an increase in vacancies and was no longer able to make the mortgage payment, and the lender would not agree to an out-of-court workout. Consequently the SARE debtor filed Chapter 11 to stave off foreclosure.

When SARE Chapter 11 filings were rampant in the early to mid-1990's critics often argued that they constituted an abuse the bankruptcy laws[4] for several reasons. *First,* the automatic stay embodied in 11 U.S.C. § 362(a) enables the debtor to prevent foreclosure for an extended period of time without filing a plan or making pre-petition payments or post-petition balloon payments. Critics argue that bankruptcy gives the SARE debtor undue leverage over the mortgagee by imposing the costs of delay on that creditor. *Second,* SARE debtors sometimes attempt to use the provisions of Chapter 11 to keep property in which the debtor has no equity, without either paying the mortgage in full or obtaining the assent of a majority of creditors. Critics say that these concerns are heightened because SARE cases fulfill few of the recognized goals of Chapter 11. For example SARE reorganization is generally not necessary to preserve jobs or the "going-concern" value in SARE cases. Whether the debtor keeps the real property or the secured creditor takes it, the property will be operated in the same manner, creating the same jobs and economic activity.

1. Old 11 U.S.C. § 522(b) and Security Interest in Rents: Who Gets the Money?

When a SARE entity files for bankruptcy, it needs to use the rents to pay attorneys' fees and to fund the plan of reorganization. Not surprisingly, most mortgagees have taken a security interest in the refits or an assignment of the rents. If any debtor is denied its cash flow, even on a loan basis (as cash

[4] Some critics even question whether SARE debtors should be excluded from Chapter 11. See Alan Robin & Jclmes Lipscomb, *Real Estate Bankruptcies and the Bankruptcy Process,* REAL PROP. PROB. & TR. J (Spring 1997).

collateral[5]), it cannot reorganize because it cannot pay legal fees or other administrative costs. The question is, then, who gets the money?

Courts long found this to be a conundrum, complicated by state law requirements for perfection of an assignment of rents. The pre-1994 Bankruptcy Code (11 U .S.C. § 552) included “rents” among those post-petition proceeds to which a pre-petition security interest could extend, “to the extent provided by such security agreement and by applicable non-bankruptcy law.” The law applicable in Michigan provides that assignments of rent are valid, provided that certain events have occurred and certain steps have been taken, effectively perfecting the assignment lien. M.C.L.A. 554.231 provides, in relevant part:

> [I]n or in connection with any mortgage on commercial or industrial property… it shall be lawful to assign the rents, or any portion thereof, under any oral or written leases upon the mortgaged property to the mortgagee, as security in addition to the property described in the mortgage. Such assignment of Tents shall be binding upon such assignor only in the event of default in the terms and conditions of said mortgage, and shall operate against and be binding upon the occupiers of the premises from the date of filing by the mortgagee in the office of the register of deeds for the county in which the property is located of a notice of default in the terms and conditions of the mortgage and service of a copy of such notice upon the occupiers of the mortgaged premises.[6]

Under the pre-1994 version of the Bankruptcy Code, the timing of a SARE’ s Chapter 1 filing could affect the perfection of a lender’s security interest in the rents. If a debtor acted swiftly enough, *i.e.* filed bankruptcy before the mortgagee had filed notice of the default in the register of deeds office or before said notice of default had been served on the tenants, the rents would become property of the debtor’s bankruptcy estate under 11 U.S.C. § 541, so that the debtor could retain the cash and use the rents in its reorganization efforts. Conversely, if the mortgagee filed the notice of default or served it on tenants before the SARE filed bankruptcy, courts construed the assignment of rents as a security interest and applied 11 U.S.C. § 552 accordingly.[7]

2. <u>New Debtor Syndrome/Bad Faith SARE Filing</u>

“New Debtor Syndrome” concerns pre-bankruptcy planning by an entity with troubled real estate on its hands. The paradigm of the New Debtor Syndrome entity (whether a real estate empire or another commercial venture) in one which creates a new entity into which a single, troubled real estate project is transferred, then the newly-created entity quickly files a Chapter 11. In addition to delaying the

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[5] If a lender’s security interest in the property is “adequately protected” as defined in 11 U.S.C. § 361, it is likely that a court will permit the debtor to use the rents as cash collateral, *i.e.* funds useable by the debtor in its reorganization. A lender might be adequately protected if, for example, it is oversecured by the value of the property itself, so that recourse to the rents can be foregone without danger to the lender’s secured status. This application, however, gives rise to a number of sub issues. For example, does the “cushion” of adequate protection (*i.e.* the amount by which the lender is oversecured) decrease as the interest on the secured loan aggregates? How much cushion is adequate to protect the lender? What measures should be taken when the value of the underlying property decreases and so decreases the secured lender’s cushion or makes the fully secured lender all undersecured lender?

[6] Mich. Comp. Laws Ann. § 554.231 (West 1988).

[7] <u>See</u>, <u>e.g.</u>, <u>In re Mount Pleasant Ltd. Partnership</u>, 144 B.R. 727, 732-33 (Bankr. W. D. Mich. 1992).

mortgagee's collection and foreclosure efforts, using a "new debtor" allows an entity to isolate its troubled assets away from its healthy ones and to restrict the ability of a creditor to get either its money or "its" property. In either case, the result is a SARE case with little good will from the creditors. Although some New Debtor Syndrome debtors have been successful, in more recent years creditors have had significant success attacking these reorganizations on the basis of bad faith.[8]

"Bad Faith" is the doctrine that can be used to dismiss a bankruptcy case suffering from New Debtor Syndrome. Bad Faith is also the basis for dismissing a SARE entity that files under Chapter 11 just moments before a foreclosure sale.

3. The Absolute Priority Rule and the New Value Corollary

The Bankruptcy Code contains a scheme of payment priorities. This priority scheme is often called the "Priority Ladder". The Absolute Priority Rule in Chapter 11 (11 U.S.C. § 1129(b)(2)) requires that all allowed claims of creditors on a higher rung of the priority ladder must be paid in full before the allowed claims on the next rung of the priority ladder can receive any payment from, or interest in, the debtor. The Absolute Priority Rule thus implements the scheme of payment priorities set forth in the Bankruptcy Code.

