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REAL ESTATE ISSUES IN BANKRUPTCY

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Until recently, the real estate market had been remarkably resilient for the better part of the past ten years. During that time many real estate professionals were immersed in the structuring and documentation of real estate transactions without much need to focus on bankruptcy issues.

The recently roiling credit markets and the consequent reduction in both commercial and residential real estate values has resulted in a new interest in the impact of a bankruptcy filing upon real estate transactions. After a quick refresher course on bankruptcy basics, this presentation will address the impact that recent bankruptcy developments may have upon certain transactions that the real estate professional will likely have been involved in over the course of the last ten years.

I. General Bankruptcy Overview

A. Types of Bankruptcies

1. The Bankruptcy Code (Title 11 of United States Code ("Bankruptcy Code") provides for five different types of bankruptcies: Chapter 7 (liquidation), Chapter 9 (municipality), Chapter 11 (reorganization), Chapter 12 (farmers) and Chapter 13 (wage earners). Of the foregoing, Chapter 7 and Chapter 11 bankruptcies are relevant to this discussion.

2. Chapter 7 (Liquidation)

   a. In a Chapter 7, an independent "Chapter 7 trustee" is appointed to marshal Debtor's nonexempt assets, liquidate and distribute proceeds to holders of allowed claims.

   b. In a Chapter 7, the Debtor essentially relinquishes all of its assets to the Chapter 7 trustee, who liquidates those assets and distributes proceeds to creditors. Once all creditors are paid in full, the holders of equity interests are able to receive a return. Often (almost always), creditors receive pennies on the dollar, if anything at all, and equity security holders receive nothing.

3. Chapter 11 (Reorganization)

   a. In Chapter 11, the entity that filed for bankruptcy protection, known as the debtor ("Debtor"), continues to operate its business/property as a "debtor in possession."

   b. The goal of Chapter 11 is generally to propose a plan of reorganization under which debts will be paid in whole or in part over time.

B. Commencement of Bankruptcy Case

1. A voluntary bankruptcy case is commenced by the filing of a voluntary petition. 11 U.S.C. § 301. Upon the commencement of a voluntary bankruptcy case, an order for relief is automatically issued.

2. An involuntary case can be commenced against a debtor by three (3) or more unsecured creditors holding undisputed claims in the amount of at least $13,475. 11 U.S.C. § 303(b)(1).

   a. Upon the filing of an involuntary petition, an order for relief is not automatically issued. Instead, the alleged debtor has the right to contest the involuntary filing. If the debtor does not contest the involuntary filing, or if the Bankruptcy Court finds that the filing was appropriate, an order for relief will be issued. 11 U.S.C. § 303(h).

C. Property of the Estate

1. The commencement of a bankruptcy case creates an "Estate." 11 U.S.C. § 541(a).

2. The Estate includes all legal or equitable interests of the debtor in property as of the commencement of the bankruptcy case. 11 U.S.C. § 541(a)(1). Based on the inclusion of equitable interests in property in the Estate, this provision is very broad and far-reaching.

3. If an entity other than the debtor is in possession of property of the Estate, absent an order of the Bankruptcy Court, such entity is required to turn over the property to the Estate. 11 U.S.C. §§ 542, 543. This includes property held by a receiver appointed by the state court. 11 U.S.C. § 543.

D. Automatic Stay – 11 U.S.C. § 362(a)

1. The "automatic stay" is an injunction which prevents virtually all actions by creditors against Debtor and property of Debtor's Estate. See 11 U.S.C. § 362(a).

    a. Certain actions are not subject to the automatic stay, including, actions based on Police Power, criminal proceedings, and governmental audits. See 11 U.S.C. § 362(b).

2. The automatic stay is effective immediately upon the filing of a bankruptcy petition.

3. The automatic stay continues to be in effect during the bankruptcy case until the earlier of (i) plan confirmation, (ii) dismissal of case; or (iii) order of the Court granting relief from the automatic stay, such as pursuant to 11 U.S.C. § 362(d).

