Lowenstein Sandler's Real Estate Podcast: Terra Firma

Episode 15:
Bankruptcy in Real Estate:
What to Do When Faced with Foreclosure

By Eric Chafetz, Stacey Tyler, Stephen Tanico

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Stacey Tyler: Welcome to "Terra Firma: Conversations on Commercial Real Estate". I'm Stacey Tyler.

Stephen Tanico: And I'm Stephen Tanico. Stacey and I are real estate attorneys at Lowenstein Sandler. On today's episode, we'll be talking about bankruptcy with Eric Chafetz, a partner in Lowenstein's Bankruptcy and Restructuring Group. Thanks for joining us today, Eric.

Eric Chafetz: Thanks for having me.

Stacey Tyler: So, one of the reasons we wanted to talk to you specifically today is because, as I'm sure a lot of us in the real estate world are seeing, there's constantly articles coming out about the spate of bankruptcies and the peril in the office market, especially in New York City. And I thought our listeners might benefit from a bankruptcy 101 kind of conversation.

What does it mean when we hear that companies are declaring bankruptcy or that a building is going into foreclosure? How should we be thinking about that as real estate professionals?

Eric Chafetz: Great. I'm more than happy to discuss. And I guess initially from a 30,000 foot perspective, the sky isn't falling. I mean, to be honest, I obviously have put a lot of thought into commercial real estate in New York, Los Angeles, and other large cities across the country. And it's interesting. I had a conversation— I've got a friend who is a professional at a debt shop that services commercial real estate companies, and we were just having a debate over what companies' office space needs are going to be and his view of the world, and I actually think he is probably right, is while people may be in the office less days a week, if everybody's in the office the same days, you're going to still need the same amount of space.

So realistically speaking, you're not going to seek to have less square footage than you otherwise would. My retort to that was, yeah, but why would anybody really want to pay for five days if you're only getting three? And he says, that's the debate.

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Eric Chafetz: During Covid, initially we definitely saw banks more interested in shoring up their real estate owners and pretending and extending and just making sure that they could at least get through the uncertainty. Over the last year or two we've definitely seen a handful of single asset real estate type bankruptcy cases where one building would file for bankruptcy, either potentially pre foreclosure to forestall foreclosure, or even post foreclosure if there was a deal in hand with the lenders. We've seen a handful of hotels file in the New York City area.

We've seen, across the country, one or two REITS file. Obviously, REITs own interest in several different properties, but we haven't seen a ton of that either, So, it seems to some extent that the commercial real estate market, at least from our perspective in New York, has stabilized in some way, shape, or form. You are still seeing, across the country, in big cities -- LA, San Francisco, and the like, one-off instances of a borrower handing the keys over to a lender and saying, "this is your problem." But for the most part, lenders don't want that responsibility – they are not in the business of running a building or operating a building. But, when it comes to bankruptcy, really what happens, just big picture, is... I'll use the example of an impending foreclosure action. The owner of a building will be aware, potentially that a bank is seeking to foreclose on it. And what it will do is it will file a bankruptcy petition with a court. I'll use the Southern District of New York, as an example.

The ramifications or the implications of the filing of that petition is that the automatic stay is put into place and the automatic stay is what it kind of sounds like. Creditors are required, including a potential bank seeking to foreclose on its mortgage, are required to stop immediately from foreclosing. If a party has a lien, they can't foreclose on that. If a party has a judgment, they can't enforce the judgment. So really, when a single asset real estate company files for bankruptcy, they are seeking to take the benefit of the automatic stay and get some breathing room to try to work out their affairs.

Generally speaking, in these cases they will move forward on a few different potential paths. The first would be a recapitalization of the existing capital structure, meaning somebody would be willing to invest in the building, put new dollars in, essentially wipe out the equity holders and move forward like that. More prevalently, and we've seen this a lot relatively recently with some of the larger hotels in New York, is they'll file what they call, a Section 363 motion.

Section 363 is the section of the Bankruptcy Code that allows a debtor— or building owner, in this case— to sell substantially all of their assets— here the building—free and clear of all liens, claims, encumbrances, etc. So, unlike a healthy sale, you can actually auction off a building. By way of example, say it has $100 million in debt... if the lenders are on board to some extent, they're going to have to just take what somebody willing to pay for the building. And if they only get $20 million, so be it, which actually provides the debtors with some leverage. And it also provides real estate investors who think they can get a good deal with a potential opportunity that you wouldn't have outside of bankruptcy. So…

Stacey Tyler: A lot of moving parts there. I think it's interesting that you bring up that leverage point, because I think a lot of people think of bankruptcy as, you know, well we failed and that's it. And, you know, now we're going out of business. But that point about it being an opportunity to renegotiate agreements is not I think, totally clear to a lot of people.