The "New Value Corollary" or "New Value Exception" is a controversial case law doctrine which operates as an exception to the "Absolute Priority Rule" by permitting the equity holders of a Chapter 11 debtor (who are on the lowest rung of the priority ladder) to take or retain the equity interest in the post-Chapter 11 company if the equity holder provides "new value."[9] In the absence of the "New Value Corollary" or the "New Value Exception", the Absolute Priority Rule dictates that the equity holders are not entitled to any interest in the debtor or return until after all the creditors on higher rungs of the priority ladder have been paid in full.[10]

In its simplest form, the New Value Corollary can permit a debtor to discharge its debts and retain its property by infusing an amount of capital which is only a fraction of the face value on the mortgage. This arrangement is usually proposed as a plan of reorganization, often permitting *only* tile equity holders the opportunity to infuse the new value in exchange for the interest in the debtor which they keep under the proposed plan. In so-called "lien-stripping, new-value" plans, the debtor's pre-bankruptcy owners ask the court to determine that the true value of the commercial real estate is much less than the unpaid principal amount of the secured debt and that, consequently, the mortgage holder's secured claim is that same low figure (because, pursuant to 11 U.S.C. § 506(a), the secured creditor's claim is calculated as the *lesser of* the value of the collateral or the amount owing to the secured creditor.)

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[8] Gretchko, Lisa Sommers, *Single Asset Chapter 11 Real Estate Cases: Bad Faith and New Debtor Syndrome Affirmed b the Sixth Circuit Court of Appeals*, Mich. Real Prop. Rev. 19 (Spring 1995); Gretchko, Lisa Sommers, *Single Asset Chapter 11 Real Estate Cases: Bad Faith, New Debtor Svndrome, and Other Pitfalls*, Mich. Real Prop. Rev. 49 (Summer 1994).

[9] It is an open question whether the new-value exception exists under the Bankruptcy Code. The Supreme Court granted certiorari in a case in which the Ninth Circuit held that the new-value exception does exist, even though there was no conflict among the circuits. The court later dismissed the appeal as moot when the parties settled the appeal. *In re Bonner Mall Partnership,* 2 F.3d 899, 908 (9thCir. Idaho 1993), *cert. granted,* 510 U.S. 1039, 114 S. Ct. 681, *dismissed as moot,* 513 U.S. 118, 115 S. Ct. 386 (1994).

[10] 11 U.S.C. § 1129(b)(2)(B)(ii).

After "lien stripping" the secured creditor, these plans often propose to have the debtor retain ownership of the commercial real estate by infusing new capital into the debtor. "Lien stripping, new value plans" are often used by SARE cases involving individual equity owners (often functioning through syndicates such as partnerships) who face large recapture tax liabilities if they lose their ownership interest in real estate. (The recapture tax liability results from the property owner taking accelerated depreciation so as to reduce income tax liability.) Because an individual's debt for recapture tax liability is generally non-dischargeable if the individual's bankruptcy case (*see* 11 U.S.C. § 523(a)(1)) equity owners in most SARE cases are highly motivated to infuse new value in order to retain their equity interest.)

The most infamous recent case of a "new value plan" occurred in *In re 203 North LaSalle Partners,* 526 U.S. 434 (1999), a protracted SARE case which was motivated by the owners' $20 million recapture tax exposure. The Supreme Court declined to decide the pivotal issue of the validity of the new value corollary, because the Court held that it was improper for the SARE equity owner to have the *exclusive* opportunity to infuse new value in exchange for the equity ownership and that the process of infusing new value should be opened up to other prospective "bidders" so as to "test the market" to make sure that the new value is infused in the best attainable price. Unfortunately, the Supreme Court offered no guidance whatsoever on the logistics of the bidding process for the SARE entity's equity.[11]

The principal problem with the New-Value Corollary itself is that its elements are not precisely defined. Under the case law, the New-Value Exception contains five requirements. The new-value contribution must be: (1) new; (2) in money or money's worth; (3) substantial; (4) necessary; and (5) reasonably equivalent to the interest retained.[12] While court decisions have provided reasonably precise definitions for the "new" and "money or money's worth" requirements, case law has not provided clear rules for the other three requirements.[13] Cases addressing the "substantial" requirement have split over whether substantiality is to be measured in absolute terms or relative to unsecured claims. Cases addressing the "necessary" requirement have split over whether the contribution must be necessary to operations or whether it may be used to pay preconfirmation creditors. Regarding the "reasonably equivalent" requirement, it was unclear whether indirect benefits to equity holders, such as expected future salary and deferral of taxes, must be taken into account.

Despite *203 N. l.aSalle,* problems alleged to arise from the New Value Exception and SARE cases continue to demand the careful attention of judges, as will be further discussed.

4. <u>Classification of the Unsecured Portion of the Mortgagee's Claim</u>.

The ability of a SARE debtor to confirm a lien-stripping plan generally turns on whether it can create an impaired class which has accepted the plan, because section 1129 of the Bankruptcy Code requires that in order for a plan to be confirmed an impaired class of claims must accept the plan. The Courts of Appeals have made it increasingly difficult for the debtor to create an impaired accepting class, by restricting the

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[11] Singer, George H. *Supreme Court Clarifies "New Value Exception" to Absolute Priority Rule - Or Does it?* ABI Journal, July/August 1999, page 1

[12] *Bonner,* 2 F.3d at 908.

[13] The lack of clarity in the case law regarding the other three requirements is set forth in J. Ronald Trost, *et al., Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification,* SB 37-ALI-ABA, 479 (1996).

debtor's ability to divide unsecured claims into more than one class.[14] The drawback to this approach is that reliance on classification rules does not ensure that reasonable lien-stripping plans are confirmed and that unreasonable lien-stripping plans are not confirmed.

B. <u>How it is Now (Post-1994); Post-1994 Legislation and Case law Dramatically Changed Singled Asset Real Estate Bankruptcies</u>.

In 1994, Congress amended the Bankruptcy Code in order to address the concerns about SARE cases. Congress added a number of sections, including: § 101(52B), which contains a definition of "Single Asset Real Estate, § 362(d)(3) which contains a fast-track provision for SARE entities with lender protection provisions, and § 552(b)(2) which attempts to simplify post-petition rent issues by eliminating reference to state law.

1. <u>Section 101(52B): Definition of Single Asset Real Estate</u>

In 1994 the Bankruptcy Code was amended to add the following definition of "Single Asset Real Estate":

> 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 and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto having aggregate noncontingent, liquidated secured debts in an amount no more than $4,000,000.