4. Actions taken in violation of the automatic stay are void and not voidable.[1]

5. In addition to being void, violations of the automatic stay are sanctionable.[2]

    a. An entity injured by any willful violation of the automatic stay shall recover actual damages, including costs and attorneys' fees and, in appropriate circumstances, punitive damages, from the party that engages in such violation(s).[3]

E. Powers of a Debtor in Possession

1. In Chapter 11, upon commencement of the case, the Debtor is called a "Debtor In Possession." The Debtor In Possession holds the same powers as a trustee in bankruptcy. 11 U.S.C. § 1107(a). The Debtor In Possession is a fiduciary of the Estate and its creditors.[4]

2. Notwithstanding the foregoing, any party in interest may seek an order of the Bankruptcy Court to appoint a trustee over the Debtor's Estate based on a variety of reasons, including, without limitation, the Debtor's fraud, incompetence or mismanagement. 11 U.S.C. § 1104. If such motion is granted, or if the Court, sua sponte, orders the appointment of a trustee, the Debtor is displaced as the manager of its Estate and is no longer a debtor in possession. As a result, the trustee, and not the Debtor, will marshal and control all assets of the Estate and will have the sole right to administer such assets. The Debtor,

[1] *In re Schwartz*, 954 F.2d 569 (9th Cir. 1992).
[2] *Fidelity Mortgage Investors v. Camelia Builders*, 550 F.2d 47 (2d Cir. 1976), *cert. den*. 429 U.S. 1093 (1977).
[3] *In re Goodman*, 991 F.2d 613 (9th Cir. 1993); *In re Pinkstaff*, 974 F.2d 113 (9th Cir. 1992).
[4] *In re Republic Financial Corp.*, 128 B.R. 793, 802 (Bankr. N.D. Ok. 1991).

however, still has the right to propose a plan of reorganization which, if confirmed by the Bankruptcy Court, will convey to the Debtor control of assets of the Estate.

II. "Recent" Developments Affecting Real Estate Practitioners.

A. 2005 Bankruptcy Code Revisions

The "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005" (commonly referred to as "BAPCA") went into effect on October 17, 2005. Although widely publicized as nothing more than a revision of the consumer bankruptcy system, the BAPCA revisions actually went much further. In fact, more than one-half of the nearly 200 pages of revisions addressed business bankruptcy issues. While most bankruptcy practitioners were critical of those revisions, it wasn't until the recent uptick in business bankruptcy filings that issues began to arise concerning the impact of those revisions upon reorganization prospects. The following is an analysis of the revisions most relevant to real estate practitioners and how those revisions have been recently addressed:

1. Limitation of Assumption/Rejection Period—Section 365(d)(4).

BAPCA amended section 365(d)(4) of the bankruptcy code to limit the number of extensions of the period within which a debtor in possession may assume, assume and assign, or reject an unexpired lease of non-residential real property. It now provides that the assumption/rejection period terminates upon the earlier of "(i) the date that is 120 days after the date of the order for relief; or (ii) the date of the entry of an order confirming the plan" and limits extensions to a single 90 day period after which a further extension can only be granted upon prior written consent of the lessor.[5]

This revision provides lessors with significant leverage in negotiations with a debtor, which often seeks to postpone the decision on what to do with its leases until the very end of the case or at least until it determines the size of the reorganized entity. Since a lessor's claim for damages upon the breach of a lease that has been previously assumed by a debtor is elevated to an administrative claim,[6] this revision helps lessors to play a more significant role in the course of a debtor's reorganization, particularly in bankruptcy cases of large retailers.

While it was once thought that this revision would permit landlords to control the reorganization process, the reduced negotiating leverage caused by a very soft commercial leasing environment has lessened the impact of these provisions. Landlords in many recent cases have accepted significant rent reductions, reduced or eliminated cure costs and even willingly accepted a debtor's assignee in order to keep premises occupied. An uptick in the commercial leasing market could return the negotiating leverage to landlords and permit them to significantly impact the course of retail bankruptcies.

