Bankruptcy and Real Estate:
Risks and Opportunities in Distressed Situations

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Today's Discussion

1. Introduction to Bankruptcy
2. Real Estate Financing
3. Treatment of Real Property Leases
4. 363 Sales
5. Chapter 11 Plans

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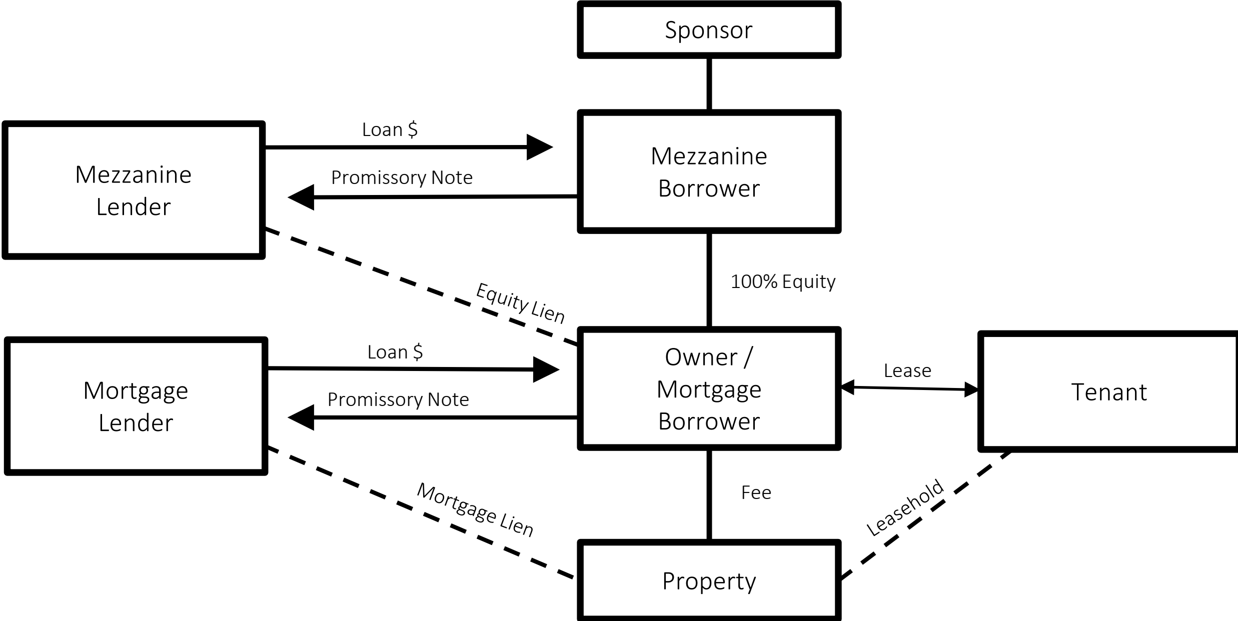
1. Introduction to Bankruptcy

Interests in Real Estate

1. Owners and Investors

2. Lenders – Mortgage and Mezzanine

3. Tenants



Commencement of Bankruptcy Case

There are three ways an entity can be put into bankruptcy:

(1) voluntarily, by the entity's board or directors or managers;

- The authority to commence a bankruptcy case generally is subject to the limitations set forth in the entity's charter documents.

(2) involuntarily, by the entity's undisputed, unsecured creditors; or

- An involuntary petition must be filed by 3 unsecured creditors holding in the aggregate over $16,750 in unsecured claims if the debtor has 12+ unsecured creditors, or 1 unsecured creditor if there are fewer than 12 unsecured creditors.

(3) involuntarily, by application of the equitable doctrine of "substantive consolidation"

- Substantive consolidation of non-debtors depends on the jurisdiction.

