DIP Financing, Bankruptcy Concerns For Transactional Real Estate Lawyers

By S.H. Spencer Compton And Andrew D. Jaeger

It has been said that capitalism without bankruptcy would be like Christianity without hell (or, perhaps, more properly, purgatory). There must be a place of punishment and redemption in order to maintain faith in both God and capital markets.

As the current economic cycle wears on (and on), as tenants either renegotiate their rents or default, many borrowers are unable to meet their debt obligations and are seeking relief in the federal bankruptcy courts. Young real estate lawyers today have little or no experience with bankruptcy matters, having only practiced in healthy, even exuberant, financial climates. This article will attempt to familiarize real estate lawyers with the basic elements of real estate related issues in connection with bankruptcies that may arise in their transactional practices. It is not intended to be an in-depth discussion of bankruptcy law, but rather a primer for real estate lawyers who find themselves working alongside bankruptcy lawyers.

A Few Definitions

Debtor in Possession: The debtor which remains in control of operations.

Exit Financing: Financing under a plan of reorganization that allows the debtor to exit bankruptcy.

Petition: (Bankruptcy Petition or Petition for Relief). The document that commences a bankruptcy proceeding.

Plan of Reorganization: A plan that sets forth the manner in which a bankrupt company intends to satisfy its creditors and exit bankruptcy.

Prepackaged Bankruptcy: A bankruptcy case in which the debtor and certain of its creditors agree to the terms of a plan of reorganization before filing a bankruptcy petition. The court then confirms the plan and the company emerges from bankruptcy quickly.

Pre-Petition Debt: Debt incurred by the debtor before a bankruptcy filing.

Post-Petition Debt: Debt incurred by the debtor after a bankruptcy filing.

Rollups: Pre-Petition Debt that is combined with/converted into post-petition debt as a condition to providing additional financing to the debtor.

Section 363 Sale: A sale of debtor assets free and clear of liens pursuant to Section 363 of the Bankruptcy Code.

Stalking Horse: A proposed buyer chosen by the debtor to make an initial bid on the debtor's asset(s). The stalking horse sets the bar that other bidders have to bid against, often in an auction setting. The court generally grants expense reimbursement and/or a break-up fee to the stalking horse.

Chapter 11 Reorganization

Chapter 11 of the Bankruptcy Code governs the reorganization of debtor entities, and while there are other types of bankruptcies, this article will focus on certain transactional issues related to Chapter 11 filings.

The goal of a Chapter 11 filing is to de-lever the debtor through the plan of reorganization process, with the hopes of turning it into a profitable venture. To give the debtor necessary time to propose a plan, the debtor is given the exclusive right to file a plan for a set period and Section 362 of the Bankruptcy Code imposes an automatic stay on all creditor collection/foreclosure efforts.

An effective reorganization will likely require additional capital which may be obtained in two ways. The debtor may sell assets pursuant to Section 363, which will be discussed below. Where practicable, the debtor also may seek Debtor in Possession (DIP) financing. Section 364 authorizes a debtor to borrow money to preserve the estate or to further the debtor's rehabilitation efforts. Most lenders extend DIP financing on a secured basis. While the collateral may not typically be comprised of material real estate, there are transactions where real estate can be a significant part of the collateral.

There are two types of DIP financing: defensive DIP loans extended by existing secured lenders to protect their collateral and the value of their pre-petition claims, and third-party DIPs extended by lenders seeking high returns. In addition to the traditional lender motives (e.g., collecting fees, an attractive rate of return and adequate security), potential DIP lenders may be induced by the opportunity to gain access to non-public information, to influence the debtor's management decisions, and/or to acquire equity in the debtor upon exiting bankruptcy. DIP loans can be profitable due to the debtor's immediate need for working capital. Additionally, a lender can be more certain of repayment because of DIP loan protections under the Bankruptcy Code.

DIP Financing

Section 364 provides four levels of secured financing:

> First: A super-priority claim over other administrative expenses (Section 364(c)(1)); (administrative expenses typically include legal and other professional and consulting fees plus other post-petition expenses);
> Second: A lien on unencumbered assets of the debtor (Section 364(c)(2));
> Third: A junior lien on already encumbered assets (Section 364(c)(3)); and
> Fourth: A senior or equal lien on previously encumbered assets—a priming lien (Section 364(d)).

A court will examine the loan terms to ensure that they are fair and reasonable. The court will only authorize a higher level of security if credit cannot be obtained at the lower level. The court may authorize a junior lien on the debtor's assets even where the senior lien documents prohibit a junior lien. A priming lien usually only occurs when a pre-petition senior lender becomes the DIP lender and primes itself or if adequate protection is provided to the pre-petition senior lender.

Mortgage/Deed of Trust

Whether a DIP loan is adequately perfected by its court-ordered lien pursuant to Section 364 of the Bankruptcy Code or whether mortgages or deeds of trust are required to perfect the DIP lien on real property can be a source of debate between real estate and bankruptcy attorneys.

Bankruptcy attorneys will assert that the Section 364 lien on all the debtor's assets provides adequate security for the DIP loan and that, if the debtor defaults, the Bankruptcy Court will enforce the order granting such lien. Furthermore, mortgages and deeds of trust are expensive and time-consuming in a situation where lack of funds and urgency prevail.

Nevertheless, real estate attorneys will ask: How can we be sure that a state court would honor the DIP lender's lien where no mortgage/deed of trust is of record? Doesn't a mortgage/deed of trust need to be recorded in accordance with applicable state law? Doesn't applicable mortgage tax have to be paid?

