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MANAGEMENT ALERT
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Bankruptcy Abuse Prevention and Consumer Protection Act
Provisions of Interest to Real Estate Owners and Lenders

This Memorandum addresses certain amendments to the United States Bankruptcy Code, 11 U.S.C. §101 et. seq. (the "Bankruptcy Code"), made by the recently enacted *"Bankruptcy Abuse Prevention and Consumer Protection Act"* (the "Act"). The amendments addressed in this Memorandum are ones of particular interest to real estate owners and lenders.[1]

Treatment of Unexpired Leases of Nonresidential (Commercial) Real Property

Pre-Amendment Law

A bankruptcy Debtor (a "Debtor") may assume or reject an unexpired lease of nonresidential real property (a "Lease") pursuant to Section 365 of the Bankruptcy Code. If the Lease is assumed, the Debtor takes on the Lease as a post-bankruptcy obligation. An assumed Lease may also be assigned to a third party. If the Lease is rejected, the non-Debtor party has a pre-bankruptcy claim against the Debtor's bankruptcy estate for the damages arising from the resulting breach of the Lease. That claim is capped pursuant to Section 502(b)(6) of the Bankruptcy Code. To assume a Lease, a Debtor must "cure" any and all existing defaults under the Lease, compensate the non-Debtor party for any actual pecuniary damages resulting from the default, and provide "adequate assurance of future performance" under the Lease.

Under the pre-Amendment law, a Chapter 11 Debtor had sixty (60) days from the date of its bankruptcy filing to decide whether it wanted to assume or reject a Lease. That period could be, and often was, extended by the Bankruptcy Court for "cause". There was no limit on the number of extensions of the sixty (60) day period that a Debtor could obtain or the total amount of time that a Debtor could be given to make the decision. If a Lease was assumed and later rejected, the rejection claim of the non-Debtor party was likely a post-bankruptcy "administrative priority" unsecured claim and such claim would not likely have been subject to the cap on rejection damages contained in Section 502(b)(6) of the Bankruptcy Code.[2]

Amendments

The initial period of time that a Debtor has to make its decision to assume or reject a Lease has been extended to the earlier of (i) one hundred twenty (120) days after the filing date, and (ii) the date of confirmation of a plan of reorganization. That initial period may now only be extended one time, for an additional period of ninety (90) days. No further extensions by the Bankruptcy Court as to any Lease are permitted without the prior written consent of the affected landlord.

If a Lease is assumed and later rejected, the non-Debtor party is now expressly entitled to an administrative priority unsecured claim equal to two (2) years rent under the Lease, subject to reduction only by payments actually received or to be received from a third party (i.e. from a new tenant). Any additional claim is now expressly made subject to the Section 502(b)(6) cap on damages.

Finally, a Debtor is no longer required to "cure" nonmonetary defaults that are not capable of being cured. For example, if the Lease makes failure to operate on any business day a default, once that default has occurred, there is no way for the Debtor to go back in time and "cure" it. The Act amends the Bankruptcy Code to eliminate the technical need for such a cure, although it does require that the non-Debtor party be compensated for any pecuniary loss that it may have suffered as a result of the breach.

This resolves a split among the courts regarding the need to cure non-monetary defaults. Oddly, however, the language resolves that issue in favor of the Debtor only for Leases. For all other executory contracts, such as franchise agreements or leases of personalty, the amendments clarify that non-monetary defaults must be cured. It is unclear whether Congress intended that Leases be treated in one fashion and other executory contracts be treated in the exact opposite fashion.

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Restrictive Use Clauses

Pre-Amendment Law

Under Section 365(f)(1) of the Bankruptcy Code, Lease clauses that prohibit the assignment of the Lease without the consent of the landlord (called "anti-assignment clauses") are unenforceable. Instead, Leases can be assumed by the Debtor and assigned to a third party without the consent of the landlord, so long as any and all existing defaults under the Lease are cured, the non-Debtor party is compensated for any actual pecuniary damages resulting from the default, and the assignee is provided "adequate assurance of future performance" under the Lease.