Chapter 7 Liquidation

- Chapter 7 provides a statutory framework to liquidate a debtor’s assets, and distribute cash proceeds to creditors based on a statutory priority scheme.
- A Chapter 7 trustee takes control of all of the debtor’s assets and causes of action, and reconciles all claims asserted against the debtor.
- The debtor has the right to transform an involuntary chapter 7 into a chapter 11.
- Any party in interest can seek a court order converting a chapter 11 case to chapter 7 “for cuase”

Chapter 11 Reorganization

- Chapter 11 provides a statutory framework to reorganize or liquidate through a court-supervised sale or chapter 11 plan.
- Except in unusual circumstances, the debtor's management remains in control of the company and the bankruptcy process.
  - If a debtor's management is replaced (typically for fraud or gross mismanagement), a chapter 11 trustee will be appointed by the bankruptcy court to run the debtor
- In most large chapter 11 cases, an Official Committee of Unsecured Creditors (the "Committee") is appointed to represent the interests of unsecured creditors.
  - The Committee is charged with, among other things, reviewing the liens of secured creditors and potential causes of action against the debtor's management, equity, and lenders.
- Chapter 11 cases are resolved through (i) confirmed chapter 11 plans, or (ii) upon completion of a restructuring transaction, dismissal or conversion.

Automatic Stay

- Once a bankruptcy case is commenced, all litigation and creditor enforcement actions come to a halt, including:
  - Acts to control property of the estate or recover property from the estate;
  - Any effort to collect, assess or recover claims;
  - Starting or continuing lawsuits;
  - Creating, perfecting or enforcing liens; and
  - Exercising setoffs (with exceptions).
- A bankruptcy court may grant relief from the automatic stay:
  - For "cause," including the lack of adequate protection in an interest in property; or
  - Against property if the debtor does not have equity in the property and the property is not necessary to an effective reorganization.

Automatic Stay: SARE

- In a single-asset real estate ("SARE") chapter 11 case, secured creditors are entitled to relief from the stay unless, within 90 days after the petition date, the debtor either:
  - Files a plan that has a reasonable likelihood of being confirmed; <u>or</u>
  - Starts paying interest at non-default contract rate interest on the lesser of the debt or the fair value of the collateral.
- The plan must have a reasonable likelihood of confirmation, so courts often decide confirmation issues in the context of motions to lift the automatic stay.
- A SARE is an entity whos business amounts to a single project or property; the real property generates substantially all of the debtor's income.
  - Operating a business independent or ancillary to ownership of the property (like a hotel, spa, or golf course) will disqualify a debtor from being a SARE.

Fraudulent Transfers/Preferences

- Transactions should be structured to account for the risk of being unwound or clawed back in bankruptcy as a fraudulent or preferential transfer.
- Fraudulent Transfers
  - Transfers can be avoided as: (i) constructive fraudulent transfers if made while the debtor was insolvent and for less than reasonably equivalent value; or (ii) actual fraudulent transfers if made with the actual intent to hinder, delay or defraud creditors.
  - There is a two-year look-back for fraudulent transfers under the Bankruptcy Code and a 4- to 6-year look-back period generally under state law.
- Preferential Transfers
  - Transfers can be avoided if made on account of an antecedent debt within 90 days of the petition date (or 1 year for insiders), subject to statutory defenses.

Executory Contracts/Unexpired Leases

- A debtor in bankruptcy has authority to assume, assign, or reject executory contracts and unexpired leases.
- An “executory contract” is a contract where the obligations of the debtor and non-debtor counterparty are so far underperformed that the failure to perform by either party would constitute a material breach.
- Assumption of a contract or lease allows a debtor to retain valuable agreements, but requires the debtor to cure any existing monetary or non-monetary defaults.
- Assignment of a contract or lease allows a debtor to transfer valuable agreements as part of going-concern transactions, or stand-alone sales.
- Rejection of a contract or lease allows a debtor to terminate obligations under burdensome or nonmarket agreements.

Sales/Chapter 11 Plans

- Chapter 11 cases generally (i) involve a court-supervised auction and sale process, or (ii) culminate in a confirmed chapter 11 plan that can provide for (a) the valuable side of the debtor’s business reorganized as a healthy going concern, (b) liquidation of the debtor’s remaining assets and causes of action, or (c) a combination of the two.
- Bankruptcy sale processes are generally cheaper than chapter 11 plans, and the market generally dictates the value of the debtor’s assets.
- Confirming a chapter 11 plan can be expensive, and, in the absence of a prepackaged or pre-negotiated plan, usually takes longer than a sale process.
    - However, a debtor generally has more control over who the ultimate owner of the debtor’s assets or business will be at the end of the case when pursuing a plan process, provided the debtor is able to garner necessary creditor support.