2. Limitation of Administrative Claim for Rejection of Previously Assumed Lease—Section 503(b)(7).

Recognizing that the revision hastening the decision to assume or reject leases would give rise to an increased number of assumed leases that were ultimately rejected, the BAPCA revisions overruled that

[5] Under BAPCA, an order extending the period to assume or reject must be obtained before the end of the 120 day period. *In re Tubular Technologies, L.L.C.*, 362 B.R. 243 (D.S.C. 2006). Previously, it was sufficient for the debtor to have simply filed the motion prior to the expiration of the period to assume or reject. *In re Victoria Station Inc.,* 875 F.2d 1380 (9th Cir. 1989).

[6] A claim for damages arising from the termination of a lease of real property is an unsecured claim that is limited to the greater of one year's rent, or 15% of the remaining rent due under the lease, but such amount cannot exceed three year's rent. The extent and priority of a claim arising from the rejection of a lease that has been previously assumed is discussed in the following section.

portion of the *Nostas*[7] decision of the Second Circuit that held that a lessor's claim for future rent gave rise to an administrative claim that was not capped by section 502(b)(6). The amendment limits the amount of the administrative claim with respect to a lease that was previously assumed and then rejected to future rent "for the period of 2 years following the latter of the rejection date or the date of actual turnover of the premises." Mitigation principles apply, but only to the extent that the lessor actually receives rent from a nondebtor. Any additional rent due beyond two years is reduced to an unsecured claim under section 502(b)(6).

A significant portion of recent chapter 11 cases have entailed the sale of a debtor's assets to a third party that selectively assumes real property leases. As a result, the issue of defaulting upon an assumed lease has been relegated to an issue of less concern. Nevertheless, in the event of an economic uptick that returns value to leasehold estates and forces premature decisions concerning lease assumption, this provision could lessen the impact upon an estate if it is ultimately forced to reject a previously-assumed lease.

3. Elimination of Nonmonetary Defaults As An Impediment to Lease Assumption—Section 365(b)(1)(A) and 365(b)(2)(D).

In the late 1990s, a furor developed from the implications of what became known as the *Claremont Acquisition* case.[8] In that case, the Ninth Circuit prohibited a chapter 11 debtor from assuming and assigning a franchise agreement due to its inability to cure a nonmonetary default arising from its failure to operate the franchise in accordance with the agreement's "going dark" clause. When the *Claremont Acquisition* ruling was extended into the realm of real property leases, it became enough of an impediment to a debtor's reorganization efforts to be overturned by BAPCPA.[9] Thus, landlords cannot prevent the assumption and assignment of real property leases based upon the inability to cure a nonmonetary default, but upon assumption and/or assignment the debtor/assignee must begin performing all nonmonetary obligations under the lease at or after the time of assumption.[10]

While this revision preserves the value of real property leases for a bankruptcy estate, it appears that other valuable executory contracts (franchise agreements, for instance) cannot be assumed if there has been an incurable nonmonetary default. One issue likely to be addressed in the near term is that of how a franchise agreement coupled with a real property lease might be treated in this context. Now that the stage appears to be set for a number of hotel bankruptcies, the ability of a franchisor to pull its franchise from a hotel property might test the applicability of the BAPCA revisions.

[7] *Nostas Assoc. v. Costich (In re Klein Sleep Products, Inc.)*, 78 F.3d 18 (2d Cir. 1996).
[8] *Worthington v. General Motors Corp. (In re Claremont Acquisition Corp, Inc.),* 113 F.3d 1029 (9th Cir. 1997).
[9] : "Although [BAPCPA] was intended to overturn the result in *Claremont*, it does so narrowly. It applies only to real property leases. Personal property leases and non lease executory contracts are expressly excluded." Collier, p. 365.05[3][c].
[10] Amended 365(b)(1)(A) provides:
(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee–

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default other than a default that is a breach of a provision relating to the satisfaction of any provision (other than a penalty rate or penalty provision) relating to a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption, except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph[.]

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4. **Expansion of the Definition of Single Asset Real Estate—Section 101(51)(B).**

In the early 1990s, the bankruptcy courts were inundated with cases concerning apartment complexes and other primarily real-estate-driven entities. Those cases would commonly founder for many months and even years while the secured lender and the debtor battled over appraisal issues in both the relief from stay and the plan confirmation context. In order to address this issue, the bankruptcy code was revised in 1994 to apply special rules limiting the automatic stay in single asset real estate cases. Very few cases were impacted by that revision because the code limited the application of those provisions to entities that had secured debt of $4,000,000 or less.