The most important SARE qualification is the $4 million cap on secured debts: this dollar limitation greatly narrows the field of SARE cases which are eligible for treatment under the 1994 amendments to the automatic stay provisions contained in § 362(d) of the Bankruptcy Code. Indeed, many of the SARE cases decided before 1994 would not qualify as SAREs simply because of the $4 million cap.

The SARE definition contained in § 101 (52B) of the Bankruptcy Code also contains several ambiguities. For example, at least one court has questioned whether a single property "which generates substantially all of the gross income of a debtor" includes raw land.[15] It is also unclear whether $4 million debt limit refers to the face amount of the secured claim, or to the lesser of the face amount or the value of the collateral.[16] Moreover, a SARE debtor may still be difficult to recognize.[17] For example,

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[14] *See,* e.g., *In re Barakat,* 99 F.3d 1520, 1526 (9th Cir. 1996), *cert. denied,* 117 S. Ct. 1312, reh'g denied, 117 S. Ct. 1725 (1997); *In re Lumber Exch. Bldg. Ltd. Partnership,* 968 F.2d 647, 649 (8th Cir. 1992); *In re Bryson Properties, XVIII,* 961 F.2d 496,502 (4th Cir. 1992), *cert. denied,* 506 U.S. 866 (1992); *In re Greystone III Joint Venture,* 995 F.2d 1274, 1281 (5th Cir. 1991), *cert denied,* 506 U.S. 821 (1992); *In re Boston Post Road Ltd. Partnership,* 21 F.3d 477, 483 (2d Cir. 1994), *cert. denied,* 513 U.S. 1109 (1995).
[15] *In re Oceanside Mission Associates,* 192 B.R. 232, 234 (Bankr. S.D. Cal. 1996).
[16] *Compare In re Pensignorkay, Inc.,* 204 B.R. 676 (Bankr. E.D. Pa. 1997) (holding that the cap should be calculated by reference to the value of the collateral) with *In re Oceanside Mission Associates,* 192 B.R. 232 (Bankr. S.D. Cal. 1996) (holding that the four-million-dollar cap should be calculated by reference to

under the Bankruptcy Code definition, a SARE case may involve members of a consolidated group of debtors operating a substantial non-realty business in the real estate.

2. Section 362(d)(3): Fast Track Treatment of SARE; Relief From the Automatic Stay

If an entity meets the definition of a SARE, Bankruptcy Code Section 362(d)(3) (which was added with the 1994 amendments to the Bankruptcy Code) gives it "fast track treatment" which requires that the SARE debtor file a reasonably confirmable plan within 90 days or commence making monthly interest payments (on each secured creditor's interest in the real estate) equal to a current fair market rate on the value of the creditor's interest in the real estate. The "fast track" can make it more difficult for the SARE to reorganize. Mortgagees enjoy the benefit of the "fast track." Indeed, lenders in workouts are now motivated to demand that non-SARE companies (such as manufacturing companies) place their factory buildings into the ownership of single-asset subsidiaries for the purpose of mandating fast-track treatment of these subsidiaries as single-asset realty entities if the workout fails and Chapter 11 becomes necessary. Not only are the transaction costs of this procedure excessive, but if Chapter 11 occurs the additional stress of fast-track treatment for the so-called SARE entities in the consolidated group might endanger the reorganization. It is ironic that these lenders can now use New Debtor Syndrome to their advantage in the aftermath of the 1994 Amendments to the Bankruptcy Code.

Congress adopted Bankruptcy Code § 362(d)(3) for the express purpose of reducing delay and potential abuse of the bankruptcy process in SARE cases.[18] Section 362(d)(3) provides, in relevant part:

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the total value of the secured creditor's nonbankruptcy claim).

[17] The following are examples of potentially difficult-to-recognize SARE debtor situations:

1. Debtor is a limited liability company owned by a group of lawyers, doctors, and dentists which owns an office building held for rental. Debtor is a SARE. This would be true even if the debtor provides its own cleaning, maintenance, snow removal, and landscape services, because these are activities incidental to the operation of the property.

2. Debtor owns a manufacturing facility occupied by its parent company. The debtor is a SARE.

3. Debtor is a limited partnership owned by a group of business executives which owns a strip shopping center with twenty-three stores, none of which stores is operated by the debtor. Debtor is a SARE.

4. Debtor is the same limited partnership owned by the same group of business executives which owns the same strip shopping center with twenty-three stores. However, the smallest of the store spaces is operated as a frozen-yogurt stand by the debtor. Debtor is a SARE, even though it operates a business other than an activity incidental to real estate because the frozen-yogurt stand is not "substantial."

5. Debtor is a corporation owning a regional shopping mall. Debtor also operates a nationwide chain of 147 ladies-apparel stores, one of which is on the debtor's premises. The debtor is not a SARE, because the business being operated by the debtor is "substantial."

[18] 3 LAWRENCE P. KING, COLLIER ON BANKRUPTCY ¶ 362.07[5][b] (1996) (citing S. REP. NO.168, 103dCong., 1st Sess. (1993) ("This amendment will ensure that the automatic stay provision is not abused, while giving the debtor an opportunity to create a workable plan of reorganization."), 140

> On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay…
>
> > (3) with respect to a stay of an act against single asset real estate… by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period)--
> >
> > > (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
> > >
> > > (B) the debtor has commenced monthly payments to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien), which payments are in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the real estate.

By its terms, Section 362(d)(3) only applies to debtors that meet the definition of SARE set forth in Section 101(52B), and therefore does not apply to cases in which the secured debt exceeds $4 million.

Section 362(d)(3) requires the SARE debtor within 90 days after the order for relief (granting an automatic stay of creditor actions) to: (1) file a reasonably confirmable plan; (2) commence certain postpetition mortgage payments; or (3) obtain an extension of the 90-day plan-or-pay deadline. [19] If the SARE debtor fails to perform any of these three options, the mortgagee is entitled to relief from the automatic stay. [20] Additional open issues under § 362(d)(3) include: (a) whether payments required by § 362(d)(3) may be made from rents generated from the property; (b) the method of determining "interest at

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CONG. REC. 10, 764 (daily ed. October 4, 1994), reprinted in App. Pt. 9(b) (statements of Rep. Brooks, chairperson of the House Judiciary Committee):

> Without bankruptcy reform, companies, creditors, and debtors alike will continue to be placed on endless hold until their rights and obligations are adjudicated under the present system--and that slows down ventures, new extensions of credit and new investments.