And I think we see that especially in situations like WeWork, for example, that a lot of us have been following in the real estate world, where that filing was an opportunity to kind of renegotiate a lot of things. So, can you talk a little bit about that please?

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Eric Chafetz: Yeah. So, WeWork was a bit unique because instead of having leases, they used licenses. But I'm just going to talk for purposes of this discussion as if they're synonymous with one another. WeWork was interesting. Their entire business model was based on leasing space in hundreds of buildings across the United States. Obviously turned out to be too much space based on Covid-19 and how folks are working currently.

But what happens and what every debtor has the opportunity to do in a bankruptcy case is pick and choose those leases that are beneficial and valuable to the estate, which is the debtor, and/or detrimental to the estate. And they can do what they call “reject” those leases that are detrimental. And one strategy that building owners like WeWork, will adopt is they'll be over-inclusive on what they are actually intending to reject for leverage purposes, in that they realize that a lot of buildings, where WeWork by way of example, where they were leasing space, they didn't want a vacancy in such a large space, so they'd be willing to give potential concessions to WeWork to stay there, even if it means that they didn't get the benefit of their initial bargain because things had to change. But one beneficial. aspect of the bankruptcy code for a building owner in the context of the WeWork case is that if the debtor, WeWork, wanted to not reject, but assume, meaning continue utilizing the space, they have to do what they call “cure “any defaults on the lease.

So, if WeWork was in arrears and hadn't paid rent for several months, they, theoretically speaking, have to pay 100 cents on the dollar of every amount that is due and owing pre-petition, which oftentimes can be millions and millions of dollars, especially in the case of WeWork where they had a ton of space and they just hadn't been paying rent.

That's not to say that those amounts can't be renegotiated as part of the leverage play that I talked about earlier, but there is some benefit if there's value for a debtor to potentially stay in a space.

Stephen Tanico: Now, just to take this back one step, and kind of unpack a little bit of this. We started this with the discussion of a real estate investor/developer is aware that a foreclosure is coming down the pipeline. What would your advice be? And it can be really more of the practical side than the absolute, you know, letter of the law side.

But what is your practical advice to clients in that situation? Because it sounds like they're at least being upfront and honest with you about the position of the business is a benefit versus being embarrassed about it, not talking about it and waiting until, you know, the lender files that foreclosure or really takes those more aggressive legal action steps.

Eric Chafetz: Yeah, from my perspective. And it may just be the nature of the beast is not real estate specific, is that business owners, building owners, they're optimists way too long. Unfortunately, we get calls from companies, most of the time it's— I don't want to say it's too late, but we could have done a lot more to help them, if they had come to us earlier. And it's just human nature to some extent. Nobody wants to, Stephen to your point, admit that their enterprise failed and that they have to file for bankruptcy. There's a stigma associated with it in some way, shape or form. But we obviously try to tell our clients that that's not the case.

Eric Chafetz: This gives you, a brand-new opportunity to start anew, and I think if I’m, representing a company and you know, there's a lender involved that may want to seek foreclosure, you want to be open, honest, and transparent with them and try to see if you can work through the process, because I think I said it before, there aren't many banks that actually want to, or let me put it this way, there aren't many money center banks, JP Morgan’s, Citibank’s of the world that actually want to own these buildings.

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If your investor is, a non-traditional lender, like a hedge fund or the like, they may have different incentives than some of the money center banks, and they may actually have, by way of example, bought a mortgage at a discounted price in order to take advantage of a potential insolvency filing.

But I still think that having an open, honest dialogue with your lender, with your other significant stakeholders, really is helpful. You don't want to do anything under the darkness of night—if you're having issues, there's—I mean, every situation is different. You want to caveat it, but if you if you're open and honest, there's oftentimes a way to work through your issues. And potentially avoid a foreclosure, in negatively public, for lack of a better term, embarrassment, if that's what you're worried about.

Stephen Tanico: Well, it's interesting, right? Because you're hitting on the psychological nature of it, but so much of it is that stigma around the term "bankruptcy" or being someone who went bankrupt, versus the kind of practical aspect of working this out. You know, I've been reading about developers and real estate players who aren't even necessarily in foreclosure but are just handing the keys back to their lender, knowing the lender never wants to be a landlord, and they can just buy that same asset back at discount at an auction following it.

So, it's interesting from our real estate perspective to see even that level of gamesmanship with not necessarily a bankruptcy, but with the idea of bankruptcy, kind of in the in the back of mind.

