

Is the Right to File Bankruptcy for Real Estate Borrowers Truly Protected?

By David L. Bruck

David L. Bruck is a partner at Greenbaum Rowe Smith and Davis LLP, in Woodbridge, New Jersey, where he chairs the Bankruptcy and Restructuring practice group.

The right to file bankruptcy is protected by federal case law upholding the policy that all parties have a right to avail themselves with the fresh start afforded by the US Bankruptcy Code, and the right cannot be waived. *See Hayhoe v Cole (In re Cole)*, 226 B.R. 647, 651-54 (B.A.P. 9th Cir. 1998). Yet, in reviewing the evolution of the law during the 1990s through the present date, that right, especially for real estate borrowers, seems to have been diminished as a result of innovative lenders, creative financing documents, and also changes to the Bankruptcy Code that limit real estate borrowers' access to and reliance on the benefits of the Bankruptcy Code. This article traces the developments that have affected the rights of real estate borrowers to file bankruptcy to protect their assets.

Evolving Lending Practices

In the late 1980s, the stock and real estate markets crashed and, with the crash, many savings and loans and other traditional sources for real estate lending failed. Their assets, which consisted largely of non-performing mortgages and real estate acquired through foreclosure, were liquidated. The task of liquidating these distressed assets fell to a federally-created entity known as the Resolution Trust Corporation (RTC). Before the advent of the RTC in 1989 (which ended traditional financing of real estate loans by thrift and savings and loan institutions), most commercial real estate loans were fully recourse to the borrower or guaranteed by the principals of the borrower. As distinguished from a non-recourse loan, a recourse loan subjects the borrower and the guarantor to liability for the outstanding balance owed to the lender, including any deficiency that may arise from a foreclosure or other sale when the value of the collateral is less than the amount of the loan.

During the period 1987 through 1995, as a result of the failed banking institutions, the commercial real estate market urgently needed liquidity. That situation led to the emergence of commercial mortgage-backed security (CMBS) loans, which brought Wall Street's access to capital markets to Main Street real estate financing. CMBS loans forced several significant changes in lending practices. With respect to determining eligibility for loans, for example, lenders shifted from the traditional approach of focusing on the actual or projected income of a given project, and the financial abilities of the guarantor of the loan, to asset-based lending, which focused on the value of the collateral.

Securitization also caused a shift toward non-recourse loans. Traditionally, loans were generally held by the bank making the loan, and participation interests in the loan were sold to other institutions. With the advent of the CMBS loan format, loans were securitized or packaged in trusts, and participations in the trusts were sold in tranches to institutional and other investors. The loans were mostly uniform in that they were documented as non-recourse with few exceptions.

The securitization of these loans, coupled with both the appetite that Wall Street had for product and the

lack of diligence by investors, led to the recession of 2007 and the fall of Lehman Brothers, Bear Stearns, and other well-known banking and brokerage houses. Once again, the real estate financing world was turned on its head.

Attempts to Minimize Bankruptcy Exposure

Lenders, based upon their experiences from the mid to late 1980s and early 1990s with borrower bankruptcies and loan restructuring through bankruptcy reorganization, developed several new concepts for commercial lending, with the primary goal of limiting or minimizing bankruptcy exposure. Among the new concepts crafted to restrict borrowers' access to the bankruptcy courts was a requirement that the borrower be a single purpose entity (SPE) or bankruptcy-remote entity. By requiring that the borrower be an SPE or bankruptcy-remote entity, lenders were able to assure that the borrower would not expose the loan's collateral to risks associated with any other business assets of the borrower or its affiliates.

To further fortify the desire to shield a loan from the threat of a bankruptcy filing, lenders frequently required additional protections, including requirements to control the borrower's authority to file bankruptcy—such as placing a creditor representative on the governing body of the borrower. The creditor representative's sole purpose was to block a bankruptcy filing, even if bankruptcy was the only means for a borrower to protect its assets for the benefit of its stakeholders.

The Rise of Golden Shares

Courts have generally not enforced restrictions on a borrower's ability to file a bankruptcy. In *In Re Lexington Hospitality Grp. LLC*, 577 B.R. 676, 683 (Bankr. E.D. Ky. 2017), for example, the court recognized that “there is a strong federal public policy in favor of allowing individuals and entities their right to a fresh start in bankruptcy.” As a result, “contractual provisions . . . that essentially prohibit a company's ability to file bankruptcy without a creditor's consent are void.” *Id.*

As courts refused to enforce attempts by creditors to control the governance of a borrower to preclude a bankruptcy, astute lenders' counsel employed a new tactic, that of the “golden share.” Golden shares are shares issued to an investor that give the holder not only equity in the borrower but also the ability to control certain votes by the members, shareholders, or boards of directors of the borrower. Whereas previously the cases involved creditors' attempts to control the governance of a borrower, now, for the first time, attempts at control were being made by vesting the creditor with an ownership interest. The vote that was intended to be controlled was foremost a vote on filing bankruptcy. *See, e.g., In re Intervention Energy Holdings LLC*, 553 B.R. 258 (Bankr. D. Del. 2016) (limited liability company agreement that granted the company's creditor a single membership unit in the limited liability company and required unanimous consent of members to file bankruptcy was void as against public policy).