[19] 11 U.S.C. § 362(d)(3). Note that filing a plan within the ninety-day period is not the debtor's only option. The SARE debtor need not file a plan if it either commences making interest payments to the mortgage holder within ninety days, or obtains an extension of the ninety-day deadline by showing cause of why more time is needed to either file a plan or commence payments. Thus, § 362(d)(3) carefully balances the interest of the secured creditor for speedy resolution of the Chapter 11 proceeding and the SARE debtor's needs for adequate time to attempt to reorganize. Also note that the payments that the debtor is required to make under § 362(d)(3) are smaller than the payments the debtor would be required to make pursuant to a plan of reorganization, with payments only of interest on the value of each secured creditor's interest in the real estate. Thus, this interest is computed based on the "lien-stripped" value of the collateral rather than the amount owing to the mortgagee. Additionally, under a plan, the debtor will also have to make payments to unsecured creditors, pay administrative and other priority claims in full, and provide for the payment of the principal balance of the secured claim. Generally a debtor that can reorganize should be capable of paying interest on the current value of the property from rental income.

[20] 11 U.S.C. § 362(d)(3).

a current fair market rate"; and (c) whether the payments must be commenced or a plan filed on the later of 90 days after the petition date or within 30 days after the court determines the debtor to be a SARE and therefore subject to § 362(d)(3).[21]

3. Section 552: Perfecting the Security Interests in Rents

In the 1994 amendments to the Bankruptcy Code, Congress added a new section to § 552(b) providing uniform federal treatment for rents and hotel revenues and dispensing with the "applicable state law" provision of the pre-1994 Bankruptcy Code. Currently, 11 U.S.C. § 552(b)(2) provides as follows:

> ... if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to the extent that the court, after notice and hearing and based on the equities of the case, orders otherwise. (Emphasis added)

As the comments to the 1994 amendments explain, "[u]nder this new provision, lenders may have valid security interests in post petition rents for bankruptcy purposes notwithstanding their failure to have fully perfected their security interest under applicable state law."[22]

Divisions of federal courts in Michigan reflect the expected result: courts no longer address whether the secured interest was perfected under the state law and instead confine query to whether the underlying law provides for a valid assignment of rents at all.[23]

4. The New Value Corollary? Post-*203 N. LaSalle*

a. *Bank of America Nat'l Trust and Sav. Assoc. v. 203 N. LaSalle St. Partnership*, 526 U.S. 434 (1999).

In 1999, the Supreme Court heard and opined on a SARE case in which the debtor; a partnership, attempted to force its plan of reorganization onto a rejecting creditor class, the secured claim of the bank, by providing in the plan for an infusion of "new value" by members of the old equity holders.[24] The plan was proposed during the debtor's exclusivity period under Bankruptcy Code §

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[21] If a debtor does not timely comply with § 362(d)(3) based on its contention that it is not a SARE debtor, and it is later determined that § 362(d)(3) does apply, relief from stay must be granted even if the debtor is ready to make payments or file a plan promptly. [*See* 11 U.S.C. § 362(e).]

[22] 11 U.S.C. 552 com. (West Group 2000).

[23] *See, e.g. In re Steams Building,* 165 F.3d 28, 1998 WL 661071 *4 (6th Cir. Mich. 1998).

[24] *Bank of America Nat'l Trust and Sav. Assoc. v. 203 N. LaSalle St. Partnership,* 526 U.S. 434 (1999).

1121(b) (a time when no other parties can file a plan of reorganization with the court). The plan limited participation in the new value infusion to those certain members of the old equity.

While declining to rule on the validity of the New Value Corollary, the Court held that old equity should not have the exclusive right to "bid" for the equity in the reorganized SARE because the exclusive bidding obfuscates whether the new value infused constitutes a fair market equivalent's worth of new value in order to retain an interest in the real estate. The Court rejected the application of the New Value Corollary on the facts of that case because the old equity had ensured itself an exclusive right to provide the new value (essentially creating an option). The Court found that the exclusive bidding opportunity was itself a property right, and that it had been improperly retained by the old equity. Thus, the Supreme Court suggested a new approach to valuation of the new value infusion, namely some form of public auction in order to show that old equity's price was the best available (and, therefore, that old equity *earned* an interest in new equity rather than retaining an interest on account of its old equity position). However, the Court did not specify the logistics of this auction process, and its implementation will undoubtedly lead to further litigation.

b. How Will Judges Work With Exclusivity and Market Valuation Issues?

As a result, it remains open whether an auction or credit-bid approach is appropriate, allowing the secured creditor to credit bid the secured portion of its claim when a SARE debtor proposes to confirm a plan under the new value corollary. Many commentators, as well as the National Bankruptcy Review Commission, considered this auction and/or credit-bid approach carefully, but declined to adopt it out of concern that it might prevent a debtor from ever confirming. a new-value plan over the objection of a secured creditor. At the same time, however, the Commission acknowledged that the credit-bid approach has advantages, and suggested that Congress give this approach serious review.[25]

Another aspect of *203 N. LaSalle* concerns the benefit to old equity. The primary motivation for the old equity to seek retention of the real property was that, should it lose the property, the partners would be personally liable for approximately $20 million in recapture tax liability. By paying the secured claim of the bank in full (over time, and not including the undersecured portion of the bank's claim), retaining the property and discharging the unsecured portion of bank debt through Chapter 11, the old equity would have paid a low current market price for the property (instead of the higher market of the time of original purchase price) and still received the tax benefit of depreciation on the original price. In short, the bank would have "paid" the principal for which old equity could gain a tax write-off. The Supreme Court, although addressing the debtor's motivation, did not resolve the issue or further address the implications.

5. Bad Faith and the New Debtor Syndrome (Recent Case Law)

Federal Courts in Michigan have issued several written opinions either dismissing SARE cases or granting a secured lender relief from the automatic stay based on findings of bad faith.[26]

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[25] Dain C. Donelson & The Hon. Robert D. Martin, *Memorandum to the Small Business Working Group Regarding Proposed New- Value Exception -- Single Asset Real Estate Entities Alternative Proposal/Additional Analysis* (Sept. 9, 1997).