BAPCA eliminated the $4,000,000 cap, thereby including among the single asset real estate provisions "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 who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental." 11 U.S.C. § 101(51)(B). As a result of these revisions, the applicability of the single asset real estate rules to real estate cases has become an often-litigated issue. Those rules require that in order to avoid termination of the automatic stay, a single asset real estate debtor must, within the latter of 90 days from the petition date, or 30 days after the court determines that the single asset real estate rules apply, either file a plan of reorganization or commence payments at the non-default contract rate of interest on the value of the creditor's interest in the real estate. 11 U.S.C. §362(d)(3).

While the definition of single asset real estate does exclude projects upon which a debtor operates a business "other than the business of operating the real property," the issue has been contested in a number of contexts. One case established that a hotel is not a "single asset real estate" debtor because it conducted enough business beyond the mere operation of the real property (room cleaning, telephone and internet services, and food service).[11]

In another case pending in the Central District of California, *In re Meruelo Maddox Properties, Inc.*, Judge Kathleen Thompson addressed the application of the single asset real estate provisions in the context of the jointly-administered cases of 54 related debtor LLC entities, the majority of which held one or more commercial real estate properties as its sole asset. Citing *In the Matter of Scotia Pacific Company, LLC,*[12] Judge Thompson concluded that the single asset real estate provisions of the bankruptcy code do not apply because "it is reasonable to presume that there is historical synergy in the whole enterprise that benefits the holding of each individual debtor and that effective reorganization in these chapter 11 cases requires a unified approach in developing a plan or plans to present for confirmation."[13] Although one or more of Judge Thompson's orders on this issue have been appealed (and this author takes no position on the likelihood of success of these appeals), it does appear that bankruptcy courts are recently taking a more restrictive position on the issue of the applicability of the single asset real estate provisions.

[11] *In re Whispering Pines Estate, Inc.,* 341 B.R. 134 (Bankr.D.N.H. 2006).

[12] "Each element must be met to be considered a single asset real estate debtor, i.e.. (1) the debtor must have real property constituting a single property or project, other than residential real property with fewer than 4 residential units; (2) which generates substantially all of the gross income of a debtor; and (3) on which no substantial business is being conducted other than the business of operating the real property and activities incidental thereto." 508 F.3d 214, 220 (5th Cir. 2007)

[13] Memorandum On Debtor's Motion For Order Determining That The Debtors Are Not Subject To Provisions Applicable to Entities With Single Asset Real Estate, entered June 17, 2009 in the pending jointly-adminstered cases of *In re Meruelo Maddox Properties, Inc.* Docket numbers 310-315 include the court's ruling on this and other related issues.

5. Inclusion of Post-Petition Income Among Property of An Individual Chapter 11 Debtor's Estate.

BAPCA added §1115 to the bankruptcy code, which specifically includes post-petition income of an individual debtor among the property of a chapter 11 estate. While seemingly innocuous on its face, this revision has raised a number of issues that impact both reorganization and collection efforts:

Cramdown: Since inclusion of post-petition income among the assets of an individual's estate would negatively impact the ability to provide new value, BAPCA also revised §1129. Some cases have interpreted the revisions contained in §1129, to eliminate the applicability of the absolute priority rule in an individual chapter 11 case.[14]

Nondischargeability: It has long been established that fees incurred in defending a non-dischargeability action are not compensable from the assets of the estate.[15] Now that an individual debtor's post-petition income is included among property of the estate, what assets can be used to defend a nondischargeability action? Given this revision, creditors seeking to collect on an obligation owed by an individual debtor might gain significant negotiating leverage if a nondischargeability action is pursued in the bankruptcy case of an individual chapter 11 debtor.

B. Other Developments With Bankruptcy Implications.

1. Limited Liability Companies.

Although the first LLC statute was adopted in the Wyoming in 1977, LLCs were relatively unknown until the IRS ruled in 1988 that it would classify a Wyoming LLC as a partnership for tax purposes. By August, 1996, every state and the District of Columbia had enacted LLC statutes. Since then, LLCs have been commonplace vehicles for real estate transactions.