Eric Chafetz: Yeah, I know that is interesting. And another strategy and I didn't discuss this, when I was talking about, a Section 363 sale process is: money center bank knows that a building is struggling. A non-traditional finance source, like a hedge fund, will come in and buy the debt, say $100 million in debt for a very discounted price, $0.30, $0.40, $0.20 on the dollar.

And what you can do in bankruptcy is what they call a "credit bid." So instead of bidding cash, you're able to bid the debt that you purchased on a dollar-for-dollar basis, irrespective of how much you actually paid for that debt. So, you have a lot of currency if you really want to own the asset. If you really think there's value there, you can get very, very good deals in bankruptcy.

Stephen Tanico: That's fascinating. And so, does that purchase of the debt occur pre foreclosure and you then show up with a credit and the amount of that debt?

Eric Chafetz: Yeah, that's exactly what happens. And you can do a foreclosure sale and you can go through the court process, admittedly that's not my area of expertise, and I know that every state's a little bit different about how borrower- or owner-friendly it is.

Stephen Tanico: It's funny. You're giving me PTSD to doing some restructuring work at the beginning of Covid for a national player having to deal with the intricacies of various states and I guess, unsurprisingly, Texas still has an auction from the courthouse steps law. And literally someone went and stood outside, and the auction was conducted on the courthouse steps.

Eric Chafetz: Wow. You know, Texas is a very unique state. I'll just leave it at that. Yeah, I love Texas.

Stacey Tyler: For the record. And we're recording. We all love Texas.

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Eric Chafetz: Yes. There are a variety of different strategies that parties can implement when it comes to getting creative in a bankruptcy process and potentially getting very good deals.

Eric Chafetz: So, Stephen, to your point about a foreclosure sale: lender can get the assets back, but you only get certain benefits by foreclosing at least under New York state law, which I'm a little bit more familiar with. Like, you can't buy assets free and clear of liens and claims and other encumbrances.

So, under the Bankruptcy Code, there's real benefits. You can get cleansed assets. And if you're buying the debt at a fraction of the face value, and you can also get the benefit of selling free and clear of, say, mezzanine debt or other mechanics' liens. So, some of that stuff will attach to the proceeds of the sale, but you don't have to worry about it going forward.

There's real value there. By way of example, I had represented, we didn't unfortunately, get to a position where the client was comfortable making a bid, but a real estate developer who was potentially interested in buying the Williamsburg Hotel down in Brooklyn. And the big issue there was the hotel wasn't fully completed.

There was a ton of construction, there were liens up the wazoo, and what bankruptcy allows you to do is, arguably you sell the business, if there's not enough cash, you sell it free and clear of liens—those liens for unpaid construction costs will attach to the proceeds. If there aren't sufficient funds to pay all the liens, it's not the new buyer's problem. They're going to have to figure out what makes the most sense and how to divvy up whatever the sale proceeds are into who, based on the priority level.

So there's just ways to get out of other obligations that you just can't do through a strict foreclosure sale under really any state law as far as I know.

Stacey Tyler: So, on that point, I personally have been involved in hundreds and hundreds of regular real estate sales, where in our world it's usually you have a month to three months to do a deal, and you take your time and do your title and survey. And then I've been involved in these bankruptcy related sales where, you know, you get a court order on a Friday and then the sale supposed to close immediately. And that leaves me just with my head spinning. So, I'd love to hear you talk a little bit about the difference in the way that transactions like that get done in the bankruptcy world via the court than in, you know, the rest of the kind of run of the mill transactions.

Eric Chafetz: You know, that's a very good question. It's not even real estate specific, to be honest. So historically, I don't want to date myself. But when I started my career back in 2004, there were more traditional reorganizations where, by way of example, if there was a retailer out there, they'd actually be given room by their lenders to say, go through bankruptcy for a year, year and a half, see what works during a holiday season, and make whatever operational tweaks need to be made.

Nowadays, unfortunately or fortunately, depending on your perspective, there aren't as many traditional money center bank type lenders involved in these situations. They may have a revolver or some piece of the debt, but a lot of bankruptcy processes are driven by hedge funds. And now private lenders. And they have a different incentive and different motives. They want to get a company into bankruptcy.

They don't care about reorganization. They just want to sell the assets. Sometimes in 45 days, sometimes in 60 days. Every case is a little bit different. They want to get into bankruptcy, sell the assets as quickly as possible and get paid. And we don't know what they paid for their debt. This is just a dollar play for them.

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And in bankruptcy we always, we like to joke—we do a lot of litigation in bankruptcy as well. And it's litigation on speed. Everything has to get done quickly based on what the lender is willing to fund, because one of the things that a bankruptcy court can't force a lender to do is find one more dollar than they want them to find.