[26] *See, e.g., In re Laguna Assoc. Ltd. Partnership,* 147 B.R. 709 (Bankr. E.D. Mich. 1992), *aff'd,* 30 F.2d. 734 (6th Cir. Mich. 1994) (granting relief from the automatic stay in case of transfer of distressed real

Moreover, the New Debtor Syndrome itself has been recognized as a pattern of conduct evidencing bad faith.[27] The *Laguna* bankruptcy court ruled that to determine bad faith, it could consider any factors which evidence an intent to abuse the bankruptcy process or use it to delay a secured creditor's legitimate effort to enforce its rights.[28] On appeal, the Sixth Circuit confirmed the bankruptcy and district courts' findings of bad faith and enumerated a list of factors evidencing bad faith in the broad context of Chapter 11 SARE cases, as follows: (1) debtor, has one asset; (2) debtor's pre-petition conduct has been improper; (3) there are only a few unsecured creditors; (4) debtor's property having been posted for foreclosure and the debtor having been unsuccessful in its defense of the foreclosure action in state court; (5) the debtor and one creditor have a standstill agreement in state court and the debtor has lost or has been required to post a bond which it cannot afford; (6) the filing of the bankruptcy petition allows the debtor to evade state court orders; the debtor has no ongoing business or employees; and the lack of possibility of reorganization.[29] Accordingly, creditors of SARE cases may still win dismissal or relief from the automatic stay on the basis of bad faith without facts of a transfer or a so-called New Debtor.[30]

VI. THE RISE OF SECURITIZATION

A. Asset Backed Securitization

Traditionally, financing for income producing properties was obtained from banks and institutional lenders such as the real estate investment divisions of life insurance companies. These lenders would make loans secured by a mortgage on the real estate and thereafter hold the loan in their own portfolio. In the event of a default the institutional lender would seek to workout and restructure the terms of the loan or to foreclose on the asset. Following foreclosure the institutional lender would often acquire ownership of the mortgaged property and seek to enhance its value by increasing occupancy through necessary tenant improvements and other incentives. The institutional lender would often hold the asset in its special asset or other similar group and ultimately seek to recover its investment over the long term through remarketing the property.

Since the last wave of commercial real estate loan defaults in the late 1980's and early 1990's, there has been a significant increase in the use of asset backed securitization as a vehicle for financing the acquisition of income producing real estate.[31] Loans are made by conduit lenders, warehoused and

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estate into newly created entity);

[27] *See Laguna,* 147 B.R. at 716 (finding certain factors to evidence bad faith, including: (1) transfer of distressed real property into a newly created or dormant entity, usually a partnership or corporation; (2) transfer occurring within close proximity to the filing of the bankruptcy case; (3) no consideration being paid for the transferred property other than stock in the debtor; (4) the debtor having no assets other than the recently transferred, distressed property; (5) debtor having no or minimal unsecured debts; (6) debtor having no company and no ongoing business; and (7) debtor having no means other than the transferred property, to service the debt on the property).

[28] *See id.*

[29] *See In re Laguna Assoc. Ltd. Partnership,* 30 F.2d 734 (6th Cir. Mich.1994).

[30] *See, e.g., In re Grand Traverse Development Co. Ltd. Partnership,* 150 B.R. 176 (Bankr. W.D. Mich. 1993)(filing Chapter 11 minutes before foreclosure deemed a delay tactic and in bad faith).

[31] Asset-backed securitization has been defined as the "sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a

ultimately sold to issuers who, in turn, raise capital through the issuance and sale in the capital markets of equity or debt instruments, which represent an interest in the securitized real estate loans. These equity or debt instruments are rated by one of the national ratings agencies such as Standard and Poor's. The offering of the debt or equity interests will be priced, in part, based upon the strength of the credit rating assigned to the security.

The conduit lender sells the loan to a depositor, which may bundle like loans in order to efficiently transfers the loan obligations and security instruments (including the mortgages and assignments of rents) into a single purpose trust, which in turn will issue securities backed by the assets held by the trust. The asset forming the basis for the securitization might consist of a mortgage and an assignment of rents, or might only include the leases themselves, in the case of a highly rated tenant, such as a national drugstore chain.

Asset based securitization requires that the assets from which payments are made to the holders of the debt/equity instruments be segregated and used exclusively to make payment to the holders of the instruments. A borrower obtaining a loan which is intended to be securitized will be required to comply with various requirements which are designed to insure that the asset being used as a basis to make payment is separately segregated so that other creditors of the borrower will not be able to make claim against the securitized asset and thereby diminish the assets available to the instrument holders.

The term of the loan documents tend to be highly standardized to promote uniformity and certainty. As the interests are often sold as a fixed stream of payments for a fixed duration, there are prohibitions against prepayment in loan agreements intended for securitization.

Following the securitization of the real estate loan, the loan will be administered by a servicer. There is very little flexibility on the part of either the servicer or the borrower to modify the terms of the loan. In the event of a default in payment, a special servicer will assume responsibility for administration of the securitized loan.

The holders of the debt or equity interests will be paid from the cash flow generated by the securitized assets. It is vitally important that the securitized assets be insulated from the claims of other creditors of the mortgagor and that there be no interruption in the cash flow generated by the securitized assets.

The segregation of the income producing asset from the claims of the creditors of the originator is typically accomplished through the creation of a separate special purpose entity or vehicle ("SPE,") which owns only the asset which is being securitized. The agencies which rate the creditworthiness of the issued instruments, such as Standard and Poor's, publish criteria for special purpose entities.[32]

In order to insure that there is no interruption in cash flow, the borrower may be required to direct rents from the property to be paid to a lockbox which is controlled by the servicer. The rents will initially be used by the servicer to make payment to instrument holders and the balance remitted to Borrower to

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transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying asset." J .C. Schenker and A. J. Colletta, Asset securitization: Evolution, Current Issues and New Frontiers, 69 Tex. L. Rev. 1369, 1373 (1991).

[32] Standard and Poor's Real estate Finance at 109 {1997).

permit payment of operating expenses, fund deferred maintenance, make leasehold improvements, and pay leasing commissions.

A bankruptcy filing by the borrower/SPE could adversely affect the stream of rental payments to the servicer. The borrower might find that as a result of the loss of a major tenant, there is insufficient rental being generated to service the debt on the property. In an effort to obtain necessary funds to pay for tenant improvements and fund leasing commissions, the borrower could file a chapter 11 and seek to use the rents for this purpose.