2. Real Estate Financing

Structuring a Bankruptcy Remote Special-Purpose Entity

- Structuring a bankruptcy remote SPE generally involves attention to at least two areas:
  - Liabilities and Creditors: Attention to forces that may lead to a voluntary filing, involuntary filing or interfere with the lender's exercise of remedies or recovery in a bankruptcy.
  - Authority to File: Attention to an SPE's ability to file bankruptcy.

Structuring a Bankruptcy Remote SPE – Liabilities and Creditors

- An SPE is a newly created entity with no prior business activities that could have given rise to preexisting creditors or other claims (tort, environmental, etc.).
- SPE activities are restricted to those necessary or incidental to the financing, which is accomplished by:
  - restrictions being placed in the organizational documents of the SPE;
  - restrictions placed in the loan documents; and
  - drafting protection against amendments into the foregoing documents.
- Restrictions on permitted debt and permitted encumbrances should be narrowly tailored in loan documents. There should be no other mortgage liens and protections against other liens.
- Seperateness covenants.

Structuring a Bankruptcy Remote SPE – Authority to File

- Restrictions on a borrower’s ability to file bankruptcy may be enforceable under state law but held void as against federal public policy.
- Applicable non-bankruptcy law governs who has the authority to make an entity’s decision to commence bankruptcy proceedings.
- Mechanisms designed to avoid an entity’s voluntary bankruptcy include:
  - Appointment of independent directors; and
    - From a nationally recognized company that provides professional independent directors.
    - Resignation, removal or replacement requires advance notice to Lender.
  - Agreements among “bona fide” stakeholders.

Structuring a Bankruptcy Remote SPE – Authority to File

- Agreements between borrower and lender to interfere with a borrower's right to commence bankruptcy may not be enforceable:
  - Waiver of right to file (*In re Bay Club Partners)*.
  - The "Blocking Director" (*Lake Michigan Beach Pottwattamie Resort*).
  - The "Golden Share" (*Intervention Energy*).
- Agreements between "bona fide" equity holders regarding a borrower's authority to file bankruptcy are generally enforceable:
  - Majority or unanimous vote among equity holders required. (*DB Capital; Squire Court; Franchise Services*).

Structuring a Bankruptcy Remote SPE – Authority to File

- An SPE is intended to be bankruptcy-remote, but not bankruptcy-proof.
- Notwithstanding the appointment of an independent director, the SPE can still commence a bankruptcy voluntarily:
  - Exercise of fiduciary duty of independent board member of SPE to file bankruptcy will be respected.
  - Fiduciary duty runs to SPE entity and, derivatively, its stakeholders under Delaware law.
  - Insolvency not required—an SPE can be solvent and still avail itself of bankruptcy protection.
  - Imminent risk of default is not required to commence a chapter 11 case.
  - Limiting/eliminating fiduciary duties of board members may trigger lender liability risks to other stakeholders.

Full Springing Recourse Liability

- Full recourse liability to a guarantor if borrower commences a bankruptcy:
  - Borrower commences a voluntary bankruptcy; or
  - Borrower and/or its affiliates engage in collusive behavior leading to an involuntary bankruptcy.
- Full recourse liability if borrower violates separateness covenants. However, *post-Cherryland,* the consequences for these violations are often heavily negotiated between:
  - "Above the line" liability for losses, and
  - "Below the line" liability for the outstanding indebtedness.

Full Springing Recourse Liability

- "Bad boy" guaranties are generally enforceable.
  - Can be enforced in state court (favorable forum), not necessarily in bankruptcy court.
  - Not against public policy, despite incentivizing managers to delay an appropriate or necessary bankruptcy filing.
  - That the liability of a "bad boy" guaranty may substantially exceed the damages is usually of no moment. Sophisticated financial parties can agree to full-recourse liability.
- A guarantor is on the hook for these "bad boy" behaviors, but this is only as good as the creditworthiness of the guarantor.

