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The Bankruptcy Times They Are Changing: **Real Estate Developers Beware**

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SHUTTERSTOCK

With all of the real estate development currently going on in our five boroughs, bankruptcy judge Michael E. Wiles' recent decision in *In re Futterman*, Case No. 17-12899 (MEW) (more on that below) got me thinking about how far the pendulum has swung in my 30 years of representing middle-market debtors in Chapter 11 cases. To paraphrase the famous Dylan song, "the bankruptcy times they are changing."

I have been practicing bankruptcy law in New York City since 1989. Over this period, as with all things, I have witnessed many changes. Of course, in October 2005, substantial changes to the Bankruptcy Code went into effect. Before discussing Judge Wiles' recent case in *In re Futterman*, I believe it makes sense to briefly discuss some of the significant evolution and trends I have witnessed over the last 30 years with respect to what the Bankruptcy Code denominates as "single asset real estate" cases (SARE).

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While many bankruptcy practitioners and bankruptcy judges may not consider SAREs the most interesting Chapter 11 cases because they do not involve the preservation of jobs or the preservation of going concern value which the Supreme Court has reminded us is the primary purpose of Chapter 11, in some districts such as the Eastern District of New York, SAREs make up a significant portion of Chapter 11 cases.

SAREs are usually filed voluntarily (a newer trend of involuntary filings in SARE cases by lenders is discussed below) and generally involve a two-party dispute between the owner of the real estate and the mortgagee. In New York City, a SARE can involve an asset with hundreds of millions of dollars in secured debt. Prior to 1994, the Bankruptcy Code did not have a definition of SARE. In 1994, this definition was added to §101 of the Bankruptcy Code. The definition, which for the most part remains the same today, provided that a SARE is "real property consisting of a single property or project … which generates substantially all of the debtor's gross income and on which no substantial business is being conducted by the debtor other than the business of operating the real property

and the activities incidental thereto with secured debts of no more than $4 million." Because of the $4 million limitation, the SARE definition excluded many cases filed in New York City. Currently, there is no debt limit. See 11 U.S.C. §101(51B). As such, if the Empire State Building were to file Chapter 11, it would likely be a SARE.

SARE cases are often filed on the eve of the foreclosure sale in order to invoke the automatic stay to halt the sale. Prior to 1994, the primary litigation in a SARE case was whether a debtor could confirm a Chapter 11 plan over the objection of the mortgagee which always held the largest claim in the case. Since §506(a) of the Bankruptcy Code provides a claim is secured up to the value of the property that secures the claim and unsecured for the balance of the claim, a mortgagee owed more than the value of the property securing the claim also usually held the largest unsecured claim in a SARE. (A simple example: If the real property was valued at $10 million at the time of Chapter 11 filing and the mortgagee was owed $11 million at the time of Chapter 11 filing, under §506(a), the mortgagee holds a secured claim of $10 million and unsecured claim of $1 million.)

In the late 1980s and early 1990s, New York City was in the midst of a major real estate recession and interest rates were substantially higher than today's low rates. In February 1989, the prime rate was 11.5%. As a result, many real property owners were unable to refinance or service mortgage loans which were tied to prime or some other variable rate. Debtor's lawyers would file plans which usually attempted to creatively argue a mortgagee's deficiency claim (the difference between the value of the collateral and the amount of the claim) could be separately classified from other unsecured trade creditors such as an elevator repair company claim or the like. This separate classification was necessitated by §1129(a)(10) of the Bankruptcy Code which requires at least one impaired class to vote to accept a Chapter 11 plan if the plan has an impaired class. (This section is controversial, and the current Bankruptcy Review Commission has recommended removing it from the Bankruptcy Code.) The uncertainty surrounding whether separate classification was permissible often led to a consensual resolution with the mortgagee. In 1994, the Second Circuit ruled a mortgagee's deficiency claim was substantially similar to other unsecured claims and must be classified in the same class. *In re Boston Post Road Ltd. Partnership*, 21 F.3d 477 (2d Cir. 1994). This ruling made it extremely difficult, if not impossible, to confirm a Chapter 11 plan over the objection of the mortgagee, unless the property was subject to second mortgage willing to vote for the plan.

Similarly, in 1994, §362(d)(3) of the Bankruptcy Code was added to require a SARE, within 90 days of the filing, to either file a Chapter 11 plan that has a reasonable possibility of being confirmed within a reasonable time or to commence payments to the mortgagee. (This section has been slightly amended since 1994 to clarify the payments to the mortgagee are at the non-default contract rate.) This addition to §362(d) of the Bankruptcy Code reduced the time a SARE could remain in Chapter 11. In the late 1980s and early 1990s, several SAREs remained in Chapter 11 for years and during this time the market improved paving the way to work out deals with the mortgagees. Today, this does not happen.

