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A legal update from Dechert's Finance and Real Estate Group

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Select Bankruptcy Cases Impacting Commercial Real Estate Finance and Securitization

Several recent court decisions have had a significant impact on the finance and real estate industry. These decisions have dealt with issues involving the enforceability of repurchase agreements; waiver of the automatic stay; substantive consolidation in complex transactions; recourse carveout liability; secured creditors' ability to recover prepayment fees, attorneys' fees, and late fees; landlord damage claims; "true leases" of real estate; bankruptcy filings by U.S. based foreign hedge funds; "single asset real estate" entities; and co-lender claims under intercreditor agreements. This article discusses these cases, highlighting their relevance to today's securitized finance and real estate industry.

Enforceability of Repo Agreements

A bankruptcy court determines that a contract for the sale and repurchase of mortgage loans constitutes a "repurchase agreement" as defined in Section 101(47) of the Bankruptcy Code and the "safe harbor" provisions of Sections 555 and 559 of the Bankruptcy Code are applicable; however, the safe harbors do not apply to the servicing rights for the mortgage loans.

In re American Home Mortgage, Inc., No. 07-11047, 2008 WL 60292 (Bankr. D. Del. Jan. 4, 2008)

In November 2006, a number of secured creditors entered into a repurchase agreement (the "Repo Agreement") with the borrowers that provided for the transfer of mortgage loans from the borrowers to the secured creditors in exchange for a payment from the secured creditors. The secured creditors were then to re-transfer the mortgage loans to the borrowers no later than 180 days after the initial transfer, upon payment of a repurchase price equal to the original price paid to the borrowers plus the "pricing differential," a per diem "pricing rate" multiplied by the number of days the mortgage loans were held by the secured creditors. The Repo Agreement also provided that the mortgage loans were sold to the secured creditors on a "servicing retained" basis, in which the borrowers retained the right to designate the mortgage loan servicer.

In August 2007, the borrowers filed a Chapter 11 bankruptcy petition. Subsequently, the secured creditors filed a complaint against the borrowers seeking, among other things, (i) a declaratory judgment that the Repo Agreement was a "repurchase agreement" as defined in the Bankruptcy Code and that, pursuant to Sections 362(B)(7), 555 and 559 of the Bankruptcy Code, the rights of the secured creditors to sell the mortgage loans under the Repo Agreement were not stayed, and (ii) injunctive relief compelling the borrowers to transfer the servicing rights to the mortgage loans to the secured creditors.

In analyzing the secured creditors' claim, the court articulated five specific factors that characterize repurchase agreements entitled to the "safe harbor" provisions of the Bankruptcy Code, which exempt the exercise of certain contractual rights to liquidate, terminate, and accelerate repurchase agreements from the bankruptcy automatic stay and avoidance powers. The court explained that such a repurchase agreement: (1) provides for the transfer of one or more mortgage loans or interests

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in mortgage related securities or mortgage loans; (2) against the transfer of funds by the transferee of such mortgage loans or interests in either mortgage related securities or mortgage loans; (3) with a simultaneous agreement by such transferee to transfer to the transferor thereof mortgage loans or interests in either mortgage related securities or mortgage loans; (4) at a date certain not later than 1 year after such transfer or on demand; and (5) against the transfer of funds.

The court found that the first factor was fulfilled, since the Repo Agreement provided for the transfer of multiple mortgage loans or interests in mortgage loans. The court noted that even if the Repo Agreement provided for the creation of a lien on the mortgage loans, it would still constitute a "transfer" under 11 U.S.C. §101(54). With respect to the second factor, the court determined that the transfer from the borrowers to the secured creditors was against the transfer of funds from the secured creditors to the borrowers. Additionally, the Repo Agreement contained a concurrent agreement by the secured creditors to transfer the mortgage loans to the borrowers that, according to the court, fulfilled the third factor. With respect to the fourth factor, the court concluded that this factor was satisfied, as the re-transfer of the mortgage loans from the secured creditors to the borrowers was to occur within 180 days of the original transfer. Finally, as the transfer of the mortgage loans from the secured creditors to the borrowers was against the transfer of funds by the borrowers to the secured creditors, the final factor was fulfilled. Thus, the court held that the sale and repurchase of the mortgage loans under the Repo Agreement was a repurchase agreement entitled to the "safe harbor" provisions of the Bankruptcy Code.

With respect to the transfer of the servicing of the mortgage loans under the Repo Agreement, however, the court found that the safe harbor provisions were inapplicable for two reasons: (i) the portion of the Repo Agreement that provided for the servicing of the mortgage loans was severable from the portion of the Repo Agreement providing for the sale and repurchase of the mortgage loans; and (ii) the portion of the Repo Agreement providing for the servicing of the mortgage loans was neither a "repurchase agreement" (under 11 U.S.C. §101(47) (2005)), nor a "securities contract" (under 11 U.S.C. §741(7)(a)(i) (2005)). Based on this finding, the court held that the borrowers were not required to transfer the right to service the mortgage loans under the Repo Agreement to the secured creditors.

This decision is of importance for repurchase lenders ("Repo Lenders") to a mortgage lender entering bankruptcy because a bankrupt mortgage lender is unlikely to have the funds necessary to buy back its loans, and the Repo Lender will likely sell the collateral loans to third-party buyers. The ability to sell these loans for an adequate price, however, is compromised if the Repo Lender is not able to sell these loans with their attendant servicing rights. ■

Forbearance Agreements: Enforceability of Waivers of the Right to the Automatic Stay

A bankruptcy court finds that a waiver of the automatic stay in a forbearance agreement is not per se unenforceable, after conducting an analysis of the following ten factors: (i) the sophistication of the party making the waiver, (ii) the consideration given for the waiver, (iii) whether other parties are affected, including unsecured and junior creditors, (iv) the feasibility of the debtor's plan, (v) whether there is evidence of coercion, fraud, or mutual mistake of material facts, (vi) whether enforcing the agreement would further the public policy of encouraging out of court settlements, (vii) the likelihood of reorganization, (viii) the extent to which failure to enforce the agreement would prejudice the creditor, (ix) the proximity in timing between the waiver and the bankruptcy filing and whether there was a compelling change in circumstances during that time, and (x) whether the debtor has equity in the property and the creditor is otherwise entitled to relief from the stay under Section 362(d).