Surprisingly, LLCs don't fit squarely within any of the entity-specific definitions under the bankruptcy code. As defined in the Code, a "corporation" includes an "association having a power or privilege that a private corporation, but not an individual partnership, possesses;" a "partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association;" and, an "unincorporated company or association," but does not include a "limited partnership." 11 U.S.C. §101(9). Although an LLC appears to be a corporation under this definition, they do have a number of characteristics in common with general and limited partnership, the latter of which is expressly excluded from the definition of a corporation under the Code.

Nevertheless, LLCs that have filed for bankruptcy have nearly always been treated like a corporation—its members are not individually liable for the debts of the LLC, and a bankruptcy filing can be effectuated either by the action of its managing member or by its members depending upon the LLC's operating agreement. Other issues concerning the impact of a bankruptcy filing upon LLCs remain unsettled.

One such issue is the effect of a bankruptcy filing by an individual member of an LLC. Issues of whether a bankruptcy filing by an individual member should cause a dissolution of the LLC and the impact of a bankruptcy filing upon the debtor member's rights to manage the LLC still have not been uniformly

[14] §1129(b)(2)(B)(ii) provides that "the holder of any claim interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property *except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14)*. The courts in *In re Roedemeier*, 364 B.R. 264 (Bankr. D. Kan. 2007), and *In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007) have been cited for the proposition that., when combined with the revision in §1129(15), an individual debtor's plan should be exempt from the absolute priority rule.

[15] *In re Weingarden*, 84 B.R. 691, 693 (Bankr. S. D. Cal. 1988); *In re Robbins, Jr.*, 151 B.R. 364, 366-367 (Bankr. W.D. VA. 1993)

decided.[16] Another issue that remains open, that of the ability to "bankruptcy proof" LLCs, is discussed later in these materials.

2. Lease Designation Rights.

In 2002, the relatively unknown concept of the sale of lease designation rights gained significant notoriety in the case of *In re Ames Department Stores*.[17] There, the bankruptcy court expanded the right of a debtor to assume and assign leases to include the right to sell that right to third parties by determining there is nothing in bankruptcy or non-bankruptcy law that prohibited this means for making the underlying economic value in leases available for the benefit of creditors.

Although the sale of designation rights quickly became a permanent part of the chapter 11 landscape, the BAPCA revisions eliminating indefinite extensions of the period in which to assume or reject will likely reduce the utility of this tactic. Since lessors must now give consent to any extension beyond 210 days after the petition date, debtors will likely be required to consult with and involve landlords in any designation rights sales because that procedure generally cannot be completed within a seven month time frame. The requirement that the trustee must begin performing all nonmonetary obligations under the lease at or after the time of assumption is also an impediment to designation rights because the procedure often permitted the lease rights designee to continue to ignore non-monetary defaults (such as "going dark" provisions) until such time as an assignee could be approved by the bankruptcy court.

3. Bankruptcy Hindrance Mechanisms: Can an Entity Be Prevented From Filing a Bankruptcy Petition?

A "hindrance mechanism" is any sort of contractual device between the debtor and a creditor that seeks to prevent the filing of a voluntary bankruptcy petition. The purpose of these provisions is to allow creditors to repossess their collateral prior to a bankruptcy filing.

Although a number of courts have held various hindrance mechanisms to be unenforceable, the practice has become increasingly prevalent over the past several years and, given the strong real estate market since then, there have been few cases addressing this issue. Nevertheless, the case law remains pretty strongly against these mechanisms.[18]