Another trend, which has developed in the past few years, has been the filing of an involuntary Chapter 11 case by a mortgagee. This has developed as savvy lenders' lawyers (especially loan to own private equity lenders) frustrated with the slow state court foreclosure process have learned that a liquidating Chapter 11 plan which affords the mortgagee the ability to credit bid its claim at a §363 sale can be confirmed in 90 days or less. A state court foreclosure process takes at least two years even if the mortgagee is successful in obtaining summary judgment. Sophisticated lender attorneys often recommend "wind down officers" who are cloaked with all of the powers of a court appointed bankruptcy trustee to oversee the sale process. These auction sales conducted under a confirmed plan in order to avoid NYC transfer tax and mortgage recording tax are often held in private law offices with no court oversight.[1] The "wind down officer" is also given great discretion as to who qualifies to bid at the auction. This is not the case in a foreclosure sale which is a public auction usually at the courthouse steps. In short, in recent years, sophisticated lenders have been able to utilize Chapter 11 to confirm a liquidating plan in as little as three months, which provides for an auction sale of the real property, rather than proceeding with the state court foreclosure process.

For example, I was recently involved in a SARE case which involved a valuable development site in West Harlem. The real estate developer who had successfully developed other projects in West Harlem had spent years of his life and millions of his own dollars in

acquiring parcels and piecing together a development site and obtaining variances and other land use benefits which made the development site extremely desirable. The developer borrowed money secured by the development site, from a private equity/family office and for variety of reasons was unable to obtain replacement financing or work out a consensual restructuring of the loan. The developer filed a voluntary Chapter 11 case for the development site and attempted to obtain refinancing. When the developer was unable to obtain refinancing, the Bankruptcy Court confirmed the mortgagee's liquidating plan which provided for an auction sale of the development site. The "wind down officer," which the lender recommended, was in charge of the sale process and had the discretion with the lender's input to select who was qualified to bid at the auction. At the auction, aside from the lender, there was one qualified bidder. The lender was declared the highest bidder via a credit bid which was approximately $10 million less than the lender asserted it was owed adding on 24% default rate interest and millions of dollars in legal fees.

Shortly after obtaining a court order approving the auction sale, the lender entered into a contract to sell the development site for approximately $20 million more than its credit bid, to the only other qualified bidder at the auction. The lender then elected to pursue collection from the debtor's principal who had guaranteed the loan. The lender sought to enforce its guarantee against the individual asserting it was owed $10 million under the guaranty based upon the difference between the lender's credit bid at the auction and the amount of its asserted claim. The individual guarantor elected to file his own personal Chapter 11 case rather than litigating with the lender in state court.

The guarantor filed an objection to the lender's $10 million proof of claim asserting, among other things, that under §1371 of the RPAPL, in a mortgage foreclosure scenario if the mortgagee was the successful bidder at the sale, in order to assert a deficiency claim, the mortgagee would have to establish the fair market value of the property. In other words, the mortgagee would not be able to assert a deficiency claim unless it proved the fair market value of the property it acquired did not exceed the amount of its credit bid. RPAPL §1371 puts the burden on the lender to prove the fair market value of the foreclosed property. Bankruptcy Judge Wiles in a decision dated April 24, 2019, rejected this argument and held that since the sale was pursuant to a bankruptcy auction and a confirmed plan of liquidation, it was not the same as the foreclosure sale and the guarantor was not entitled to the protections he would be entitled to under the New York State real property law.[2] As a result of Judge Wiles' decision, a mortgagee appears to have the ability to assert a deficiency claim against a guarantor even though the mortgagee ultimately recovers more than the full amount of its claim by flipping the property. This result seems at odds with Judge Henry J. Friendly's oft quoted statement that bankruptcy "must not only be right, it must seem right." *Knapp v. Seligson (In re Ira Haupt & Co.)*, 361 F.2d 164, 168-69 (2d Cir. 1966).

If Judge Wiles' reasoning is adopted by other bankruptcy judges in similar cases, guarantors of construction loans and other mortgage loans have another important factor to consider when filing a SARE as they could be subject to a deficiency claim by the credit bidding lender, regardless of the true value of the real property the credit bidding lender acquired at the §363 sale. The pendulum has definitely swung.

1. In my 30 years, I have attended numerous bankruptcy auctions at law offices or other places outside the courthouse, outside the presence of a bankruptcy judge and I have witnessed numerous occasions of if not outright bid collusion, bid interference. Bankruptcy Judge Cornelius Blackshear required all auctions to be conducted in his courtroom. This too has changed.

2. Judge Wiles' decision seems at odds with Supreme Court jurisprudence. In *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.*, 549 U.S. at 450-55, the Supreme Court has stated:

> Indeed, we have long recognized that the "'basic federal rule' in bankruptcy is that state law governs the substance of claims, Congress having 'generally left the determination of property rights in the assets of a bankrupt's estate to state law.'" Ibid. (quoting *Butner v. United States*, 440 U.S. 48, 57, 54, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979); citation omitted). Accordingly, when the Bankruptcy Code uses the word "claim"—which the Code itself defines as a "right to payment," 11 U.S.C. §101(5)(A)—it is usually referring to a right to payment recognized under state law. As we stated in *Butner*, "[p]roperty interests are created and defined by state law," and "[u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." 440 U.S., at 55, 99 S.Ct. 914; accord, *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 161, 67 S.Ct. 237, 91 L.Ed. 162 (1946) ("What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed is a question which, in the absence of overruling federal law, is to be determined by reference to state law").

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