In re Frye, 320 B.R. 786 (Bankr. D. Vt. 2005)

A bank entered into a forbearance agreement with a borrower as consideration for a voluntary dismissal of the borrower's Chapter 13 bankruptcy case. In the forbearance agreement, the borrower agreed to allow the bank to seek relief from the automatic stay in any subsequent bankruptcy proceeding involving the borrower. Under the terms of the forbearance agreement, the borrower was required to sell certain portions of its land and use the proceeds to redeem the mortgaged property from the bank. The redemption date was extended several times by mutual agreement of the parties.

On the third redemption date, however, the borrower filed another Chapter 13 bankruptcy case. The bank responded by requesting relief from stay in

accordance with the forbearance agreement, and the borrower objected.

The court found that the waiver of the right to the bankruptcy automatic stay in the forbearance agreement was not *per se* unenforceable. The court distinguished this case from one in which the waiver of the automatic stay was inserted into the original loan documents. In those cases, the waiver would be *per se* unenforceable, meaning that there would be no circumstance under which such a waiver could be enforced.

According to the court, a waiver of the automatic stay will only be enforceable if the equities of the situation favor enforcement. The court explained that such an inquiry requires an analysis of the following ten factors:

(i) the sophistication of the party making the waiver;

(ii) the consideration given for the waiver;

(iii) whether other parties are affected, including unsecured and junior creditors;

(iv) the feasibility of the debtor's plan;

(v) whether there is evidence of coercion, fraud, or mutual mistake of material facts;

(vi) whether enforcing the agreement would further the public policy of encouraging out of court settlements;

(vii) the likelihood of reorganization;

(viii) the extent to which failure to enforce the agreement would prejudice the creditor;

(ix) the proximity in timing between the waiver and the bankruptcy filing and whether there was a compelling change in circumstances during that time; and

(x) whether the debtor has equity in the property and the creditor is otherwise entitled to relief from the stay under Section 362(d).

The court ultimately determined that the equities weighed in favor of enforcing the waiver provision in the forbearance agreement unless the borrower could demonstrate that there was (i) equity in the property, (ii) a likelihood that the borrower would effectively reorganize, or (iii) sufficient prejudice to other creditors to outweigh the bank's right to relief from the automatic stay.

This case is significant in that the court did not find the contractual waiver of the automatic stay *per se* unenforceable, and was willing to enforce such a waiver in a negotiated workout context. ■

Substantive Consolidation

The Third Circuit addresses the standard for substantive consolidation, discarding the use of a "checklist of factors" in favor of employing five principles to be advanced by substantive consolidation.

In re Owens Corning, 419 F.3d 195 (3d Cir. 2005)

A pre-bankruptcy syndicate of lenders extended a two billion dollar loan to a parent company, which included guarantees by certain subsidiaries. After filing for bankruptcy, the companies sought substantive consolidation of the assets and liabilities of the parent and its subsidiaries. The lenders opposed the consolidation.

The lower court granted substantive consolidation. The U.S. Court of Appeals for the Third Circuit reversed, and in doing so articulated a new standard for determining under what circumstances a court may substantively consolidate affiliated entities. The court rejected the use of a "checklist of factors" as insufficient. According to the court, it is often unclear what weight should be given to each such factor, and when using a "checklist," bankruptcy courts can lose sight of the policy rationale behind substantive consolidation.

Instead, the Third Circuit explained that bankruptcy courts must keep a "steady eye" on the principles to be advanced by substantive consolidation. Those principles are:

(i) respecting the general rule of entity separation absent compelling circumstances;

(ii) that the harms substantive consolidation addresses are nearly always caused by

debtors who disregard entity separateness;

(iii) mere administrative ease is not a sufficient harm to call substantive consolidation into play;

(iv) since substantive consolidation is extreme and imprecise, its use as a remedy should be rare and of last resort, after considering and rejecting other remedies; and

(v) substantive consolidation should not be used offensively, (*i.e.*, having the primary purpose of tactically disadvantaging a group of creditors, or altering creditor's rights).

The court went on to hold that in order to prevail on a request for substantive consolidation, the proponents must prove that either (i) prior to the filing of the bankruptcy petition, the entities disregarded separateness so significantly that their creditors relied on the unity of the two entities and treated them as one legal entity, or (ii) post-petition, their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.

In this case, the Third Circuit found that there was no pre-petition disregard of corporate separateness. In fact, the lending transaction was premised on the separateness of the company's affiliates. Additionally, the Third Circuit found that there was no hopeless commingling post-petition.

In its decision, reversing the lower court's order granting substantive consolidation, the Third Circuit specifically found that the district court had erred in its determination that the commingling of assets justified consolidation because the affairs were so entangled that consolidation would have been *beneficial*. According to the Third Circuit, the beneficial nature of substantive consolidation is only a justification when *every* creditor will benefit, not when consolidation merely provides benefit to *some* creditors.

The Third Circuit reviews a district court's application of the Owens Corning *test in the case of* In re Lisanti Foods*, and finds sufficient evidence to satisfy the first prong of the* Owens Corning *test and grant substantive consolidation.*

In re Lisanti Foods, 241 F.App'x 1 (3d Cir. 2007)

In its review of a district court's application of the *Owens Corning* test, the Third Circuit held that substantive consolidation was properly granted under the first prong of the test because the evidence established substantial identity among the borrowers. Specifically, the court pointed to the fact that all three borrowers

(i) had the same directors, officers, and shareholders;

(ii) conducted the same general business operations under very similar names;

(iii) engaged in intercompany dealings with each other without the usual corporate formalities;

(iv) did not charge each other for all services which they rendered to one another; and

(v) moved profits between and among each other.

Additionally, witnesses testified that for the purposes of secured and unsecured lending, the borrowers were viewed as a single entity when credit terms were extended. According to the Third Circuit, these facts were sufficient to satisfy the first prong of the *Owens Corning* test, and grant substantive consolidation.

The Fifth Circuit reverses a bankruptcy court's order for substantive consolidation.