Real estate loans which form asset based securitizations typically require that the SPE be a bankruptcy remote entity. A bankruptcy remote entity is one which is unlikely to become a Chapter 11 Debtor because of structural and organizational safeguards.

In some forms of securitization, the asset being securitized will include only a right to receive rental payments under a lease. This form of securitization might be used, for example, to fund the cost of constructing 50 drug stores which are to be the subject of sale and lease-back agreements with a national drug store chain. Where the leases are truly triple net, such a lease would have a readily determined cash flow and could form a pool of securitized assets. In this instance the owners of the stores would be required to make a “true sale” of the lease receivables to a special purpose, bankruptcy remote entity. So long as the transfer of the lease receivables is made in the form of a “true sale”, those receivables should not be available for use by the owners of the stores in any chapter 11 proceedings, for the reason that the owner would have no interest in the receivables.

The special purpose entity formed to acquire ownership of the receivables would have as its sole business the collection of the receivables and payment to the servicer. The limited nature of the business of tile SPE makes it unlikely that it will have any significant debt obligations which might result in a bankruptcy filing.

In order to reduce the risk of a bankruptcy filing by a special purpose entity, there will often by limitations on the purpose of the SPE, limitations on incurring debt, and prohibitions against any merger, consolidation, liquidation, asset sale, dissolution or other similar transaction. The SPE will be required to maintain its business operations separate and apart from the business operations of other income producing properties owned by affiliates of the SPE. The conduit lender will typically require borrower counsel to provide a non-consolidation opinion. In order to impede any bankruptcy filing by the SPE there may be a requirement that an independent director be appointed and that such director approves any bankruptcy filing.

B. Risks of Consolidation

A structured financing through a single purpose entity is only effective if the existing entity and the new entity are legally separate and, as importantly, are treated as such by each other, their creditors, and the courts. A single-purpose entity is created with the intention of ensuring that it is kept separate from affiliates of the SPE and that the credit problems or bankruptcy of one entity will not affect the others. If the separate status of the SPE is not respected and maintained by its affiliates, the lender may lose the advantages of the structured financing for which it bargained, by a bankruptcy court’s granting a *substantive consolidation* of the affiliated entities and affording the creditors of other affiliated entities with competing interests recourse to the assets of the single-purpose entity for satisfaction.

Substantive consolidation is an equitable doctrine that a bankruptcy court may use to pool assets of separate entities into a common fund, and the creditors of the affiliated entities all hold claims against the common fund. "Substantive consolidation is the merger of separate entities into one so that the assets and liabilities of both parties may be aggregated in order to effect a more equitable distribution of property among creditors." Matter of Baker & Gettv Financial Services, Inc., 78 B.R. 139, 141 (Bankr. N.D. Ohio 1987). The end result of a substantive consolidation order by a bankruptcy court is akin to a merger of two corporations under state law. The effect of a substantive consolidation will be to deprive the Trustee of the sole and exclusive right to the use of the securitized assets to make payments to instrument holders, and to permit other creditors to lay claim to these assets.

Courts apply a number of factors and various tests to determine whether entities should be consolidated, and it is difficult to predict when entities will be substantively consolidated. In most cases, it is not possible to render an unqualified opinion with respect to substantive consolidation under prescribed circumstances or in certain business relationships due to the general equity powers of the bankruptcy courts in this area; the lack of defined scope and dimension in applying substantive consolidation, and the evolving nature of the substantive consolidation doctrine. The application of the doctrine is extremely fact intensive and relates to the business and creditor relationships leading up to bankruptcy as well as other factors. Accordingly, case law is only a general guide in attempting to anticipate what circumstances merit its application.

In analyzing whether substantive consolidation of a parent and subsidiary is appropriate in a bankruptcy setting, courts often begin with a "piercing the corporate veil" or "alter ego"approach. In determining whether to consolidate the assets and liabilities of a parent corporation and a subsidiary, the following factors were considered: (1) parent ownership of all or a majority of the capital stock of the subsidiary; (2) common directors and officers; (3) parent financing of the subsidiary; (4) parent incorporation of the subsidiary; (5) grossly inadequate capital of the subsidiary; (6) parent payment of the salaries or expenses or losses of the subsidiary; (7) lack of independent business of the subsidiary from the parent; (8) commonly referring to the subsidiary as a department or a division of the parent; (9) directors and executive officers of the subsidiary failing to act independently and taking direction from the parent; and (10) failure of the subsidiary to adhere to formal legal requirements as a separate and independent corporation are not observed.[33] Other factors which will be considered by the bankruptcy court in determining whether to order a substantive consolidation include the following: (1) use of consolidated financial statements; (2) the unity of interests and ownership between the various entities; (3) the existence of parent and inter-corporate guarantees of loans; (4) degree of difficulty in segregating and ascertaining individual assets and liabilities; (5) transfer of assets without formal observance of corporate formalities; (6) commingling of assets and business functions; and (7) the profitability of consolidation alt a single physical location.[34]

The factors set forth above will not be mechanically applied and must be evaluated in the overall "balancing of equities" favoring consolidation versus those favoring separation.[35] The party proposing

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[33] Matter of Gulfco Investment Corporation, 593 F.2d 921 (10th Cir. N.H.1979); Fish v. East, 114 F.2d 177 (10th Cir. 1940).

[34] In re Vecco Construction Industries. Inc., 4 B.R. 407, 410 (Bankr. E.D Va. 1980); In re Richton, 12 B.R. 555, 558 (Bankr. S.D.N. Y. (1981); In re Stop & Go of America. Inc., 49 B.R. 743, 747 (Bankr.D.Mass. 1985).

[35] See In re DRW Property Co., 82, 54 B.R. 489, 495 (Bankr.N.D. Tex. 1985); In re Doughnut Queen.

consolidation bears the “substantial"”burden of demonstrating that a prejudice resulting therefrom is outweighed by the benefit to be obtained.[36]

C. True Sale Issues

If the transfer from the borrower/originator to the special purpose entity is characterized as a disguised secured transaction, the bankruptcy of the originator will affect the structured financing. If the transaction is treated by the court as a secured loan, instead of a true sale of the securitized asset, the bankruptcy by the borrower/originator may impede payment of the cash flow to the servicer and the borrower/originator may be able to make use of the rents as cash collateral upon providing adequate protection for the use thereof. Under these circumstances, the transaction is viewed as a secured loan by the SPE to the originator/borrower.

