community
BANKER

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Welcome to the latest issue of the COMMUNITY BANKER.

The Community Banker is prepared by attorneys at Olson & Burns P.C. to provide information pertaining to legal developments affecting the field of banking. In order to accomplish this objective, we welcome any comments our readers have regarding the content and format of this publication. Please address your comments to:

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The attorneys at Olson & Burns represent a wide range of clients in the financial and commercial areas. Our attorneys represent more than 30 banks throughout North Dakota.

A Chapter 11 Bankruptcy Can be a Not Awful Thing

A bankruptcy filing need not strike fear into the heart of a lender; in fact, sometimes the debtor's bankruptcy filing is better for the bank. That's because the debtor will be under the supervision of the bankruptcy court and has to answer to it. If the debtor files for Chapter 7 or 13, there will be a court-appointed trustee to keep an eye on the collateral. If the debtor files for Chapter 11, the debtor will be a debtor-in-possession and can continue to operate the business, but it also has certain fiduciary obligations – it can't just squander the assets. Additionally, though the trustee isn't running the business

(unless the court decides one should), the United States Trustee requires the debtor to submit monthly financial reports and other periodic reports concerning progress and developments in the case.

Be aware that most transactions conducted by the debtor-in-possession in the ordinary course of business do *not* require court approval; the discretion to act with regard to ordinary business matters without getting prior court approval is the most basic administrative power of the debtor-in-possession. The purpose of a reorganization under Chapter 11 of the Bankruptcy Code is to restructure the business' finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its shareholders. The general idea behind the chapter is that it is more economically efficient to reorganize than to liquidate because it maintains the business's going-concern value and sustains jobs and assets.

The bankruptcy may be especially a good thing if the lender doesn't trust the debtor's honesty or if the lender doesn't trust the debtor's management ability. While the management of a Chapter 11 debtor is typically left in possession to operate the business, the bankruptcy court can order the appointment of a "day-to-day" trustee upon request of a party if the oversight of a trustee is needed. A trustee would be needed where the current management of the debtor has been fraudulent or dishonest, or has grossly mismanaged the business. If a trustee is appointed, the management is ousted and the trustee is put in complete control of the business.

The Bankruptcy Code also provides creditors with a number of remedies that are not available under North Dakota law to keep the debtor in line. Another plus in a bankruptcy is that the debtor as a Chapter 11 debtor becomes a more attractive purchase for a prospective buyer, if necessary. From the perspective of a buyer, the sale of all or most of the debtor's assets usually is handled easier and safer through the bankruptcy court if the debtor is having financial difficulties.

Because the goal of a Chapter 11 is to maintain the status quo while permitting the reorganization, there are many varieties of defenses, moves and strategies a lender can employ. Some of the issues that a bank can focus on are (a) whether the secured asset is the only asset of the debtor; (b) whether there is a likelihood of a successful reorganization within a reasonable time; (c) whether rents or income produced by the secured assets are necessary to the continued operations or to a plan of reorganization; (d) whether relief from the stay or failure to get relief from the stay will actually hurt the bank; (e) whether optional relief such as dismissal or conversion, appointment of an examiner or trustee, is available; (f) whether a creditor's plan might emerge because of the debtor's inability to propose or carry out its plan; (g) whether the secured lender is a senior or junior lienholder; and (h) whether the debtor is a person, partnership, or corporation.

As in all bankruptcies, when a petition is filed, all creditor actions against the debtor and its assets are automatically stayed; this gives the debtor time to get its creditors together to discuss its financial issues and for negotiation. The automatic stay prevents creditors from going it alone to get an advantage over other creditors or to pressure the debtor into action.

As far as negotiating a workout agreement with a debtor in bankruptcy, the same considerations and strategies to a work out of a non-bankrupt entity apply. The major difference is that any agreement hashed out between the bank and the debtor has to be approved by the bankruptcy court, after notice and an opportunity for hearing is given to all creditors and other parties in interest. If the workout agreement is complex and covers all or nearly all of the debtor's assets, it might be wise to include the agreement in a Chapter 11 plan.

Single Asset Real Estate

A recent bankruptcy case we handled got us to thinking more about "single asset real estate" in a Chapter 11 bankruptcy.

In certain situations, a lender can get its real property collateral out of the borrower's bankruptcy case much faster when the borrower is a "single asset real estate entity." Under the Bankruptcy Code, the secured party may obtain relief from the automatic stay to foreclose on the real estate if the debtor fails to either (1) file a plan of reorganization within 90 days from filing the petition or 30 days after the court has determined that this is a single asset case, or (2) make specified monthly payments. 11 U.S.C. § 362(d)(3). The plan of reorganization must have a reasonable possibility of being confirmed within a reasonable time or the debtor must make monthly payments in an amount equal to the applicable non-default rate of interest on the value of the creditor's interest in the real estate. In other words, the single asset real estate borrower can't just hang out in a Chapter 11 bankruptcy case producing unconfirmable plans unless it pays the secured creditor a monthly amount equal (in most cases) to its interest payment under the lender's promissory note.

The benefits of a shorter bankruptcy case may be worth the effort to create or maintain "single asset real estate" status for the borrower through contract terms. (However, be aware that the bankruptcy court can wreck your planning and effort by conditioning or modifying the bankruptcy stay instead of lifting the stay. 11 U.S.C. § 362(d).)

The Bankruptcy Code defines "single asset real estate" as: (a) a single piece of real property or project (excluding residential property with fewer than four units); (b) which generates substantially all of the income for the debtor (who is not a family farmer); and (c) the company operates no substantial business other than operating the property or project. 11 U.S.C. § 101(51B).

The parties might litigate over whether a particular project generates most or all of the gross income of a debtor; resolving that question may turn on whether the income is passively received by the owner, like rents, or is the product of labor and effort, like a hotel that operates a restaurant and bar or a golf course with a restaurant and a pro shop. Also, whether the real property constitutes a single property or project may depend upon the connection among even non-contiguous parcels in a common plan of use. As a rule of thumb, hotels, resorts, restaurants, casinos, hospitals or other types of real estate with independent revenue streams typically do *not* qualify for single asset real estate status.

When a lender reviews the borrower's bankruptcy petition, it should check whether the borrower has ticked the box stating that it is a single asset real estate debtor. If a lender believes its borrower should have, but did not, declare its single asset real estate status, the lender should consider moving immediately to have the debtor designated as a single asset real estate entity in order to start the 90-day clock as soon as possible.

So, if you have a single asset real estate borrower (apartment owner, developer, mall owner, etc.), you may want to include among the loan documents the terms and promises described below to try to take advantage of a borrower's single asset real estate status:

- The borrower should represent and warrant that (a) its assets/collateral constitute "single asset real estate" within the meaning of 11 U.S.C. § 101(51B); (b) it shall not conduct substantial business on the collateral other than the business of operating the real property and incidental activities; and (c) every parcel within the collateral is linked by a common scheme or plan of use.

- The borrower should promise and agree that it shall not alter the conditions of the collateral regarding which it has represented and warranted.

- The borrower should represent and warrant that it consents to treatment as a single asset real estate entity in any bankruptcy case.

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