In re Amco Insurance, 444 F.3d 690 (5th Cir. 2006), *cert. denied*, 127 S.Ct. 389 (2006)

An individual, Rehmat Peerbhai, owned and managed two companies: AIG and AIA. Wells Fargo agreed to make loans to both AIG and Peerbhai, but required Peerbhai to personally guarantee AIG's obligations. After defaulting on the loan, AIG and AIA declared bankruptcy and Wells Fargo sought relief from the automatic stay to pursue state court litigation. The bankruptcy court granted a partial lifting of the stay, expressly permitting Wells Fargo to pursue state court remedies against Peerbhai individually. Ultimately, Wells Fargo and Peerbhai entered into a forbearance agreement and agreed to a settlement amount.

A few months later, the bankruptcy trustee filed an application for substantive consolidation, seeking to

consolidate AIA and Peerbhai as a single debtor in bankruptcy. At the time, Peerbhai was not in bankruptcy. The bankruptcy trustee argued that the finances of AIG, AIA, and Peerbhai were so commingled that the only equitable distribution was substantive consolidation. The bankruptcy court agreed and granted substantive consolidation retroactively.

The U.S. Court of Appeals for the Fifth Circuit reversed, holding that by granting Wells Fargo partial relief from the automatic stay, the bankruptcy court "explicitly authorized and consented to Wells Fargo's pursuit of state court remedies against Peerbhai." In granting the subsequent motion for substantive consolidation, the bankruptcy court "sought to undo what [it] had earlier specifically authorized by applying the consolidation of the estates [retroactively]."

While the Fifth Circuit declined to address Wells Fargo's argument regarding the bankruptcy court's power to grant substantive consolidation, the court noted that the jurisdictions that have allowed substantive consolidation have emphasized that it be used sparingly and, citing *In re Owens Corning*, further noted that substantive consolidation should only be used as a last resort after considering and rejecting other remedies.

These decisions are significant in light of the continued importance of the issue of substantive consolidation in complex real estate transactions. ■

Recourse Carveout Liability

A district court imposes personal liability on the guarantors of a thirty-three million dollar non-recourse loan for violating the terms of the guaranty by permitting the borrower to jeopardize its status as a single purpose entity.

Blue Hills Office Park LLC v. J.P. Morgan Chase Bank, 477 F. Supp. 2d 366 (D. Mass. 2007)

In a complicated commercial lending case, involving a thirty-three million dollar non-recourse loan, the district court imposed personal liability on the guarantors under the terms of a recourse carveout guaranty.

Under the terms of the guaranty, the occurrence of certain events, including the failure of the borrower to maintain its status as a single purpose entity, triggered personal liability for the guarantors for the full amount of the loan. According to the court, the borrower failed to maintain its single purpose entity status by (1) commingling funds, (2) making it costly and difficult to segregate, ascertain, or identify its individual assets from those of its affiliates, and (3) failing to at all times have a participating independent director. In particular, with regard to the first two violations, the court noted the fact that the borrower had transferred a two million dollar settlement payment to an account which already held funds owned by the guarantors, and to which they had complete access. Additionally, with regard to the third violation, the court explained that the individual who was expected to serve as the independent director did not participate in the management of the borrower entity in that capacity.

This decision is significant because the court upheld the loan document requirements of separateness, and imposed full liability for the unpaid indebtedness on the guarantors. ■

Allowance of Prepayment Fees, Attorneys' Fees, and Late Fees

The First Circuit permits a commercial lender to receive a bargained-for prepayment fee as an unsecured claim from a solvent debtor.

Gencarelli v. UPS Capital Business Credit (In Re Gencarelli), 501 F.3d 1 (1st Cir. 2007)

In 2002, a borrower and his company entered into a pair of secured commercial loan agreements, each containing a prepayment fee clause. In 2004, the borrower and his company filed for bankruptcy, and sold the business in the course of the bankruptcy proceedings. The sale was successful, raising funds sufficient to pay all creditors in full, with a multimillion dollar surplus for equity. The secured lender was paid in full with interest, but the borrower objected to payment of prepayment fees.

In a case of first impression in the First Circuit, the Court of Appeals ruled that a commercial lender had a right to receive a bargained-for prepayment fee from a solvent debtor. The court agreed with the prior ruling of the bankruptcy court that the creditor was

precluded from collecting the prepayment fee as a component of its secured claim under Section 506(b) of the Bankruptcy Code, because the prepayment fee could not be considered a "reasonable fee." Nevertheless, the court determined that an oversecured creditor may be entitled to collect a prepayment fee as the functional equivalent of unsecured debt under Bankruptcy Code Section 502.

The court reasoned that Bankruptcy Code Section 502, not 506(b), governed the ultimate test for allowability and, at the very worst, an oversecured creditor's claim for a prepayment fee should be collectible as an unsecured claim. The court explained that Section 506(b) is designed to protect general creditors from the inequities that would occur if secured creditors were able to cloak unreasonable fees and charges with secured priority. According to the court, however, it did not make sense that oversecured creditors should be penalized by disallowing such fees and charges altogether, especially when unsecured creditors can collect them pursuant to Section 502.

This case is significant because although it disallowed a prepayment fee as part of a secured claim under Bankruptcy Code Section 506(b), which is an unfortunate result for lenders, it provided a possible method to recover such amounts as an unsecured claim under Section 502.

The Third Circuit disallows a lender from collecting the balance of attorneys' fees from a foreclosure proceeding in a bankruptcy proceeding.

Youngman v. Fleet Bank, N.A. (In re A&P Diversified Technologies Realty, Inc.), 467 F.3d 337 (3d Cir. 2006)

In this case, a mortgage between a borrower and lender provided that the borrower would pay the reasonable attorneys' fees of the lender. The borrower defaulted on its loan, and the lender instituted a foreclosure action. The borrower responded by filing for bankruptcy, thereby staying the foreclosure proceeding. The lender was granted relief from stay and obtained a final judgment for the property in the foreclosure proceeding, including an award of $7,500 in attorneys' fees, an amount limited by state law.

The lender then sought to collect the balance of its attorneys' fees in the bankruptcy, pursuant to its rights under the mortgage and Bankruptcy Code Section 506(b). Section 506(b) permits the holder of a secured claim to collect any reasonable fees, costs, or charges provided for pursuant to the agreement under which such claim arose. The bankruptcy court found that Section 506(b) was applicable, and awarded the lender's attorneys' fees in the amount of $304,181.45 and expenses in the amount of $32,772.43.