Post-Petition Funding: DIP Financing

- The Bankruptcy Code has special rules to encourage lenders to provide financing to companies in bankruptcy (“DIP financing”).
- DIP lenders can be pre-petition lenders or “new money lenders.”
- DIP financing can be (and usually is) secured.
- Security can be junior to pre-petition liens, but usually, security ranks ahead of all pre-petition-secured creditors (a “priming lien”).
  - Requires consent of the pre-petition secured lenders or “adequate protection” of affected pre-petition secured creditors;
  - Because consent or adequate protection from pre-petition lenders may be hard to obtain, debtors often ask pre-petition lenders to provide DIP financing themselves.

Post-Petition Funding: DIP Financing (cont'd)

- Every pre-bankruptcy creditor is at risk of being subordinated to DIP financing in every case.
- The DIP lender will establish a budget and will often impose a timeline for a sale or plan process.
    - Accordingly, the DIP lender will often have significant influence in a case.

Post-Petition Funding: Cash Collateral

- Through use of rents or proceeds of collateral (e.g., cash from liquidation of accounts receivable), Debtors can pay the costs of the chapter 11 case through use of rents generated by the collateral, or proceeds from sale of assets.
- If existing cash or cash proceeds are subject to pre-petition liens, the debtor may use such cash only with the consent of the secured parties or by court order based on a showing that the secured claims are adequately protected.
- The debtor and the secured parties may reach a pre-filing agreement whereby, in exchange for the use of cash collateral, the debtor provides "adequate protection" to the secured parties for the use of cash collateral to protect against a diminution in the value of the collateral resulting from such use.

Post-Petition Funding: Adequate Protection

- Whether a debtor uses cash collateral or receives DIP financing, existing secured creditors are entitled to "adequate protection" for (a) use of their collateral and (b) priming of their pre-petition liens.
- Secured creditors receive protection through one or more ways, including:
  - Grant of additional liens on unencumbered property, replacement liens, super-priority administrative claims;
  - Periodic cash payments of post-petition interest at a non-default rate and/or attorney fees;
  - Increased reporting rights;
  - A budget agreed to by the secured creditors;
  - Milestones for a sale or plan process agreed to by the secured creditors.
- Liens and/or payments are only required to the extent of diminution of value of the secured creditors' interest in the collateral.

Post-Petition Funding: Risks Arising from Affiliated Debtors

- Diversion of rents from collateral to fund other properties with negative cash flow or general overhead expenses.
- Imposition of senior priming lien on collateral to secure a DIP loan, or creation of an administrative claim, where DIP proceeds may not benefit the collateral.
- Secured lender is entitled to "adequate protection," but what is adequate will depend on court's assessment of fair market value of the collateral—"equity cushion" alone can be adequate even if it is reduced by use of rents or priming lien.
- If court concludes that only a single class is required to accept the plan, a multi-debtor joint plan may enable the debtor to satisfy the requirement of at least one impaired consenting class even if a single debtor may have no separate class that accepts.

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3. Treatment of Real Property Leases

Treatment of Leases in Bankruptcy: Overview

- A debtor has 120 days to decide whether to assume or reject an unexpired nonresidential real property lease.
  - The Consolidated Appropriations Act ("CAA") extends this deadline from 120 days to 210 days. This amendment terminates on December 27, 2022.
- A debtor is allowed one 90-day extension for "cause", but, if granted, any subsequent extensions may only be granted with the prior written consent of the lessor.
- A debtor's decision to assume or reject a lease is subject to court approval. Courts apply the deferential business judgment standard.
- If a lease is not assumed or rejected during the statutory period, the lease is automatically deemed rejected and the debtor is required to immediately surrender the leased property.

Treatment of Leases in Bankruptcy: Interim Period between Petition Date and Lease Assumption or Rejection

- Leases continue in full force.
- A lessor cannot terminate the lease unless the Bankruptcy Court grants relief from the automatic stay.
- Bankruptcy/insolvency termination clauses are unenforceable.
- A debtor may run going-out-of-business sales.
- A debtor must pay rent each month in full and on time.
  - If the debtor fails to make such a payment, the landlord can file a motion to compel payment of rent and/or a motion to force the debtor to make a decision to assume or reject the lease.