Courts have reached different conclusions regarding the enforceability of golden shares. In rejecting the use of a golden share in *Intervention Energy Holdings*, the court concluded that the parties' agreement was an attempt to “contract away the right to seek bankruptcy relief”—contrary to the “well settled principle that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy.” *Id.* at 263, 264. In 2018, however, the Fifth Circuit Court of Appeals ruled that federal bankruptcy law does not prevent a bona fide equity holder from exercising its voting rights to prevent the corporation from filing a voluntary bankruptcy petition even if the shareholder also happens to be a creditor of the company. *In re Franchise Services of North America*, 891 F.3d 198 (5th Cir. 2018). The court held that under Delaware law a shareholder is generally free to act in its self-interest, unencumbered by any fiduciary duty. Key to the holding was the fact that the shareholder had paid \$15

million to acquire all of the debtor's preferred stock. Although the shareholder's parent company was an unsecured creditor by virtue of a \$3 million debt, the court found "no evidence that their arrangement was merely a ruse" to ensure payment of the debt. *Id.* at 208. Thus "[w]e are not confronted with a case where a creditor has somehow contracted for the right to prevent a bankruptcy or where the equity interest is just a ruse." *Id.* at 203 n.1.

In a more recent case, a federal bankruptcy court in Delaware declined to follow the *Franchise Services* decision. *In re Pace Indus., LLC*, No. 20-10927 (Bankr. D. Del. 2020). Ruling orally, Bankruptcy Judge Mary Walrath said she found "no reason to conclude that a minority shareholder has any more right to block a bankruptcy—the constitutional right to bankruptcy by a corporation than a creditor does." Transcript of Telephonic Hearing on Motion to Dismiss at 40, <https://bit.ly/33kPKJi>. The court emphasized that "[f]ederal public policy allows any entity to file for bankruptcy, and it is the same regardless of who is seeking to block that filing." *Id.* Contrary to the *Franchise Services* decision, Judge Walrath found that Delaware law would impose a fiduciary duty on the part of a shareholder exercising a blocking right—a duty "owed not only to other shareholders, but to all creditors." *Id.* at 40-41.

Single Asset Real Estate

The Bankruptcy Reform Act of 1994 also affected real estate lending by adding a new type of debtor, the single asset real estate (SARE) debtor, defined by Bankruptcy Code section 101(51B). The SARE debtor is a debtor whose sole asset is real estate, and the only income is the income derived from the ownership and management of the real estate. The definition originally was restricted to debtors with a debt limit of \$4 million; however, the debt limit was eliminated in the Bankruptcy Abuse Prevention Consumer Protection Act of 2005, which was passed on April 20, 2005. As a result, a SARE characterization is now applicable to many more cases.

This change is significant because Bankruptcy Code section 362(d)(3) requires that a SARE debtor either file a plan of reorganization or commence payments on its mortgage within 90 days of the entry of the order for relief. The effect was to reduce the time to file a plan during what was otherwise the debtor's exclusive period. Failure to comply with this limited time frame exposes a SARE debtor to an order lifting the automatic stay. The goal of the legislation was to expedite the bankruptcy process in real estate cases for the benefit of lenders.

Almost simultaneously with the enactment of the Bankruptcy Reform Act of 1994, the decision in *In Re Jason Realty, L.P.*, 59 F.3d 423 (3d Cir. 1995), restricted a real estate borrower from the use of cash collateral when part of the loan documentation contained an "absolute" assignment of rents. *Jason Realty* stands for the proposition that rents absolutely assigned at the time of the loan are not the debtor's property and cannot be used as cash collateral. The SARE debtor was now hindered by not only the inability to use the revenue generated by its sole asset to operate the property but also with the lack of access to the revenue to fund its plan of reorganization. The onslaught of adverse legislation and case law against the rights of real estate borrowers continued.

Springing Guaranties

Finally, to make it extremely painful for the guarantor (frequently the owner of the borrower) to authorize the filing of a bankruptcy petition for the borrower, lenders developed the "springing" or "exploding" guaranty. Bear in mind that CMBS loans were specifically stated to be non-recourse. The springing guaranty is a contractual provision in a guaranty of an otherwise non-recourse loan that converts the loan to full recourse as against the guarantor upon an act of the borrower that "threatens the collateral value"

of the asset that secures the loan. Thus, the springing guaranty takes away with one hand what was given with the other; the bargained for non-recourse is only valid so long as the borrower does not trip on the “bad boy” carve-out triggers.