So if they're willing to give a debtor 45 days, 60 days, and we don't have another buyer out there or another third party willing to invest additional monies, the court's not going to force them to do that. So, you're kind of stuck with the timeline that you have. And to your point, Stacey, that's one of the main reasons why these sale processes and these cases are so fast is because the lenders have a ton of sway under the U.S. bankruptcy system.

Stephen Tanico: It's dangerous. Yeah. Because you just you talked about kind of a shift in how bankruptcy and restructuring are looked at. You know, I remember always being told as a non-bankruptcy lawyer like, good luck in bankruptcy, if it goes to court, it's the Wild West. And you know, whatever paper you have, take it, throw it out the window and pray to whatever God you believe in and hope for the best.

You know obviously the Bankruptcy Code hasn't changed that much, but are you seeing kind of a shift in, you know, and maybe it's dependent on the type of lender, but with more of an appetite for that kind of risk in going to a bankruptcy or using that as leverage in terms of working something out or restructuring something before that? But I guess generally with the kind of black box that used to be bankruptcy court, how does that still factor into what you're seeing in the market, knowing that the end result could just be... who knows?

Eric Chafetz: Yeah. No, it's interesting because you—j just like any practitioner, you're looking for as much certainty as you can possibly find if you're going to file for bankruptcy. If you file, you know, obviously, if you're a litigator, you file your litigation in the court or before or hopefully get before the judge that you think is going to give your client the best chance to win.

There are certain jurisdictions in the United States that are more prevalent when it comes to large bankruptcy filings. That's what I mainly focus on. Delaware is a very large venue, Southern District of New York, Southern District of Texas, and now even more so in New Jersey. What I'm seeing in the real estate specific context is there's a ton of cases filed in Brooklyn.

There's a lot of very large single asset type real estate cases filed there. And admittedly, I don't know the exactly the reason why, they probably could file in the Southern District of New York, but I'm assuming the answer is that the judges are just more well versed in these specific issues because they deal with them all the time. But yeah, it's a fair point. It's an interesting observation.

Stacey Tyler: You don't have to file where the building is located for a single asset deal?

Eric Chafetz: Let’s just say there are many ways to manipulate venue.

Like in larger bankruptcy cases, you can file in, I'll use the Southern District of Texas, which is Houston, if you open up a P.O. Box a week or two before a bankruptcy is filed. Whether it's right or wrong, that's what's done. Yeah, it’s unique. But generally speaking, would it make sense for the building? Yes, the answer is yeah, but it doesn’t necessarily mean it has to be that way.

Stephen Tanico: God it's too bad that we don't have a paywall, because that would be a really good tease for you know, if you're subscribing, paying for this, hear Eric's secret thoughts.

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Stacey Tyler: That one trick that bankruptcy court clerks hate.

Eric Chafetz: Yeah, that's really funny.

Stacey Tyler: So, one other question I've been getting from clients in New York City lately is about receivership. I've heard from a few clients whose buildings have gone into receivership, and as the tenants, they're left scratching their heads wondering, what does that mean for me when I'm not really sure who my landlord is anymore? Can you talk a little bit about that?

Eric Chafetz: Yeah. So, generally speaking, the receiver steps into the shoes of the debtor and becomes the manager of the building. So, if you're managing the building, your rent check should be paid to the receiver until you hear otherwise. The receiver can operate the business and try to sell the building and try to maximize value for all the stakeholders.

But my understanding in that context is, unless you hear otherwise, you should be paying whomever the receiver directs you to pay because that's what's required.

Stacey Tyler: That's helpful. I'm also getting the question, what do you do if the receiver says, well, I don't have your security deposit, so I can't give it back to you?

Eric Chafetz: That's a problem.

Eric Chafetz: But I guess it doesn't surprise me. Unfortunately, some of these debtors' books and records are probably a total mess and there's a reason a receiver is appointed. It's generally not because of good record keeping or good behavior on behalf of the owner. So, who knows how or what they actually did with the monies that they were supposed to be holding in escrow or in a segregated account for one or more potential tenants?

Stacey Tyler: Yeah, all the more reason to go in with a letter of credit rather than cash. It helps both of you sometimes.

Eric Chafetz: Yeah. If you can put the risk on a third party and a letter of credit in bankruptcy, especially in the context, I guess, of a real estate deal and a non-real estate deal, is material because it's not considered what they call "property of the estate". Generally speaking, if you were to have a security deposit that you referred to and you ask a debtor or a bankrupt party to give that money back, their like "no, this is money that we're keeping in our general account".