The Third Circuit reversed the lower court, holding that both the note and mortgage that had provided for the payment of attorneys' fees were extinguished when the final judgment of foreclosure was entered. The court explained that under the merger doctrine, a contract is deemed to merge with a judgment thereon, thereby precluding the lender from asserting claims based on the original terms and provisions of the contract. Accordingly, once the foreclosure judgment was entered, the mortgage was no longer an enforceable agreement between the two parties because it had ceased to exist. Therefore, the lender was no longer the beneficiary of the agreement under which the claim for attorneys' fees arose, and as a result there was no longer any contractual basis for the award of attorneys' fees under Section 506(b).

A bankruptcy court distinguishes the facts before it from the precedent set forth by the Third Circuit in In re A&P *to allow the lender to recover post-foreclosure attorneys' fees, interest, and late fees.*

In re Price, 361 B.R. 68 (Bankr. D.N.J. 2007)

In this case, a borrower executed and delivered a secured note to a creditor in the original principal amount of $610,000.00. The borrower defaulted under the note, and the creditor instituted a foreclose action against the borrower, which resulted in a final judgment being entered against the borrower and a sheriff's sale being ordered. Two days prior to the sheriff's sale, the borrower filed for Chapter 11 bankruptcy protection. Over the next three years, the borrower engaged in various "bad faith" acts with regard to the creditor and the property, including the transfer of property without court approval, the tendering of numerous "bounced" checks with respect to mortgage payments, and resisting the creditor's repeated requests for relief from automatic stay. Finally, after three years, the mortgaged property was sold.

The creditor's secured claim amount included interest of $118,446.18, late charges of $1,053.25, and legal fees of $8,306.33. The borrower objected to the creditor's attorneys' fees and costs and interest based upon the fact that the creditor had obtained a valid final judgment prior to its bankruptcy petition, and

was therefore estopped from collecting post-judgment attorneys' fees and interest under the precedent set forth in *In re A&P* (discussed above).

The bankruptcy court disagreed with the borrower, and distinguished the facts of this case from those in *In re A&P*. Using the doctrine of quasi-estoppel, the court explained that it would be inequitable to allow the borrower to both: (a) vigorously and successfully oppose five different applications filed by the creditor to return to state court and continue the foreclosure proceeding; and (b) prevent the creditor from recovering such amounts that could have been incorporated into the foreclosure judgment had it not been repeatedly thwarted by the borrower's bad faith. The court concluded that the facts of this case warranted the exercise of the court's equitable powers to craft a remedy ensuring the fair treatment of the creditor, and such remedy was to allow the creditor to recover attorney's fees, late fees, and interest.

These cases are significant because, while the precedent set forth *In re A&P* seems to prevent creditors from looking past the four corners of a foreclosure judgment to recover attorneys' fees, late fees, or interest fees as a general rule, *In re Price* disregards that precedent where the debtor has acted in bad faith.

A bankruptcy court finds that an oversecured creditor is entitled to postpetition default interest that is specified in a promissory note, but is not also allowed to recover additional late charges.

In re Cliftondale Oaks, LLC, 357 B.R. 883 (Bankr. N.D. Ga. 2006)

In this case, the borrower executed a $1 million promissory note in favor of a creditor, secured by a lien on real property of the borrower. The note contained a default interest provision that required an additional 5% interest on any past due amounts as well as a late charge of 5% on any amounts overdue for more than 15 days. The borrower defaulted on its obligation under the note, and the creditor instituted foreclosure upon the property. The borrower filed for Chapter 11 bankruptcy protection and sold the property for an amount sufficient to pay the creditor's claim in full.

Applying Bankruptcy Code Section 506(b) to the creditor's claim, the court concluded that the creditor was entitled to the default interest specified in the note. In reaching its decision, the court examined two different approaches to the question of whether a creditor is entitled to post-petition default interest. The first approach holds that default interest is allowable in bankruptcy as long as it would be enforceable under state law. The second approach requires the bankruptcy court to review the equities of the case to determine whether the default interest rate should be paid.

According to the court, the creditor in this case was entitled to the default interest rate specified in the note under either approach. First, the interest rate was permissible under Georgia state law. Second, the facts in this case would not render the default interest inequitable or unconscionable, due in large part to the fact that the borrower's bankruptcy estate was solvent and therefore no junior creditors would be impacted. The court disallowed the late fees, however, explaining that an otherwise reasonable late fee of 5% might be deemed "unreasonable" when coupled with default interest. The court concluded that the 5% default interest was sufficient to compensate the creditor for the administrative costs of the borrower's default, and payment of both would provide the creditor with a double recovery.

A district court finds that the 5% late fee provision in a promissory note constitutes a penalty, and is unenforceable under Illinois law.

Heath v. U.S. Mortgage, LLC, No. 05-cv-0138-MJR, 2006 WL 488642 (S.D. Ill. Feb. 28, 2006)

In this case, an over-secured creditor had included a 5% late fee provision in the promissory note signed by the borrower. When the borrower filed for bankruptcy, the creditor included the late fee in its claim. The bankruptcy court concluded that the late fee was payable to the creditor because the loan documents supported the creditor's request for late fees, the reorganization plan contemplated that reasonable late fees could be added to the principal, and the creditor was over-secured.

The district court reversed the award of late fees, however, finding that a flat 5% late fee was an unenforceable penalty under Illinois law. The court explained that the fee was not dependent on the length of the delay in payment, but was a flat percentage levy that could not escape the "penalty" label. Since the court determined that the late fee constituted an unenforceable penalty under Illinois law, it could not be allowed as a component of the creditor's secured claim.

These cases are significant as they illustrate the continued inconsistency with which bankruptcy courts treat default interest and late fees. ■

Landlord Damage Claims Secured by Letters of Credit

The Fifth Circuit holds that a landlord's damages do not automatically become a claim in bankruptcy, and if no claim is made, the landlord is entitled to pursue recovery from a letter of credit to the full gross amount of the landlord's claim without regard to statutory capping under Section 502(b)(6) of the Bankruptcy Code.