In the context of the assignment of a "shopping center" Lease, Sections 365(b) and 365(f)(2) of the Bankruptcy Code state that "adequate assurance" included compliance with use and other Lease restrictions. However, some Bankruptcy Courts have held that certain use clauses are disguised anti-assignment clauses, and have refused to enforce them in connection with an assignment of a shopping center Lease.

Amendments

In the Act, Section 365(f)(1) of the Bankruptcy Code, the section rendering anti-assignment clauses unenforceable, is made expressly subject to Section 365(b), which requires enforcement of use and other clauses in shopping center Leases. The House Report states that this change makes it clear that the assignee of a shopping center Lease is bound by the restrictive use clause in the Lease, thereby over-ruling bankruptcy cases that had held to the contrary. The language change is, however, not as declarative of that result as one might like, leaving open the possibility of further litigation on this issue.

Serial Filings

Pre-Amendment Law

Under the pre-Amendment law, a Debtor that owned real property would stop the foreclosure of such real property by filing a bankruptcy case, thereby bringing into play the "automatic stay" contained in Section 362(a) of the Bankruptcy Code. A foreclosing lender could then be obligated to stop the foreclosure process and obtain relief from the automatic stay from the Bankruptcy Court before proceeding. Often the lender had to repeat some or all of the foreclosure process after relief from stay had been obtained. There was little in the Bankruptcy Code to prevent the owner of real property from filing a series of bankruptcy cases, or from transferring the real property to a series of new shell entities for whom new bankruptcy cases could be filed, to frustrate the legitimate efforts of a lender to foreclose on its collateral after default.

Methods of overcoming a serial-filing Debtor included (1) having the Bankruptcy Court in the first case enjoin either subsequent bankruptcy filings by the Debtor or subsequent bankruptcy filings with respect to the real property, (2) having the Bankruptcy Court in the first case grant relief from the automatic stay as to the real property in any subsequent bankruptcy case, (3) having the Bankruptcy Court in the first case find that any subsequent bankruptcy filing with respect to the real property would be in bad faith and subject to immediate dismissal, (4) obtaining immediate emergency relief from the automatic stay in the subsequent case, (5) proceeding with the foreclosure and obtaining subsequent relief from the automatic stay from the Bankruptcy Court that relates back to the date of foreclosure, or (6) having the subsequent case dismissed because the Debtor was not an eligible Debtor under Section 109(g) of the Bankruptcy Code (i.e. a prior case of that Debtor had been dismissed by the Bankruptcy Court for failure by the Debtor to prosecute the case or had been voluntarily dismissed by the Debtor after the filing of a motion for relief from the automatic stay). However, there was no explicit statutory authority for strategies 1-3, and they still did not prevent a serial filing from occurring. Strategy 4 was very difficult to execute, strategy 5 was risky, and strategy 6 did not prevent the need to re-commence or repeat some or all of the foreclosure process.

Amendments

The Act contains three (3) primary methods to address to the serial filing problem. They are:

- New Section 362(d)(4), which permits a Bankruptcy Court to enter an order granting relief from automatic stay as to real property and finding that the Debtor has engaged in a scheme to delay, hinder or defraud creditors that involved either the unauthorized transfer of an interest in the real property or multiple bankruptcy filings. Such an order may be recorded in the real property records and, if so recorded, provides relief from the automatic stay with regard to that real property for two (2) years after its entry. If such an order is entered and recorded, the real property is also not subject to the automatic stay for that same two (2) year period pursuant to Section 362(b)(20) of the Bankruptcy Code, provided that the Debtor may ask the Bankruptcy Court to impose a stay due to changed circumstances or for other good cause shown. This moves the onus of acting quickly from the lender to the Debtor.
- New Section 362(b)(21), which provides that no automatic stay exists in a case where the Debtor is ineligible to file a bankruptcy case under Section 109(g) of the Bankruptcy Code or where the Debtor has been enjoined by a prior Bankruptcy Court from re-filing. This strengthens Section 109(g), which previously only permitted the lender to seek to have the impermissible bankruptcy filing dismissed, by making an impermissible filing a non-event with regard to a pending foreclosure, and provides statutory authority for a court to enjoin the filing of a subsequent case.