The following factors will be considered by a court in determining whether the transfer by the borrower/originator to the SPE is a true sale or a secured loan.[37]

1. The court will consider the intent of the parties as evidenced by their writings, and may also look at parol evidence of the parties conduct, practices, objectives, business activities and relationships, in addition to the writings.

2. The absence of recourse by the SPE against the originator will be considered to favor a true sale. A purchaser who retains recourse does not acquire the risks associated with true ownership.

3. The right of the SPE to retain any surplus generated by the securitized assets will favor a determination of a true sale. If the SPE obtained the assets in a true sale it should have a claim to any surplus over what is needed to service the loans generated by the assets.

4. The extent of the originator’s continuing obligation to the SPE after the transfer of assets will be considered. The SPE should bear losses associated with uncollected receivables. If the transaction was a true sale, the originator would have no interest in whether the accounts were actually collected. If the originator acts solely as a collecting agent for the SPE and all other factors indicating a true sale are satisfied, a court should still find that the transaction was a true sale.

5. The equitable powers of the bankruptcy courts will be applied, consistent with the manner in which the bankruptcy courts have considered the substantive consolidation issue.

D. In re Kingston Square Associates - Can a SARE Function as a Bankrupt Remote Entity?

In In re Kingston Square Associates, 214 B. R. 713 (Bankr. S.D.N.Y. 1997), a related group of SARE entities were precluded from filing Chapter 11 by provisions in their charters that prevented the entity from seeking a voluntary bankruptcy without unanimous consent of each board of directors (or

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Ltd., 41 B.R. 706, 709 (Bankr.E.D.N.Y. 1984).

[36] In re N.S. Garrott & Sons, 48 B.R. 13, 18 (Bankr.E.D. Ark. 1984).

[37] These are taken from the Comment of Thomas Gordon, Securitization of Executory Future Flows as Bankruptcy-Remote True Sales, 67 U. Chi. L. Rev .1317, 1331-37 (2000).

equivalent), respectively. These provisions were required by securitized lenders along with a mortgage. Accordingly, the lender placed its own designee on the board. As discussed above, these provisions were intended to make each SARE entity bankruptcy remote and thereby lower the risks and so the originator borrowing interest rates up the securitized line. In *Kingston,* however, the principal of the SARE entities, reasonably believing an equity value remained in the property, found his way around the bankruptcy remote provisions by soliciting unsecured creditors to file involuntary Chapter 11 proceedings.

The issue before the court in *Kingston* concerned whether such an involuntary proceeding was filed in good faith, and whether such acts constituted collusion. The court found that the bankruptcy filing was *bona fide* and that there was no collusion involved, although it noted the presence of factors suggesting dismissal, including the single asset nature of each entity and proximity to a foreclosure sale. The court found that "a bankruptcy proof provision in a corporate bylaw does not prevent outside creditors from banding together to file an involuntary petition," reasoning that tee documents did not "establish a bar to prevent any party connected with the Debtors from acting on its own to file involuntary petition."[38] Apparently, this form of the bankruptcy remote entity is not so remote at all, as the provisions can be avoided.

But the court did not stop there. Instead, the court pointed to the role of the designee director as a mitigating factor in favor of the debtors.[39] When a company becomes insolvent or comes into the realm of insolvency, the fiduciary duties of the directors shifts from the shareholders to the creditors. In light of this, the bankruptcy court considered whether the lender's designee director, who was appointed and paid by the secured party had breached his fiduciary duty to other creditors, by delaying bankruptcy proceedings in favor of foreclosure. In short, although the designated director position is not offensive on its face, that person, by fulfilling his role and limiting the actions of the entity, may breach the duties inherent to his position by acting to that end. These findings, although *dicta,* further erode the effectiveness of direct limitations on a SARE entity in order to create a bankruptcy remote entity.[40]

E. LTV Case - Fate of Asset-Backed Securitized Lending in a Recent Bankruptcy Case

The recent unpublished opinion of In re LTV Steel Companv. Inc., United States Bankruptcy Court, Northern District of Ohio, Case No. 00-43866 has focused a great deal of attention on the risk that a securitization will be deemed a secured loan instead of a true sale. The bankruptcy court had entered an interim cash-collateral order which removed receivables from a special purpose entity, and permitted the debtor to make use of the receivables as cash collateral. A number of non-consolidation opinions had been issued which concluded that the securitized assets and the SPE were bankruptcy remote, which enabled the debtor to secure financing at more favorable rates than would have been available through traditional secured financing.

In 1994 (after emerging from one chapter 11 reorganization) LTV created a special purpose vehicle, "LTV Sales Finance", in order to Finance $270 million in receivables by means of an asset backed securitization. Again in 1998, LTV created another special purpose vehicle, LTV Steel LLC, to finance $30 million in inventory. LTV received a non-consolidation opinion and four subsequent confirmation opinions affirming the separateness of LTV and the special purpose entities.

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[38] *See id.* at 729-30.
[39] *See id.* at 736-736.
[40] *See Id.*

LTV filed bankruptcy. At a cash collateral hearing the Debtor was granted permission to use the receivables that supported the asset backed securitization. The order granting such permission specified that: (1) an issue existed as to whether the transaction between LTV and the special purpose vehicle was a true sale or a disguised secured transaction; (2) the secured lender was required to turn over cash proceeds to the Debtor to provide working capital; (3) the secured lender would be entitled to an administrative expense claim if it was determined that the transactions were true sales; and (4) the secured lender was provided with adequate protection.

Abbey National, the secured lender, challenged the order (which required it to turn over cash proceeds of the receivables) on the ground that the transaction between Sales Finance and LTV was a true sale. The bankruptcy court, however, affirmed its order, stating that whether the transaction was a true sale was a fact that could only be resolved through an evidentiary hearing. The bankruptcy court further concluded that the Debtor retained some *equitable* interest in the receivables, making them property of the Debtor's estate, and subject to use as cash collateral.[41]

The court reviewed its perception of the equities of the case and noted that, without the proceeds from the receivables, the debtor would be forced to immediately turn out the lights. This would result in unemployment for 17,000 employees in a geographic area dependant on steel. Moreover, approximately 100,000 retirees would be left without medical benefits. These factors were considered in allowing the Debtor to use the SPE's receivables as cash-collateral.