Treatment of Leases in Bankruptcy: Obligations to Pay Rent

- Payment of "stub rent" is an important factor that should be considered for any entity with significant lease obligations.
- "Stub rent" refers to the amount of rent due to a landlord corresponding to the period of occupancy between the date the debtor files for bankruptcy and the first post-petition rental payment due date under the unexpired lease.
  - Under the **billing date approach** (followed in the 3rd and 8th Circuits), if the date rent becomes due and payable under the lease is prior to the petition date, then the stub rent does not need to be paid immediately (but the landlord may seek rent for the post-petition period as an administrative expense).
  - Under the **proration approach** (followed in the 2nd, 4th, and 9th Circuits), the debtor is obligated to pay stub rent on a prorated basis immediately for the period of occupancy between the petition date and the first post-petition rental payment due date, regardless of when the monthly payment was due.

Treatment of Leases in Bankruptcy: Obligations to Pay Rent (cont'd)

- Rent deferral
  - Section 365(d)(3) of the Bankruptcy Code authorizes a court to defer post-bankruptcy lease payments for up to 60-days for "cause."
  - Due to the ongoing COVID-19 pandemic, bankruptcy courts have become more willing to grant 60-day post-petition rent deferrals, with some courts even granting extensions beyond the 60-day period in certain cases.
    - As a result, filing and taking advantage of a rent deferral period have become a more common debtor tactic.
  - Recent examples include the following:
    - *Pier 1 Imports* (deferring rent payments beyond 60-day period)
    - *Modell's Sporting Goods* (deferring rent payments beyond 60-day period)
    - *JC Penney* (deferring rent payments for 60 days)
    - *CEC Entertainment* (deferring rent payments for 60 days)

Treatment of Leases in Bankruptcy: Assumption of Lease

- In order to assume a lease, a debtor must cure all defaults other than insolvency-related defaults and provide adequate assurance of future performance of lease obligations.
- Effect of assumption:
  - Lease continues;
  - If the debtor breaches the lease after it is assumed, then the landlord can file an administrative expense claim.

Treatment of Leases in Bankruptcy: Assignment of Lease

- A lessee may assign an unexpired lease that has been assumed even when the lease prohibits assignment.
  - Use restrictions in a lease may be viewed as an unenforceable anti-assignment provision (for example that the tenant can only operate a certain store in the space).
  - Special rules apply for "shopping center" leases, which provide shopping center landlords (1) the right to object to a proposed assignment on the basis that it would disrupt the tenant mix at the shopping center and (2) that use restrictions in those leases cannot be overridden by an assignment.
- Assignee will need to provide adequate assurance of future performance.
- Assignment may be part of a larger sale of all or a portion of the debtor's business to a third party.

Treatment of Leases in Bankruptcy: Rejection of Lease

- Effect of rejection:
  - The debtor is relieved of its obligation to perform remaining obligations under the lease. The lease terminates as of the rejection date and upon the debtor's surrender of the leased premises to the landlord.
  - The landlord is left with a claim for damages against the bankruptcy estate.
- Debtors often request authority to abandon certain property at a leased space they are rejecting. This is usually granted but the landlord has the right to assert a damage claim for the costs it incurs due to such abandonment.

Treatment of Leases in Bankruptcy: Rejection of Lease (cont'd)

- Landlords are entitled to certain damages upon rejection:
  - Administrative expense claim for the portion of its claim attributable to post-petition, pre-rejection period;
  - Unsecured pre-petition claim for amounts not paid for pre-petition and any damages arising from the debtor's future nonperformance (though future rent is subject to a cap); and
  - Secured claim to the extent of any deposit, and an unsecured pre-petition claim if the allowable claim exceeds any deposit.