- New Sections 362(c)(3) and 362(c)(4), which provide that if a Debtor who is an individual has filed other bankruptcy cases within the one (1) year prior to the current case, the automatic stay (i) will only be in effect for 30 days (if there was only one prior case) or (ii) will not come into effect at all (if there were two or more such prior cases), in either case subject to the ability of a party in interest to request that the stay be re-imposed.

Single Asset Real Estate Cases

Pre-Amendment Law

In 1994, the Bankruptcy Code was amended to address the filing of bankruptcy cases by entities that owned only one piece of real property where a majority of the debt was held by one secured party. These cases were referred to as "single asset real estate cases". The 1994 amendments permitted the secured lender to obtain relief from the automatic stay in these cases unless the Debtor promptly either (1) began monthly payments to the lender in an amount sufficient to cover interest on the secured debt at the current market rate, or (2) filed a plan of reorganization that had a reason possibility of being confirmed within a reasonable time. If neither of these events occurred within ninety (90) days of the filing of the bankruptcy case (or such longer period as the Bankruptcy Court allowed within the ninety (90) day period), the lender would be entitled to relief from the automatic stay. At that time, this special relief was limited to cases where the secured debt did not exceed $4,000,000.

Amendments

The Act amends the Bankruptcy Code as to "single asset real estate"[3] (1) to change the interest rate used to determine the amount of the required monthly payments from a current market rate of interest to the non-default contract rate, (2) to clarify the available sources of the funds that may be used for the payment, and (3) to remove the $4,000,000 limitation. The first change requires a higher payment in a falling interest rate market, but a lower payment in a rising market. The second change addresses certain case law that either required that all payments come from the Debtor or forbade payments from the assets of the Debtor. The third change expands greatly the universe of cases to which the subsection might apply.

The Act also changes the date by which the Debtor must either have begun payments or have filed a confirmable plan. That must now occur by the later of ninety (90) days after the filing of the case or thirty (30) days after the Bankruptcy Court determines that the Debtor owns "single asset real estate." The inclusion of this latter milepost will likely permit a Debtor to challenge the status of its real property as "single asset real estate" at a relief from stay hearing without having immediately to accede to relief from stay if it is found to be wrong in its legal assessment that its property is not "single asset real estate".

Dispossessory Proceedings

Pre-Amendment Law

Like any other litigation against a Debtor, dispossessory proceedings were subject to the automatic stay that comes into play upon the filing of a bankruptcy case. To commence a dispossessory, or to continue one already in progress, the landlord had to obtain relief from the automatic stay from the Bankruptcy Court in all cases.

Amendments

The Act makes two (2) changes to existing law with regard to dispossessory proceedings and the automatic stay. They are as follows:

- New Section 362(b)(22) provides that a landlord may continue a dispossessory action to obtain possession from the Debtor/tenant of the leased residential premises after a bankruptcy filing by the Debtor/tenant if the landlord has obtain prior to the bankruptcy filing a judgment entitling it to possession of the premises, provided that the Debtor/tenant may file with its bankruptcy petition a certificate that certifies that the tenant had the right to cure the default under non-bankruptcy law even after the entry of a judgment for possession and include therewith rent (paid into the registry of the Bankruptcy Court) under the lease for thirty (30) days. If the Debtor/tenant does not make such a filing and payment, the stay does not apply to the continued dispossessory efforts of the landlord. If the Debtor/tenant does make such a filing, then Debtor/tenant may within the thirty (30) days after the filing of the first certificate file a second certificate certifying that the entire default has been cured. The Landlord may object to such certificate. If the landlord does not object, the stay remains in place. If the landlord does object, then a hearing will be held within ten (10) days and, if the Debtor/tenant was not correct in its certificates, the landlord is entitled to relief from stay to continue the dispossessory without further court order.
- A landlord may commence a dispossessory for possession of a residential premises fifteen (15) days after the filing by the landlord with the Bankruptcy Court of a certificate stating that the Debtor/tenant has endangered the premises or has used or permitted the use of a controlled substance in the premises within the thirty (30) days prior to the date of the certificate, provided that the Debtor/tenant may file an objection to the certificate within fifteen (15) days of the filing of the

certificate stating that it is factually incorrect or that the alleged events have been remedied. If no objection is timely filed, the stay is no longer in effect. If an objection is timely filed, the Bankruptcy Court must hold a hearing within ten (10) days, and the Debtor/tenant must prove that either the certificate was incorrect or that the alleged matters have been remedied.