As expected, the court's decision was met with concerns as to its effect of the securitized lending business. If courts are not prepared to enforce the transaction as a true sale and permit the debtor's use of the securitized assets as cash collateral, the favorable loan pricing available on a securitization would be adversely impacted. If the cash flow from the securitized assets could be impacted by a bankruptcy, the cost of securing credit would increase for all securitized loans which posed such a risk.

Lawyers for Abbey National and the Debtor have subsequently settled. As part of the settlement, Abbey National loaned $700 million to the Debtor for DIP financing, deemed the transaction at issue a traditional receivable financing, rather than a true sale followed by a securitization, and the lenders are buying back the securities that were issued. Ultimately the court's holding could make it more expensive for all borrowers.

VII. Expected Amendments to the Bankruptcy Code (Proposed Bankruptcy Reform Act of 2001) and New UCC Article 9

A. Expected Amendments to the Bankruptcy Code (Proposed by Bankruptcy Reform Act of 2001)

1. Leases of nonresidential Real Estate: The proposed amendment to 11 U.S.C. 365(d)(4) affects commercial real estate leases. If the Bankruptcy Reform Act of 2001 becomes law, it will amend 11 U.S.C. § 365(d)(4) to give the debtor and trustee in all bankruptcy cases a deadline of the *earlier of* 120 days after the order for relief or the date of the entry of an order confirming a plan in which

[41] The court stated that "Debtor's business requires it to purchase, melt, mold and cast various metal products. To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept."

to assume or reject an unexpired lease of non-residential real estate. The new law will also provide that the Bankruptcy Court can grant a 90-day extension of this deadline prior to the expiration of the 120-day period upon the motion of the Trustee or the lessor for cause. Thus, it appears that the Bankruptcy Reform Act of 2001 will sharply curtail the ability of Bankruptcy Courts to extend indefinitely the deadline for debtors and trustees to assume or reject leases of non-residential real estate and, instead, will put a 90-day cap on all motions to extend the assumption/rejection deadline. The proposed new law also provides that if the Court grants an initial extension of the assumption/rejection deadline, the Court may grant a subsequent extension only upon written consent of the lessor on each lease of non-residential real estate.

If this provision becomes law, it will have a dramatic impact on the logistics of the bankruptcy reorganization of any large business with multiple locations. Such business might well be served by hiring consultants *before* filing bankruptcy to conduct an in-depth analysis of the profitability of each location so that the debtor will know *before* it files bankruptcy which leases it needs to assume, and which leases it should reject. The House Bill and the Senate Bill contain identical language for the proposed amendment to 11 U.S.C. § 365(d)(4), thus it is likely that this provision will become law.

2. New SARE Definition: If the Bankruptcy Reform Act of 2001 becomes law, the definition of "single asset real estate" will be changed significantly, because the proposed new law would eliminate the $4 million cap. The new law would also except family farms from the definition of single asset real estate. In other words, if the new law goes in to effect, all single asset real estate entities (other than family farms) will have to comply with the "fast track" provisions of 11 U.S.C. § 362(d)(3). The language in the House Bill and Senate Bill is identical, which makes it likely that this provision will pass and become law.

3. Asset-Backed Securitization: If the Bankruptcy Reform Act ultimately becomes law, amendment to Section 541 of Title 11, dealing with property of the estate, will protect the assets that form the basis of a certain asset-backed securitization from becoming property of the bankruptcy estate. At subsection (b) of § 541, after "Property of the estate does not include---" will be inserted:

> (8) any eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent that such asset (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a);

S. 420 § 912; available online at thomas.loc.gov (Apri12, 2001).

Asset-backed securitization is defined in the proposed Bankruptcy Reform Act of 2001 as follows:

> The term asset-backed securitization means a transaction in which eligible assets transferred to an eligible entity are used as the source of payment on securities, including, without limitation, all securities issued by governmental units, at least one class or tranche of which was rated investment grade by one or more nationally recognized securities rating organizations, when the securities were initially issued by an issuer;

8.420 § 912. This definition will cover structured financings wherein a company creates a special purpose vehicle with the single purpose of holding assets which back securities, where at least one class or tranche of the securities was rated investment grade at the time of issuance. The proposed Bankruptcy Reform Act of 2001 defines 'eligible entity' to cover the traditional special purpose vehicle:

> a trust, corporation, partnership, governmental unit, limited liability company (including a single member limited liability company), or other entity engaged exclusively in the business of acquiring and transferring eligible assets directly or indirectly to an issuer and taking actions ancillary thereto.

Further, the proposed Bankruptcy Reform Act of 2001 defines eligible asset to explicitly make lease receivables and commercial mortgage loans bankruptcy remote. These assets will be the ones normally transferred in the real estate asset-backed securitization.

What this amendment means is that, under the proposed Bankruptcy Reform Act of 200 1, a transfer will be deemed a "true sale" if the assets and the entities comply with the definitions in the Act. This change might have necessitated a different decision than the interim decision issued by Judge Bodoh in LTV, discussed above.

B. UCC Article 9

The new Article 9 which becomes the law in Michigan on July 1, 2001 contains an expanded definition of "account", as follows:

§ 9.102 Definitions and Index of Definitions

> (a) Article 9 definitions. In this article:
>
> > (2) "Account", except as used in "account for", means a right to payment of a monetary obligation whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of …

Arguably, this broadened definition of "account" includes rent. However, section 9-109(d)(11) excludes from the scope of Article 9 "the creation or transfer of an interest in or lien on real property, including a lease or rents there under, except to the extent that provision is made for liens on real property, fixtures, fixture fillings, security agreements covering personal and real property."

Read together, sections 9-102(a)(2) and 9-109(d)(11) will undoubtedly create significant confusion as to whether new UCC Article 9 applies regarding perfection of an assignment of rents. At a recent seminar, several professors noted that if the rents *truly* stem from real estate, then the new article 9 would not apply to them. That said, however, those same professors indicated that many situations involving rent will be very confusing, such as golf course fees, rents for luxury suits at stadiums, etc. After the new UCC Article 9 becomes law, the prudent way to perfect an assignment of rents will be under both the Michigan statute (MCLA 554.231 et seq.) *and* by filing financing statements, just in case the rents could conceivably be deemed to be "accounts" within the meaning of the New UCC Article 9.