These triggers—“bad boy” clauses that result in the imposition of full recourse liability on the guarantors or situations typically referred to in springing guaranties—have included such provisions as (1) failure to pay real estate taxes (*see Blue Hills Office Park LLC v. J.P. Morgan Chase Bank*, 477 F. Supp. 2d 366 (D. Mass. 2007) (imposing liability on guarantors)), (2) failure to obtain lender’s consent to subordinate financing (*see Princeton Park Corporate Center v. SB Rental I LLC*, 410 N.J. Super 114 (App. Div. 2009) (imposing liability on guarantors even though the subordinate financing was satisfied before the default)); and (3) waste of the mortgaged premises (*see Travelers Ins. Co. v. 633 Third Assocs. et al.*, 14 F.3d 114 (2d Cir. 1994) (holding that failure to pay real estate taxes was waste, and holding the guarantors liable for the amount of the debt));

Additional “bad boy triggers” have included violating one of the SPE provisions and, yes, filing a bankruptcy. *See Wells Fargo Bank v. Cherryland Mall Limited Partnership*, 812 N.W.2d 700, 803 (Mich. Ct. App. 2011) (listing common recourse triggers, including “any voluntary or collusive involuntary bankruptcy or insolvency filing by or on behalf of the borrower”). At issue in *Cherryland Mall* was a provision that the loan debt would become full recourse if the debtor “fails to maintain its status as a single purpose entity as required by, and in accordance with the terms and provisions of this Mortgage.” *Id.* at 806. The SPE provisions of the mortgage provided that “Mortgagor is and will remain solvent and Mortgagor will pay its debts and liabilities . . . from its assets as the same shall become due.” *Id.* at 807. As a result, even though there was no bankruptcy filing, the guarantor was fully liable on the debt because it failed to make the mortgage payment.

Some states have enacted laws against springing guaranties. For example, the Michigan legislature, perceiving the *Cherryland Mall* decision as injurious to the economy of Michigan, enacted the Michigan Nonrecourse Mortgage Loan Act (MNMLA) on March 29, 2012. The act provides that “[a] post-closing solvency covenant shall not be used, directly or indirectly, as a nonrecourse carve-out or as the basis for any claim or action against a borrower or any guarantor or other surety on a nonrecourse loan.” Mich. Comp. Laws § 445.1593. As such, under Michigan law, a springing guaranty provision is now invalid and unenforceable. The Sixth Circuit Court of Appeals applied the MNMLA retroactively. *See Borman LLC v. 18718 Borman LLC*, 777 F.3d 816 (6th Cir. 2015).

Needless to say, the effect of full recourse upon a guarantor for what was otherwise a non-recourse loan can be life-changing, and its impact on the commercial real estate market profound. In states where courts have enforced the provisions of springing guaranties, these decisions leave the guarantor, who is most often the controlling party or owner of the borrower entity, with an unenviable conundrum. The guarantor must either: (1) avoid the triggering of bankruptcy and put his personal financial well-being first, but breach his fiduciary duty to manage the affairs of the borrower prudently for the best interest of the shareholders and creditors of the borrower; or (2) file for bankruptcy and fulfill his fiduciary responsibility to the equity holders and creditors of the borrower but expose his personal financial well-being to a recourse loan.

A borrower filing bankruptcy at the direction of a guarantor with a springing guaranty will produce disastrous results for the guarantor. The decisions of the courts that have considered the issue, however, have generally ruled in favor of enforcing the guaranty, reasoning that the imposition of a financial burden on an individual guarantor is not an impairment of a borrower’s right to file bankruptcy. *See 51382 Gratiot Ave Holdings, LLC v. Chesterfield Dev. Co.*, 835 F. Supp. 2d 384, 401 (E.D. Mich. 2011).

Published in Pub: Volume 34, Number 6, ©2020 by the American Bar Association. Reproduced with permission. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or stored in an electronic database or retrieval system without the express written consent of the American Bar Association.

Unfortunately, courts generally fall back upon the rules of construction—where the language of the agreement is unambiguous, the courts will not make a better contract than the parties themselves made—as well as the all too familiar phrase that courts use when they want to avoid an issue: if the law is to be changed it is up to the legislature to tackle the problem. In short, while courts have generally found it contrary to public policy to enforce attempts by creditors to control the governance of the borrower to preclude the filing of a bankruptcy, as discussed earlier in this article, those same public policy arguments seem immaterial when it comes to springing guaranties, which, in effect, preclude the filing of a bankruptcy by threatening to exact a monetary penalty on the guarantor for the breach of an anti-bankruptcy covenant.

The difference may lie in the venue. The governance restriction cases arise most commonly in the bankruptcy courts on motions to dismiss brought by lenders. Springing guaranty cases arise predominantly in state or federal district courts when a lender commences suit on the guaranty after completion of the foreclosure. Bankruptcy courts are known to enjoin suits by lenders against guarantors of a debtor's corporate debt under Bankruptcy Code section 105 so long as the guarantor is needed for the reorganization effort and the reorganization process continues. *See In re Lahman Mfg. Co.*, 33 B.R. 681, 683 (Bankr. D.S.D. 1983).

Conclusion

The combination of amendments to the Bankruptcy Code, coupled with state and federal case law limiting a real estate borrower's access to and benefits of the Bankruptcy Code, has changed the real estate financing environment for borrowers, guarantors, and lenders. It is time for courts to recognize that a bar to filing bankruptcy in whatever shape is a bar nonetheless, and such bars should not be enforceable.