Treatment of Leases in Bankruptcy: Rejection of Individual Leases under Master Lease

- Although debtors are afforded great latitude in deciding which executory contracts and unexpired leases they will assume or reject, the Bankruptcy Code requires all such assumptions or rejections to be *cum onere* or "as a whole."
  - In other words, a debtor cannot "cherry pick" the provisions of an executory contract or lease that it finds favorable and assume those, while rejecting those provisions it finds burdensome; rather, the entire executory contract or lease must either be assumed or rejected.

Treatment of Leases in Bankruptcy: Rejection of Individual Leases under Master Lease (cont'd)

- A court will allow a debtor to assume some leases under a master lease, while rejecting others, if the court determines that the master lease does not constitute a single integrated agreement.
  - Whether a writing is a single, integrated contract is determined by state law.
- Factors that a court may consider include the following:
  - Stated intent of the parties (i.e., whether the master lease manifests an intent that it constitute one integrated and indivisible agreement);
  - If multiple lessees, whether the lessees are all jointly and severally liable;
  - Ability to sell or assign individuals properties;
  - Cross-default provisions among leases; and
  - Allocation of rent based on individual leases.

Treatment of Leases in Bankruptcy: Calculating Lease Rejection Damages

- Section 502(b)(6) caps damages under a rejected lease of nonresidential real property:
  - Unpaid pre-petition obligations; plus
  - The "rent reserved" under the lease for the greater of (i) one year or (ii) 15% of the remaining term of the lease, not to exceed three years, following the earlier of the petition date or the date the premises are surrendered.
- If the 502(b)(6) cap is greater that the actual damages, the rejection claim is determined by reference to actual damages.
  - Section 502(b)(6) is not a formula for calculating a landlord's claim—it is a limit on damages recoverable in the bankruptcy.
- Section 502(b)(6) does not limit a Landlord's administrative expense claim for rent accrued during the post-petition Debtor's occupancy of the property.

Treatment of Leases in Bankruptcy: Lease Rejection Damages and Security Deposits

- Security deposits are applied as a dollar-for-dollar reduction against the 502(b)(6) cap.
  - Security deposits held by Landlords are considered property of the Debtor's estate (often listed as assets in the Debtor's schedules).
- The law is less clear if the Landlord is the beneficiary of a letter of credit because unlike security deposits, letters of credit are not considered property of the Debtor's estate.
  - However, courts in a number of jurisdictions have held that letters of credit are merely forms of security deposits and should be treated like security deposits, resulting in a dollar-for-dollar reduction against the 502(b)(6) cap.

Treatment of Leases in Bankruptcy: Avoidance of Pre-Petition Lease Payments

- If a tenant has not been making its rent payments on time, or makes a "catch up" payment to cover rent arrearages, landlords must consider the risk that rent payments made within 90 days of the tenant's bankruptcy can be avoided as a preferential transfer under section 547 of the Bankruptcy Code.
- Rent payments made under the timing required under the lease may give a landlord a statutory defense to any preference action based on the payments being made in the "ordinary course of business."
- Late payments by a distressed tenant/counterparty could impair "ordinary course of business" defense.
  - But, you should still accept payments that might constitute a preference because ***CA$H IS KING***.

Treatment of Leases in Bankruptcy: Avoidance of Pre-Petition Lease Payments (cont'd)

- The CAA amends section 547 to prohibit a debtor from avoiding payments made by a debtor during the preference period for "covered rental arrearages" and "covered supplier arrearages." To qualify for the exemption:
  - (a) the debtor and the counterparty must have entered into a lease or executory contract before the filing,
  - (b) they must have amended the lease or contract after March 13, 2020, and
  - (c) the amendment must have deferred or postponed payments otherwise due under the lease or contract. The preference exemption will **not** apply to the payment of fees, penalties, or interest imposed in the post-March 13, 2020 amendment.
- This CAA amendment terminates on December 27, 2022.