But because a letter of credit is held by a bank, it's not considered a property of the estate, and you can still draw on it oftentimes there's some nuances, but you can draw on it irrespective of bankruptcy without violating the automatic stay, which is something I was talking about earlier, so that there is some value when it comes to that.

Stacey Tyler: Right? Yeah, I'm used to hearing about it as landlord counsel and pushing for that in order to avoid the risk if the tenant goes bankrupt. But it sounds like if the landlord is the one who goes bankrupt, it would help the tenant as well to have that letter of credit held somewhere else, whose you know, still solvent.

Eric Chafetz: Yeah, it depends. If it's cash collateralized, it depends on the specific wording to some extent, but I would be a lot more comfortable having that than just dollars deposited in an operating account that you really will never be able to trace. That

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seems like your problem when it comes to dealing with receivers is they may have the money, but they can't identify your specific dollars, which could be a big problem.

Stacey Tyler: For sure.

Stephen Tanico: I guess, is there anything else, Eric, kind of with the way this conversation has flowed that there be value in adding? I feel like we kind of spun away from the entry level 101 type conversation, which it totally fine. But it feels weird now to be like, you know, can you tell me what a receivership is?

Eric Chafetz: Yeah. And receivership an alternative to a bankruptcy proceeding. But I guess just from a bankruptcy perspective, like some of the hot button issues that landlords care about say by way of example in a retail type bankruptcy, which I'm assuming a lot of your clients could arguably be. There's a split in the case law depending on where bankruptcy case is filed, about how you deal with rent for the month in which you file for bankruptcy, it's called “stub rent.”

Some courts require you to pay it immediately. Some courts don't necessarily require you to pay it. And that's always a hot button issue for landlords. We always fight for that when we're wearing our creditor hat. I'm trying to think of any other issues that landlords… there's, I guess, a big issue that landlords are very cognizant about: in retail type cases where there's a going out of business (GOB) sale about how those sales are advertised, what the GOB folks are able to do in the conduct of those sales.

There's big issues when there's a mall at issue or a shopping center and they've got all their tenants. They've got to be very conscious of that. So, we deal with those issues all the time. I guess just one anecdotal point, and I'm not sure if your listeners will be interested, but I found this kind of interesting because it actually went to the Supreme Court. Just at a very high level...

The old Sears store in the Mall of America, there was a lease there that I think Sears paid, don't quote me on the numbers, $100,000 for a 40-year lease. But they, when the mall was open, agreed to pay all the build out costs. So, they did that. They had, I guess, a very nice store out in Minnesota.

And Sears filed for bankruptcy. The purchaser, which was a company called Transform (billionaire Eddie Lampert who was the former owner of Sears.) They tried to assume that lease with a zero cure amount because there was nothing owed. They paid everything that they were required to pay because they paid the build out costs. And there was a very expensive, very hotly contested issue about the treatment of a lease.

It was a very unique set of circumstances, but Transform ended up getting to keep the lease, or at least the trust that creditors would benefit from, were able to get a very, very valuable lease for no money despite the fact that, let's just say the landlord was not very happy.

Stacey Tyler: I guess that goes to the point of it's really hard to predict how these things are going to shake out, as it's all super fact sensitive, but in general, sounds like our advice to our listeners would be try to be a little upfront with your team if you think that bankruptcy or some other type of, measure will be in your future.

Eric Chafetz: Yeah, I think that's very true. And I hate to sound like a lawyer, but facts matter and it's hard to give a black and white answer to certain questions. And every situation is a bit different. But bankruptcy shouldn't be a scary word. It doesn't mean you're a

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failure. There shouldn't be a stigma associated with it. And there really are some benefits.

If you're a building owner, if you're a lender, it really just depends on your perspective. And the one piece of advice I could give you is if you're wearing your lender hat, you're wearing your developer hat, your building owner hat, and you do think you're running into a problem and your counterparty is dealing with financial distress: You should reach out to an attorney sooner rather than later because there's oftentimes a solution. But the longer you wait, unfortunately, the solution gets harder to reach.

Stephen Tanico: Awesome. Thanks so much, Eric.

Eric Chafetz: Oh, of course I didn't know what to expect.

Stacey Tyler: Well, I hope you had as much fun as we did. That about wraps it up for us today. Thank you, Eric, for joining us and helping us get a little bit smarter about bankruptcy.

Stephen Tanico: And thank you, listeners for tuning in today. Be sure to like, subscribe, and follow Terra Firma wherever you're listening to this episode. Stacey and I would love to hear from you, so feel free to reach out to us at Terrafirma@lowenstein.com – until next time.

Stacey Tyler: Ciao!

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