In re Stonebridge Technologies, Inc., 430 F.3d 260 (5th Cir. 2005) (per curiam)

In this case, the tenant was required to give a security deposit of cash and a letter of credit of over $1.4 million, in order to lease certain office space. The tenant subsequently filed for bankruptcy and entered into negotiations with the landlord to reduce its lease obligations. The parties ultimately reached an agreement rejecting the lease, which was approved by the bankruptcy court. Shortly thereafter, the landlord drew down the full amount of the letter of credit.

The bankruptcy trustee brought suit against the landlord claiming, among other things, that the landlord had retained an amount in excess of the "cap" on landlord claims under Section 502(b)(6) of the Bankruptcy Code. The bankruptcy court ruled in favor of the trustee, but the Fifth Circuit reversed, holding that the statutory cap on a lessor's claim was inapplicable because the landlord did not file a proof of claim against the estate.

According to the court, a claim against the bankrupt estate by the landlord is not automatic simply because the debtor rejected a lease. In this case, since the tenant's obligations to the landlord were substantially secured by cash and the letter of credit, the landlord recovered from these sources when the tenant defaulted, instead of filing a claim against the estate. The court explained that letters of credit are obligations between non-debtor parties and, as a result, are not part of the bankruptcy estate. Accordingly, there was no claim by the landlord against an asset of the debtor that would render the claim subject to the statutory cap.

The Eleventh Circuit holds that the proceeds from a standby letter of credit belong to debtor's estate to the extent that they exceed the lessor's damages, and should be turned over.

In re Builders Transport, Inc., 471 F.3d 1178 (11th Cir. 2006), *cert. denied,* 127 S. Ct. 2112 (2007)

In this case, the debtor, prior to filing for bankruptcy, entered into a lease with a landlord. In accordance with the terms of that lease, the debtor obtained a letter of credit in favor of the landlord to secure the debtor's obligations under the lease. When the debtor subsequently filed for bankruptcy and defaulted under the lease, the landlord drew down on the letter of credit.

The debtor then filed a complaint in the bankruptcy court, arguing that the proceeds from the letter of credit were property of the bankruptcy estate and subject to turnover to the extent such proceeds exceeded the landlord's allowed lease rejection claim under Section 502(b)(6) of the Bankruptcy Code. The bankruptcy court found in favor of the landlord and declined to include any of the proceeds from the letter of credit in the debtor's bankruptcy estate.

In affirming the judgments of the bankruptcy and district courts as to both liability and damages, the U.S. Court of Appeals for the Eleventh Circuit first looked at the doctrine of independence. Under this theory, a letter of credit is looked at as an independent contract between the issuing institution and the beneficiary, and therefore considered outside the scope of the debtor's bankruptcy estate. Unlike the Fifth Circuit in *In re Stonebridge Technologies, Inc.* (discussed above), however, the Eleventh Circuit rejected this approach and reasoned that once the letter of credit proceeds are distributed by the issuing institution, the right to retain those proceeds is determined by looking at the underlying contract between the debtor and the beneficiary. Since the contract with the debtor determined the parties' respective rights to the proceeds, the Eleventh Circuit held that the doctrine of independence was not applicable to the letter of credit proceeds.

The Eleventh Circuit then looked to the lease and applicable state law to determine the debtor's rights to the proceeds. The court found that in every contract there is an implied covenant of good faith and fair dealing, which would require the return of proceeds in excess of the landlord's claim. Therefore, the landlord did not have a right to any portion of the letter of

credit proceeds that exceeded the landlord's damages as lessor, and any excess belonged to the debtor's estate.

In determining the amount of damages owed to the landlord, and the remaining excess that the debtor could recover, the parties did not dispute the actual amounts calculated by the bankruptcy court. The undisputed amount owed to the landlord was less than the statutory cap under Section 502(b)(6) of the Bankruptcy Code. Since it was less than the cap, the court did not have to address the issue of whether the Section 502(b)(6) cap on landlord's claims should apply.

This case is significant because, unlike the Fifth Circuit in *In re Stonebridge Technologies, Inc.* (discussed above), the Eleventh Circuit rejected the doctrine of independence and permitted the proceeds from a letter of credit to be considered as part of the debtor's bankruptcy estate. The different approaches that courts have taken with respect to the treatment of letter of credit proceeds is particularly important in light of the frequency with which these instruments are employed in real estate transactions. ■

Analysis of ''True Leases''

The Seventh Circuit analyzes various United Airlines leasing programs and determines in two cases that there was not a true lease but, applying Colorado law, in the third case finds a true lease structure exists.

United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609 (7th Cir. 2005), *cert. denied*, 126 S. Ct. 1465; *United Airlines, Inc. v. U.S. Bank National Ass'n, Inc.*, 447 F.3d 504 (7th Cir. 2006); *United Airlines, Inc. v. HSBC Bank USA*, 453 F.3d 463 (7th Cir. 2006)

United Airlines entered into various transactions with bond issuing entities in San Francisco, Los Angeles, and Colorado, whereby United leased land to the bond issuer, who then leased the land back to United, charging rent equal to the amount that was needed to pay the bondholders. These three "leasebacks" all contained, among other things, the following common features: (1) a "hell or high water clause," (2) a prepayment right on the part of United, and (3) the inclusion of a balloon payment at the end of the lease period.

When United later filed bankruptcy, it sought to have these transactions classified as financing transactions, rather than "leases" under Section 365 of the Bankruptcy Code. This distinction was critical in these cases because if the court determined that a transaction was a "lease" under the Bankruptcy Code, United would have been required to fully perform all of its obligations under the lease or surrender the property for failing to do so. Alternatively, if the court were to find a transaction to have been a financing and not a true lease, United would have the right to retain the property without paying the full price agreed to by the parties. Instead, United would only have to pay the bond issuer enough to give the issuer the economic value of the security interest, and if this value were less than the balance due on the loan, the difference would become an unsecured debt.