Homestead Exemption[4]

Pre-Amendment Law

A Debtor that is an individual is entitled to exempt certain property from its bankruptcy estate, and retain it post-bankruptcy. That property includes some or all of the Debtor's interest in its homestead. Although there are both federal and state exemptions, the extent of a Debtor's homestead exemption is typically determined by state law. In some states, the exemption is fairly minimal. In other states, however (Florida and Texas, for example), the homestead exemption is virtually unlimited.

Prior to the act, to use the exemptions of a particular state, a Debtor had to reside in that state for the greater part of the one hundred eighty (180) days prior to the bankruptcy filing. Under this regime, some wealthy Debtors moved to a state with an unlimited homestead exemption, converted all of their assets (exempt and non-exempt) into a home, waited ninety-one (91) days to file for bankruptcy, and retained all of the value of their assets as exempt while discharging their debts. Although several legal theories were developed to discourage and prevent this practice, no such theory was universally accepted as resolving this perceived abuse of the bankruptcy process.

Amendments

In the Act, limitations are placed on state homestead exemptions in two ways. First, to use the homestead exemption of a particular state, an individual Debtor must now reside in the state for the entire 730 day (two year) period prior to bankruptcy filing. If the Debtor has not lived in the same state during the entire 730 day period, then it may only use the state exemptions of the state in which it lived for the greatest portion of one hundred eighty (180) days prior to the 730 day period.

Second, even if a Debtor qualifies to use the more generous homestead exemption of a particular state, certain additional limits are placed on homestead exemptions. First, they are reduced by the value of any non-exempt assets converted to the homestead in the ten (10) years prior to the bankruptcy filing. Second, the exemption is limited to $125,000 plus the value of any homestead owned by the Debtor in the same state 1215 days (3 years plus 120 days) prior to the filing date. Finally, the exemption is limited to $125,000 for anyone convicted of, or owing obligations related to, a series of federal crimes.

Post-Bankruptcy Association Fees Not Dischargeable

Pre-Amendment Law

A post-bankruptcy fee or assessment due to a condominium association, a cooperative or a homeowners' association is not dischargeable in bankruptcy if the Debtor either physically occupied the dwelling unit or rented it to a tenant who paid rent during the assessment period.

Amendments

The Act removes the requirement that the Debtor either physically occupy the unit or have it rented to a tenant that paid rent during the assessment period. Instead, so long as the unit is owned by the Debtor or the Debtor has rights to possess it, the post-bankruptcy association fees and assessments cannot be discharged.

Discharge in only relevant in an individual bankruptcy case, and discharge objections must be filed and prosecuted in order to preserve the non-dischargeability of the associated claim. This limits the importance of this change, in light of the typical amount of these assessments relative to the cost of the required litigation. However, if an association has a large claim against an individual, this would be a helpful development for the association.

Endnotes

1 The amendments described herein do not go into effect until one hundred eighty (180) days from the date of the enactment of the Act (April 20, 2005), and then only apply in cases filed after that date, unless otherwise indicated herein.

2 The right to an administrative claim for the full rejection damages claim, and the inapplicability of the damages cap, were supported by case law but were not explicit statutory mandates.

3 "Single asset real estate" is defined in Section 101(51B) of the Bankruptcy Code as real property that constitutes a single property or project (other than residential property with less than 4 units), which generates substantially all of the gross income of the Debtor (who is not a family farmer) and on which no substantial business activities are conducted other than the operation of the real property and activities incidental thereto.

4 The changes described in this Section went into effect upon the enactment of the Act, with respect to cases filed on or after enactment.

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