Treatment of Leases in Bankruptcy: True Lease vs. Disguised Financing

- A debtor may request abankruptcy court to "recharacterize" a lease as a disguised financing
- Factors in determining whether a lease agreement is a "true lease" or disgusined financing include:
  - The intent of the parties (including how the parties characterized the transaction in the agreement)
  - Whether the lease includes a nominal purchase option
  - Whether the lease term covers the useful life of the property
  - Whether rent is calculated at a market rate
  - Whether the tenant has obligations normally associated with ownership
- Consequences of recharacterization include:
  - No obligation to pay rent timely
  - Treatment as debt under chapter 11 plan (e.g., cramdown)
    - Debt may potentially be unsecured if lessor failed to record and/or file protective UCC-1

4. 363 Sales

363 Sales: Overview

- A Section 363 Sale is the process by which assets are sold in bankruptcy.
- Assets may be sold "free and clear" of liens and other interests.
- Normally, the debtor accepts bid and enters into an agreement with the lead bidder, known as the "stalking horse."
- The agreement is submitted to the court for approval and, as part of that approval, competing bidders are given an opportunity to top the stalking horse bid in connection with an auction process.
- Ultimately, the sale will be approved if the debtor can show it has accepted the highest or otherwise best offer.
- A 363 Sale is <u>NOT</u> a sub rosa plan.

363 Sales: Credit Bidding

- A credit bid allows a secured creditor with a valid security interest in the assets being sold to bid for its collateral by proposing to set off its claim against the purchase price of the assets.
- The ability to credit-bid gives the lienholder protection against an attempt to sell its collateral too cheaply.
- It is generally accepted that a secured creditor *can credit-bid the full face amount of its debt*, not only the secured portion under 11 U.S.C. § 506(a).
- Bankruptcy Code section 363(k) provides that a secured creditor may credit-bid in a sale of its collateral unless "*the court for cause orders otherwise.*"
  - "Cause" is generally assessed on a case-by-case basis, but can include improper conduct by the buyer, a dispute as to the validity of the secured debt, or to avoid chilling the auction process.

363 Sales: Selecting a Stalking Horse

- Bankers may conduct a mini-auction to select the Stalking Horse.
  - The goal is to identify the highest or otherwise best offer, taking into account price, structure, assumption of liabilities, timing, and other concerns.
- A secured lender may become a Stalking Horse through a credit bid.
- One of the main benefits of being a Stalking Horse is that, subject to court approval, the Stalking Horse may be entitled to a termination fee and/or expense reimbursements if the Stalking Horse is not the successful purchaser at an auction.
- The Stalking Horse may negotiate milestones that the debtor must meet to avoid default.

363 Sales: Bid Procedures and Auction Process

- A debtor can technically proceed with a private sale (no overbid process).
  - *However*, bid procedures are the standard practice.
- Bankruptcy sales usually use a 30 – 60-day auction process.
- Bid procedures will be subject to notice, hearings, and court approval.
  - Committee, lenders, landlords, and others will often comment or object.
- Bidders should consider 363(n) issues.
  - A debtor or other stakeholder may avoid a sale or recover damages if bidders agreed among themselves to fix the price.
- The court will approve specific procedures for assumption, assignment, proposed cure amounts, etc.

363 Sales: Sales Free and Clear

- Section 363(f) <u>can</u> allow sales free and clear of:
  - Successor liability; and
  - Ownership disputes (subject to limitations and depending on the jurisdiction).
- Section 363(f) <u>does not</u> allow sales free and clear of:
  - Government approvals;
  - Ongoing environmental obligations; and
  - Assumption and Assignment of Contracts/Leases.

363 Sales: 363(m) Considerations

- 363(m): Any reversal or modification of the sale on appeal will not affect the sale's validity unless its authorization has been stayed pending appeal.
- Debtor and Buyer must negotiate up front whether the sale will close over an appeal.
  - This could affect ability to get title insurance in a real estate transaction.

363 Sales: Considerations for Hotel 363 Sales

- Due to COVID-19's impact on the hospitality industry, 2020 saw an increase in chapter 11 filings by hotel owners.
- Hotel properties are generally subject to franchise leases or management agreements that include a license to use trademarks or trade names.
- Courts have not been consistent, but recent decisions have found that the Bankruptcy Code bars the assignment of any trademark license without the licensor's consent under the standard established by the agreement.
- As a result, a debtor franchisee generally cannot transfer the flag to a buyer without complying with the franchise agreement's consent provisions.