In the first case regarding these transactions, the U.S. Court of Appeals for the Seventh Circuit used California state law to determine United's San Francisco "leasing program" was not a true lease, but was instead a financing transaction. Even though the transaction was clearly documented to look like a "sub-lease" and a "leaseback," the Seventh Circuit concluded that California law dictated that the court look past the form of the transaction and focus on the function instead. In determining that the transaction was not a "true lease," the Seventh Circuit found the following factors of significance. First, the "rent payments" were not measured by the market value of the maintenance base, but instead by the amount United borrowed. The inclusion of a hell or high water clause, which required United to pay rent even if (i) the leaseback from the airport ended before 2033 (the expiration of the lease term), (ii) the property was submerged in an earthquake, or (iii) some other physical or legal event deprived United of the use or economic benefit of the maintenance base, illustrated the lack of connection between rental value of the maintenance base and United's financial obligation. Second, after 2033, the bond issuer would have no remaining interest in the real property, as the full tenancy interest would revert to United for no additional charge. Reversion without additional payment is the UCC's *per se* rule for identifying secured credit. Third, a balloon payment has no parallel in a true lease, although it is a common feature of secured credit. Finally, United could terminate the sublease and leaseback immediately by prepayment, whereas in a "true lease," prepayment would only secure the tenant's right to occupy the property for an additional period.

In the second case regarding these transactions, the Seventh Circuit applied the same rationale as it did in the San Francisco case (described above) to determine that United's Los Angeles "partial assignment" and "facilities sublease" were secured loans and not "leases" under Section 365. Once again, the court determined that California law mandated that the substance of the transaction was more important than the form the parties chose for the transaction. The factors that lead the court to determine that the transaction was better classified as a financing, and not a "lease" were: (i) United's rental payments were tied to the amount borrowed from the bondholders; (ii) the transaction involved a balloon payment; (iii) there was a "hell or high water" clause; (iv) pre-payment of United's obligations would end the arrangement between United and the bond issuer; and (v) the bond issuer did not have a remaining interest in the property at the end of the transaction.

In contrast to its decisions regarding United's transactions in San Francisco and Los Angeles described above, the Seventh Circuit applied Colorado law to determine that the Denver transaction between United and a bond issuer should be treated as a "lease" under Section 365 of the Bankruptcy Code. A critical distinction for the Seventh Circuit in this case was the fact that United and the bond issuer had included both the ground lease and the provisions regarding the facilities in one document. The ground lease required United to pay monthly ground rentals which were based upon a per square foot rate and the cost of the common use items that the bond issuer provided for the entire airport, and United made its rental payments directly to the bond issuer. According to the court, under no circumstances could these ground lease provisions be considered a financing arrangement. Under Colorado law, the bond-related portions of the agreement could not be severed from the ground lease provisions and accordingly the Denver transaction as a whole had to be viewed as a true lease.

These cases are significant in light of the frequency with which sale-leaseback and sub-lease structures are used in various real estate transactions. Considering the different treatment afforded to a given structure in bankruptcy depending on whether it is characterized as a "true sale" or a "true lease," these cases provide useful guidance for consideration when structuring such transactions. ■

Bankruptcy Filings by U.S. Based Foreign Hedge Funds

Chapter 15 was recently added to the Bankruptcy Code. The purpose of Chapter 15 is "to provide effective mechanisms for dealing with cases of cross-border insolvency." 11 U.S.C. §1501. In general, recognition of a foreign proceeding under Chapter 15 gives a United States bankruptcy judge greater discretion and flexibility in administering the case, and it gives a debtor additional relief (with greater benefits being conferred to proceedings recognized as foreign main proceedings), including, in some cases, application of the automatic stay of Section 362 of the Bankruptcy Code to property of the foreign debtor located within the United States.

A district court grants limited Chapter 15 benefits to the debtor hedge funds and suggests that if no creditors objected, the debtor could obtain the full benefits of Chapter 15.

In re SPhinX, Ltd., 371 B.R. 10 (S.D.N.Y. 2007)

In this case, the debtor hedge funds were established under and regulated by Cayman Islands law. Beyond books and records required to be maintained under Cayman Islands law, however, the hedge funds had virtually no contact with or presence in the Cayman Islands (no employees were there, there were no offices there, none of the directors resided there or held board meetings there, and no assets of the funds were located there). At least ninety percent of the funds' assets were located in accounts in the United States and the business was managed pursuant to a fully discretionary investment management contract by a Delaware corporation located in New York City.

In July 2006, the debtor hedge funds filed voluntary winding up petitions in the Cayman Islands. These funds then sought to file a Chapter 15 motion and have the U.S. Bankruptcy Court for the Southern District of New York recognize the Cayman Islands proceeding as a foreign main proceeding.

After initially recognizing the Cayman Islands proceeding as a foreign proceeding, the bankruptcy court turned to the more complex question of whether the proceeding should be recognized as a foreign main proceeding. The bankruptcy court, in making

this determination, listed several factors it considered important:

(i) "the location of the debtor's headquarters;"

(ii) "the location of those who actually manage the debtor;"

(iii) "the location of the debtor's primary assets;"

(iv) "the location of the majority of the debtor's creditors or of a majority of the creditors who would be affected by the case;" and

(v) "the jurisdiction whose law would apply to most disputes."

When weighing these factors, the bankruptcy court explained that flexibility is important and that the weighing should be done in light of Chapter 15's focus on protecting interested parties, fair procedures, and maximization of the debtor's value. Importantly, the bankruptcy court looked to the acquiescence of the creditors as to whether the foreign proceeding should be considered a foreign main proceeding.

The bankruptcy court found that most of these factors, as well as other pragmatic considerations, weighed against recognizing the Cayman Islands proceeding as a foreign main proceeding. However, since the case involved liquidation and not reorganization, and because virtually none of the creditors objected to the Cayman Islands proceeding, the bankruptcy court explained that it would ordinarily grant the recognition. In this case, however, the bankruptcy court found that since the primary purpose of the Chapter 15 proceeding was to halt an appeal in another U.S. litigation case, it would only recognize the Cayman Islands proceeding as a foreign nonmain proceeding.

On appeal, the District Court for the Southern District of New York affirmed. The district court agreed that the improper purpose weighed against the recognition of the Cayman Islands proceeding as a foreign main proceeding. The district court did suggest, however, that if there was no objection by the creditors then, notwithstanding that the factors weighed against recognition as a foreign main proceeding, the bankruptcy court could grant the recognition.