Further, what if in a bankruptcy with multiple debtors, an SPE subsidiary is dismissed from the bankruptcy case? If the Bankruptcy Court no longer has jurisdiction, how can a DIP lender enforce its lien in state court when there is no mortgage or deed of trust?

All of the foregoing appear to be questions of first impression. We have found no case law to answer them.

Although the real estate attorneys' concerns may be myriad and well-founded, in the absence of further collateral-specific issues (such as breaks in the chain of recorded title due to poorly documented corporate mergers and acquisitions), the cost, complexity and delay of creating and recording mortgages or deeds of trust are often prohibitive.

363 Sales

Another way a debtor can raise operating capital is to sell assets. Section 363 of the Bankruptcy Code allows a debtor to sell property in the ordinary course of business without court approval (Section 363(c)); or other than in the ordinary course of business with court approval (Section 363(b)). The court is empowered to order these sales to be made free and clear of existing liens (Section 363(f)).

Most often, to maximize the value of the asset to be sold, a debtor will negotiate an asset purchase agreement with a potential purchaser who will then act as a stalking horse. After evaluating all offers, the debtor enters into a contract with a proposed purchaser, which is subject to both Bankruptcy Court approval and to being out-bid, sometimes in an auction-like process. Although the stalking horse purchaser may get outbid, it nonetheless gains several advantages. The stalking horse bidder will likely receive a break up fee and expense reimbursement as well as enjoying an inside track with the debtor, official committees, counsel and their advisers.

Alternatively, rather than use the stalking horse method, the debtor can proceed straight to auction with the outcome subject to Bankruptcy Court approval.

Exit Financing and Asset Sales

Exit financing is a loan made pursuant to a confirmed plan of reorganization in connection with the debtor's exit from bankruptcy. It is analogous to a take out loan entered into after completion of construction to pay off a higher cost construction loan. Exit financing may pay off the DIP loan, certain creditors and fund operations. Unlike DIP financing, there is no lien created by the Bankruptcy Court order. Accordingly, mortgages/deeds-of-trust are required to create the lender's lien. Exit financing, however, does not require payment of mortgage tax (Section 1146(a)).

Additionally, a debtor may sell assets pursuant to a confirmed plan of reorganization. A sale pursuant to a confirmed plan of reorganization does not require the payment of transfer taxes (Section 1146(a)) and may be free and clear of liens (Section 363(f)).

Practitioners should be aware of a recent case concerning the court-ordered exemption from mortgage recording taxes and/or transfer taxes arising out of a Section 363 sale. Section 1146(a) exempts from stamp or similar taxes the delivery of a transfer instrument under a confirmed plan. The issue is whether "under a confirmed plan" includes a transfer prior to but in accordance with a subsequently confirmed plan.

In Florida Dept of Revenue v. Piccadilly Cafeterias Inc., 128 S. Ct. 2326 (2008), a transfer was made by a debtor prior to a confirmed plan. The Bankruptcy Court, Federal District Court and the U.S. Court of Appeals for the Eleventh Circuit all held that the transfer was exempt under Section 1146(a). The Supreme Court reversed, holding that to be eligible for the Section 1146(a) exemption, the plan must have been previously approved.

Title Insurance Concerns

Title insurance will likely be unavailable to the DIP lender without recorded mortgages or deeds of trust. What risks does this present? In addition to raising state court enforceability questions, a Bankruptcy Court order does not confirm the ownership of real estate, the quality of title or, in some cases, the existence or priority of pre-existing liens. Furthermore, creditors improperly or not noticed in the bankruptcy action may not be bound by the Bankruptcy Court order authorizing the DIP financing.

Whether the transaction is a sale, a DIP financing or exit financing, involving the title insurance company early on in the transaction is advantageous. The title insurance company will review the motion, the Bankruptcy Court order and the parties noticed. The real estate attorney should point out to its client that, despite a Bankruptcy Court order authorizing a sale "free and clear" of liens, local municipalities have consistently refused to honor the Bankruptcy Court order as it applies to real estate taxes. Accordingly, real estate taxes will probably have to be paid to be removed from a municipality's tax rolls.

Because the sale of real estate in a Section 363 sale is unlikely to be in the ordinary course of business, the title insurance company will probably require court approval to insure the transaction. This might not apply where the debtor is a homebuilder or a condominium sponsor, but the outcome will be fact-specific.

A recent court decision is giving title insurance companies concerns. In it, the Bankruptcy Appellate Panel for the Ninth Circuit reversed a lower court order and held that the senior lien holder could not purchase the real property free and clear of a junior lien, notwithstanding the junior lien holder's failure to obtain a stay pending appeal of the sale order. In Re PW, LLC, 391 B.R. 25 (9th Cir. BAP 2008). As a result, title insurance companies are now taking a much closer look at Bankruptcy Courts' "free and clear" orders before agreeing to insure.

Last, there is often confusion surrounding the statutory 10-day stay of the Bankruptcy Court order for the sale of property and the 10-day right of appeal period. It is important to distinguish between these two different 10-day periods.[1]

A Bankruptcy Court order for the sale of property is stayed for 10 days. However, this may be waived by the court. (Rule 6004(g)). Note that the waiver of the stay does not vitiate the 10-day appeal period. This separate and distinct 10-day period may not be waived by the court. (Rule 8002). Generally, title insurance companies will not insure over the 10-day appeal period and will require that the order become final to insure. See In Re PW, LLC, 31 B.R. 25 (2008).

Endnotes:

1. The 10-day period for the stay and the 10-day appeal period will both increase to 14 days on Dec. 1, 2009, unless Congress enacts legislation to reject, modify, or defer the proposed amendments.

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