The rationale for prohibiting these mechanisms was succinctly stated by the bankruptcy court in *In re 203 North LaSalle Street Partnership*: "since bankruptcy is designed to produce a system of reorganization and distribution different from what would be obtained under nonbankruptcy law, it would defeat the purpose of the Code to allow parties to provide by contract that the provisions of the Code should not apply.[19]" That rationale was applied in a very detailed decision by Judge Tina Brozman in the *Kingston Square Assocs.* case. There, the court addressed the enforceability of bankruptcy remote vehicles—corporate entities with governing documents calculated to prevent a bankruptcy filing. Before lending approximately $277 million to thirty-eight different related entities, a financial institution required those entities to amend their by-laws to condition a bankruptcy filing upon unanimous consent of the board and required the appointment of an independent director who was to be appointed by the financial institution. The bankruptcy court denied a motion to dismiss a bankruptcy filing by these entities (which

[16] *In re Daugherty Constr.,* 188 B.R. 607 (Bankr.D. Neb. 1995); *Broyhill v. DeLuca (In re DeLuca)*, 194 B.R. 65 (Bankr.E.D.Va. 1996); *JTB Enterprises v. D & B Venture (In re DeLuca),* 194 B.R. 79 (Bankr.E.D.Va. 1996); *Allentown Ambassadors, Inc. v. Northeast American Baseball, LLC (In re Allentown Ambassadors, Inc.),* 361 B.R. 422 (Bankr. E.D.Pa. 2007); *Movits v. Fiesta Invs., LLC (In re Ehmann),* 319 B.R. 200 (Bankr.D. Ariz. 2005).
[17] 287 B.R. 112 (S.D.N.Y. 2002).
[18] See, e.g., *In re Kingston Square Associates,* 214 B.R. 713 (Bankr.S.D.N.Y. (1997).
[19] *In re 203 North LaSalle Street Partnership,* 246 Bankr 225, 231 (Bankr. N.D. Ill. 2000).

was engineered by the principal of all of the entities despite the by-law prohibitions), and appointed a trustee due to the board's failure to adhere to its fiduciary responsibilities.

The bankruptcy hindrance mechanism has been employed with increased sophistication in recent years in the corporate, LLC and partnership context. The changing nature of the real estate market should cause this issue to be heavily litigated in bankruptcy courts over the next few years.

III. A Bankruptcy "Twist" On Five Issues Likely To Have Recently Been Addressed By Real Estate Practitioners.

A. Acquisition of Property.

The current economic client is likely to engender the distressed sale of real estate from bankruptcy estates. The bankruptcy code authorizes debtors to sell assets "free and clear of all liens and interests" in certain circumstances (11 U.S.C. §363). The mechanism for sales out of bankruptcy estates is quite flexible, but always requires such sales to be subject to overbid.

The most recent significant development in the Ninth Circuit on this issue is the ruling in *In re Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)* in which the Bankruptcy Appellate Panel held in part that: (1) Section 363(f)(3) permits a sale free and clear of junior liens only if the price paid is equal to or greater than the aggregate amount of all liens held against the property; and (2) Section 365(f)(5) permits a sale free and clear of junior liens only if a legal or equitable proceeding could force the junior lienholder to accept a money judgment (but that proceedings such as a cram down chapter 11 plan cannot qualify as such legal or equitable proceedings).[20]

While the *Clear Channel* decision could impact the utility of §363 sales, a recent decision from the Western District of Washington limited the application of *Clear Channel*.[21] If courts follow the lead of the court in *Jolan* and opt to limit *Clear Channel* to its specific facts, free and clear sales in the Ninth Circuit are likely to remain an often used bankruptcy tactic.

B. Relief From Stay in the Bankruptcy Case of Junior Lienholders.

While a senior lender is nearly always highly attuned to a borrower's bankruptcy status, it is far less common to investigate the status of junior lienholders. In today's market, however, the need to determine whether junior lienholders are the subject of a pending bankruptcy case is also of paramount importance.