A bankruptcy court denies the debtor any protections under Chapter 15, leaving open the possibility that the debtor could seek protection under other chapters of the Bankruptcy Code. In reaching this decision, the court expressly disagrees with the court in In re SPhinX, Ltd., *(discussed above), from the same jurisdiction, and holds that it is irrelevant whether any creditors object.*

In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 374 B.R. 122 (Bankr. S.D.N.Y. 2007)

In this case, the debtor funds were open-ended investment companies with registered offices in the Cayman Islands. The administrator and investment manager of the debtor funds were both United States entities, and the investor registers were held in Dublin, Ireland. Virtually all of the debtor funds' assets were located in the Southern District of New York. With the exception of two directors, no employees lived in the Cayman Islands.

On July 30, 2007, after a devaluation of much of their asset portfolios, the debtor funds voluntary sought to wind up under the supervision of the Cayman Grand Court. The debtor funds petitioned the U.S. Bankruptcy Court for the Southern District of New York to recognize the Cayman Islands proceedings as foreign main proceedings under Chapter 15 of the U.S. Bankruptcy Code, or, in the alternative, as foreign nonmain proceedings.

The bankruptcy court looked to the same factors the court in the *SPhinX* case (discussed above) did to determine whether the Cayman Islands proceedings were foreign main proceedings. Like the *SPhinX* court, the bankruptcy court found that the factors weighed against recognition of the Cayman Islands proceedings; however, unlike the *SPhinX* court, the bankruptcy court gave no weight to whether there were creditor objections to the recognition. The bankruptcy court found that while normally there is a presumption that if the registered office of the debtor is located in the jurisdiction where the proceeding is filed, that proceeding will be recognized as a foreign main proceeding, this presumption is for administrative efficiency and does not relieve a court of its duty to make a determination that the presumption is justified. Specifically, the bankruptcy court found that where there is evidence that an entity's center of main interests is elsewhere, the foreign representative has the burden of proving the center of main interest. In this case, in light of the merely tangential connections of the business to the

registered office jurisdiction of the Cayman Islands, the bankruptcy court refused to recognize the Cayman Islands proceedings as foreign main proceedings.

In order to be found to be a foreign nonmain proceeding, the bankruptcy court found that nontransitory economic activity must be conducted in that foreign jurisdiction (that is, there must be a local place of business there). Since the only activities performed in the Cayman Islands were activities to support the U.S. based business, the bankruptcy court concluded that the burden was not met and the Cayman Islands proceedings were not foreign proceedings.

While it refused to recognize the Cayman Islands proceedings as either foreign main or foreign nonmain proceedings, the bankruptcy court left open the option for the debtor funds to file in the United States under Chapter 7 or 11 of the Bankruptcy Code.

In a third related case, a bankruptcy court denies recognition of a Cayman proceeding as a foreign main proceeding without an evidentiary hearing, finding that even where no creditors object to recognition, the court can still require evidence that recognition is appropriate.

In re Basis Yield Alpha Fund (Master), No. 07-12762, 2007 WL 4723359 (Bankr. S.D.N.Y. Jan. 16, 2008) (decision and order on motion for summary judgment seeking recognition as foreign main proceeding)

In this case, much like the two cases above, the debtor was a hedge fund formed in the Cayman Islands. As a result of an economic downturn, the hedge fund filed for liquidation in the Cayman Islands. Thereafter, the representatives of the fund sought Chapter 15 recognition (either main or nonmain) in the Bankruptcy Court for the Southern District of New York. No creditors filed objections to the recognition. As a result, the representatives of the fund asked the court to grant summary judgment on their request for recognition as a foreign main proceeding. The representatives of the fund did not file any evidentiary support for their summary judgment motion.

The fund relied on a statutory presumption in Section 1516 of Chapter 15 of the Bankruptcy Code, which provides that in the absence of contrary evidence, a foreign proceeding should be recognized as a foreign main proceeding if it takes place in the jurisdiction in which the debtor is registered. The court found that sole reliance on this presumption was misplaced. The court reasoned that it had the power to require evidence, even when there are no objections to the recognition. The court said that it was not a rubber-stamp and that a factual inquiry into whether recognition is appropriate cannot be sidestepped simply because there are no objections or because the representatives chose not to plead facts. The court found that the fund, much like the debtor funds in the cases mentioned above, had little to no contact or business in the Cayman Islands and therefore recognition would not be appropriate on summary judgment and the fund needed to present evidence to support its position.

These cases are significant because of the prevalence of U.S. based entities that are organized under foreign laws in the securitization, CDO, Repo, and hedge fund industries. ■

Determination of "Single Asset Real Estate" Entities

Bankruptcy Code Section 362(d)(3) provides for expedited relief against debtors determined to be "single asset real estate" entities, including a short time period in which a debtor must file a confirmable plan of reorganization or make monthly interest payments on its secured debt. Thus, designation as a "single asset real estate" entity can have a significant impact on a bankruptcy proceeding.

A bankruptcy court holds affiliated Chapter 11 debtors individually holding a single real estate development project to be "single asset real estate" entities despite acquisition, design, construction, marketing and sales efforts by the affiliated debtors.

In re Kara Homes, Inc., 363 B.R. 399 (Bankr. D.N.J. 2007)

Affiliated Chapter 11 debtors sought a judicial determination that they were not "single asset real estate" entities as defined in 11 U.S.C. §101(51B) and that expedited relief under 11 U.S.C. §362(d)(3) was inappropriate. The affiliated debtors each owned separate real estate development projects for the construction of single family homes and condominiums.

In analyzing the issue, the court cited the following factors necessary for a Chapter 11 case to be considered a single asset real estate case: (i) real property constituting a single property or project; (ii)

that real property must generate substantially all of the income of the debtor; and (iii) the debtor must not be involved in any substantial business other than the operation of its real property and the activities incidental thereto.

With respect to the first factor, the court noted that each affiliated debtor's business was comprised of a developable piece of land and a housing plan that rested upon it. The court found this satisfied the first factor requiring the real property to constitute a single property or project. The court also held the second factor, that the real property generates substantially all of the income of the debtor, was satisfied. The court found that the primary, if not only, source of income for the affiliated debtors was from the sale of homes.

With respect to the third factor, the debtors asserted that in addition to holding real estate, they researched and purchased developable land, designed and constructed homes, marketed and sold the homes and that these activities constituted "substantial business" and not "activities incidental" to the operation of the homes. The court, however, held these activities to be "merely incidental" to the debtors' efforts to sell the homes or condominium units. According to the court, the threshold inquiry is whether the "nature" of the activities is such that a "reasonable and prudent business person would expect to generate substantial revenues from the operation activities—separate and apart from the sale or lease of the underlying real estate." In this case, the services performed by the affiliated debtors were not performed for the benefit of third parties and, as such, the affiliated debtors could not expect to generate income from these activities if the eventual sale of the real property were impossible. Consequently, the court classified the affiliated debtors as single asset real estate entities.

A bankruptcy court holds that a Chapter 11 debtor, whose income was derived from harvesting timber on 200,000 acres of property it owned and on additional property upon which it had a contractual right to harvest, was not a singe asset real estate entity.

In re Scotia Development, LLC, 375 B.R. 764 (Bankr. S.D. Tex. 2007)

The debtor was an entity created to own and operate timberland. The debtor owned approximately 200,000 acres of timberland and had the right to harvest timber on an additional 10,500 acres of private timberland. The debtor encountered financial troubles, and was eventually forced to file for Chapter 11 bankruptcy protection. A group of secured creditors filed a motion seeking a determination that the debtor was a "single asset real estate" entity.

The court began its analysis of whether the debtor was a "single asset real estate entity" by examining its operations, rather than just its real property holdings. Specifically, the court found that the debtor's timberlands comprised nine watersheds, each having unique topography, hydrology, and environmental concerns. Thus, the court found that these watersheds represented separate projects.

With such a diverse set of projects, each with unique demands, the court found the debtor's business was to manage, maintain, and oversee its timberlands, rather than to merely own the land. To conduct these operations, the debtor employed over sixty individuals, including scientists and foresters. The specialized knowledge and expertise of these employees was an indispensable aspect of the timber harvesting operation.

Comparing the aforementioned findings of fact to the definition of "single asset real estate," as articulated in Section 101(51B) of the Bankruptcy Code, the court held that the debtor was not a "single asset real estate" entity. The court utilized an "active-versus-passive" criterion, examining the nature of how a property generates revenue. According to the court, "[r]eal property that, for the generation of revenues, requires the active, day-to-day employment of workers and managers...and that would not generate substantial revenue without such labor and efforts, should not be regarded as single asset real estate.'" The debtor's numerous activities, including, protection of the timberlands from forest fires, erosion, insects and other damage, overseeing reforestation efforts, and monitoring and implementing environmental and regulatory compliance were "sufficient to remove [the debtor] from the category of a passive investment vehicle."

These "single asset real estate" cases are significant in light of the 2005 Bankruptcy Code amendment that removed the limit on "single asset real estate" to cases involving $4 million or less of secured debt. As a result, courts are just beginning to address the issue of when the "single asset real estate" definition will apply to larger, more sophisticated real estate projects. ■

Co-Lender Claims Under Intercreditor Agreements

The Eleventh Circuit holds that a secured creditor is not barred by the doctrine of res judicata from bringing state law claims against a bank co-creditor of a Chapter 11 debtor where the bank co-creditor failed to abide by its notification obligations under an intercreditor agreement with the secured creditor.

Eastman Kodak Co. v. Atlanta Retail, Inc. f/k/a Wolf Camera, Inc., 456 F.3d 1277 (11th Cir. 2006)*, cert. denied,* 127 S. Ct. 836 (2006)

In this case, a secured creditor, Kodak, had been a long-standing supplier to the debtor. In September 1998, Kodak and Wachovia, another secured lender to the debtor, entered into an agreement under which Kodak's loans were subordinated to those of the debtor's other creditors, including Wachovia. Concurrently with the subordination agreement, Kodak and Wachovia entered into an intercreditor agreement whereby each party agreed to use "best efforts" to notify the other of occurrences "which may significantly affect the other Secured Creditor with regard to the ability of [the debtor] to meet its obligations."

In 1999, Kodak began discussions with the debtor regarding a $30 million loan to further expand the debtor's business. Kodak alleged that during these discussions, Wachovia entered into an agreement with the debtor under which the debtor's covenant defaults would be waived until the Kodak loan was completed. Kodak claimed that it was never informed of this agreement, despite Wachovia's obligation to inform Kodak under the intercreditor agreement. Kodak made the $30 million loan to the debtor under the express condition that the loan fund new development, but the loan proceeds were actually transferred to Wachovia and the other pre-petition lenders to pay a portion of the debtor's debts.

On June 21, 2001, the debtor filed a Chapter 11 petition, and Kodak filed its own separate proceeding against Wachovia in New York State Court. The debtor and Wachovia filed suit against Kodak in the Georgia bankruptcy court, seeking an injunction against Kodak's New York action, and the bankruptcy court entered an order barring the suit on the basis of *res judicata*.

On appeal, the Eleventh Circuit reversed, holding that the doctrine of *res judicata* did not bar Kodak's New York action. The court reasoned that two of the elements necessary for *res judicata* were missing. First, Kodak could not have received full relief in the bankruptcy court action in Georgia because the only relief available in a plan confirmation hearing is a denial of confirmation of the debtor's plan. As Kodak would have been unable to obtain damages against Wachovia by objecting to confirmation of the debtor's plan, the confirmation order did not prevent Kodak from seeking relief in another forum.

Second, the state court claim did not involve the same nucleus of operative fact or "transaction or occurrence." The Eleventh Circuit found that the focus of the bankruptcy court was the "equitable distribution of the debtor's funds and the administration of the estate." In bringing the New York action, however, Kodak was not contesting the enforcement of its agreements with the debtor. Instead, it brought a fraud claim against Wachovia based upon Wachovia's alleged inducement of the loan from Kodak to the debtor.

This case is significant because it permitted one creditor to seek recovery from another for the breach of an intercreditor agreement in a wholly separate proceeding from the bankruptcy proceeding of the related borrower. ■

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