Although some courts have taken the position that the minimal nature of a junior lienholder's subordinate lien rights in real property are outside the scope of the automatic stay, courts in the Ninth Circuit are consistent in holding the contrasting view. As a result, it is necessary to obtain relief from stay in the pending bankruptcy case of a junior lienholder.[22] Failure to obtain relief from stay in the bankruptcy case of a junior lienholder before foreclosing could void the entire sale.[23]

C. 1031 Exchanges.

Investors commonly decide to sell an investment property and re-invest in another property. Savvy investors know they can defer the capital gains taxes by using the 1031 Tax-Deferred Exchange. Many

[20] 391 B.R. 25 (9th Cir. BAP 2008).
[21] *In re Jolan*, 2009 Bankr. Lexis 928 (Bankr. W.D. Wash. April 30, 2009).
[22] *In re Stanton*, 248 B.R. 823 (BAP 9th Cir. 2000), *aff'd* 285 F.3d 288 (9th Cir. 2002).
[23] *40235 Washington Street Corporation v. Lusardi*, 329 F.3d 1076, 1078 (9th Cir. 2003, *cert. denied,* 540 U.S. 983 (2003).

real estate practitioners have been inundated with 1031 exchanges by owners of tenant-in-common property interests ("TICs") since 2002, when the IRS issued guidelines that qualified TICs as "like-kind" properties eligible for use in 1031 tax exchanges.

Since the "qualified intermediary"("QI")[24] business is relatively unregulated and hundreds of independent QIs have recently sprung up across the country,[25] Bankruptcy can magnify the risk associated with 1031 exchanges. Recently, two high profile bankruptcy cases involving QIs have made real estate professionals more aware of the risk that can be associated with the use of QIs. The bankruptcy case of the 1031 Tax Group and related entities that is currently pending before the bankruptcy court in the Southern District of New York [Case No. 07-11448(MG)] concerned allegations that the company's owner, Edward Okun created affiliated entities that borrowed money from QIs and squandered those funds on corporate jets and other extravagances. Although the bankruptcy court denied a motion to appoint a trustee, Mr. Okun has relinquished control of the entities and has reached agreements with creditors sufficient to permit the recent approval of a plan of reorganization. In addition, a federal case currently pending in Los Angeles concerning Southwest Exchange, Inc. and Qualified Exchange Services, Inc., both entities controlled by Donald McGahn, alleges the misappropriation of more than $95 million in customer proceeds to fund other businesses and personal activities.

D. Restructuring Tenant In Common Interests.

Another difficulty posed by TIC interests involves a restructuring of the debt secured by the underlying real property where only a portion of the TIC members have filed for bankruptcy protection. The challenge for the debtor and the Bankruptcy Court involves dealing with the complexities of restructuring the entirety of the debt where only a portion of the real property is under the jurisdiction of the Bankruptcy Court. Typically, the bankruptcy case is commenced by the entity that retained the management rights with respect to the property, and this entity may hold only a slim percentage of the TIC interests. The other TIC members, who are typically passive investors, either individually or through entities, may have their rights significantly altered or may be able to block the reorganization attempts.

Recently, the debtors in *In re GTS Property Portfolios, LLC*, Case No. 2:09-bk-14774 (Bankr. C.D. Cal.), were able to confirm a joint plan of reorganization over the objections of the secured lender in a case that involved TIC interests held by four separate entities in a portfolio of nine apartment complexes in Texas, Florida and South Carolina. This resolution required the acquisition of the two non-debtor TIC entities and then the subsequent commencement of cases by those entities. TIC interests played a significant role of a prominent Northern California developer in the bankruptcy case of *In re Benjamin S. Catlin*, Case No. 09-43616-C-11 (Bankr. E.D. Cal.), which ultimately saw a myriad of TIC interests transferred into a liquidating trust to be monetized following confirmation of the chapter 11 plan. The ability to restructure TIC interests ultimately will depend on the documents used in establishing such interests, the rights and remedies of the respective debtor and non-debtor parties and the relative bargaining strength of each TIC member. Lenders can certainly take advantage of this difficulty throughout the bankruptcy case.

IV. Conclusion.

The current economic climate and foundering real estate market makes it extremely likely that the real estate practitioner will need to become familiar with bankruptcy issues that haven't often been addressed over the course of the last several years. Hopefully, this presentation will have helped gird the real estate practitioner with the knowledge necessary to spot these issues and to adequately address them.

[24] QIs are also often referred to as "facilitators" or "accommodators".

[25] Recent developments have resulted in a move to tighten the regulation of this industry. Several well-qualifed QIs do exist, but as always the real estate professional must do its due diligence before recommending any such entity.