5. Chapter 11 Plans

Chapter 11 Plan: Overview

- In a chapter 11 case, a plan typically does the following:
  - Provides for the means of implementation of the restructuring (e.g., continued operations, restructuring debt, issuance/exchange of securities, sale of property, etc.).
  - Classifies all claims and interests and describes the treatment of each impaired class.
    - A claim can only be placed in a class with other claims that are substantially similar.
    - All claims within a particular class must receive the same treatment.

Chapter 11 Plan: Overview (cont'd)

- All impaired claims (i.e., claims that are not paid in full, in cash, or reinstated according to their original terms without any modifications) must be solicited for a vote—claims that are not impaired are deemed to vote in favor of the plan.
  - Unless creditors consent, the plan must follow the "Absolute Priority Rule" (discussed below).
  - Shareholder approval not required under "cramdown" rules (discussed below).

Chapter 11 Plan: Exclusivity

- Chapter 11 gives incumbent management and board the exclusive right to file a reorganization plan for the first 120 days of a case.
  - As noted above, a SARE debtor must propose a plan or start paying interest within 90 days of the petition date or relief from stay may be granted.
- Debtors can request, and are often granted, an extension to the 120-day exclusivity period.
  - There is an 18-month limit to exclusivity.
  - Creditors can seek to terminate or modify exclusivity.

Chapter 11 Plan: Required Contents of the Plan

- The chapter 11 plan must, among other things, classify all claims and interests, describe the treatment of each impaired class and provide for the implementation of the plan.
  - A claim can only be placed in a class with other claims that are substantially similar.
  - All claims within a particular class must receive the same treatment.
- The plan must follow the "Absolute Priority Rule" (below).

Chapter 11 Plan: The Absolute Priority Rule

- The "Absolute Priority Rule" requires that each senior class in the priority ladder (below) be paid in full prior to any payment to a junior class.
  - *Unless*, the senior class consents to less than full payment.
- <u>Class 1</u> – Secured Claims
  - Multiple tranches – paid in order of claims or in accordance with inter-creditor agreements.
  - Liens not properly perfected are subject to avoidance.
  - Will receive unsecured "deficiency" claims if collateral is insufficient to pay in full.
- <u>Class 2</u> – Administrative and Priority Claims
  - Must be paid in full in order for a debtor to emerge from bankruptcy through a plan.
  - Examples include: taxes, expenses incurred after filing, 20-day trade claims, cure payments on assumed leases/contracts, reclamation claims.
- <u>Class 3</u> – Unsecured Claims
  - Unsecured claims generally receive payment of claims on a pro rata basis.
  - Plan may differentiate between bond and trade debt and treat associated claims differently.
  - Contractual subordination agreements are enforced.
- <u>Class 4</u> – Equity Interests
  - Equity interests will receive a distribution only if the debtor is solvent and all other senior classes are paid in full.

Chapter 11 Plan: Solicitation and Voting

- Creditor votes are solicited on a class-by-class basis.
  - Acceptance of a plan by an impaired class of claims requires acceptance by creditors holding at least two-thirds in amount and more than half in number of the allowed claims actually being voted.
  - If a class of claims is not impaired under a plan, there is a conclusive presumption that the plan has been accepted by the class and by the holder of each claim.
  - A class that receives nothing under a plan is deemed to have rejected the plan.
- If every impaired class votes to accept, then court asks to confirm the plan.
- If no impaired class votes to accept, then the plan cannot be confirmed.
- At least one class of non-insider, impaired claims must vote to accept the plan in order for a plan to proceed to confirmation.

Chapter 11 Plan: Confirmation

- To be confirmed, a plan must be accepted by each impaired class or any dissenting class must be "crammed down."
- Acceptance requires more than one-half in number and two-thirds in amount of those who actually vote to accept the plan.
- The Bankruptcy Court must find that the 13 requirements of section 1129 are met, the most significant of which are:
  - At least one class of impaired creditors has accepted the plan;
  - "Best interests of the creditors test."
    - Every creditor must receive at least as much as it would receive in a chapter 7 liquidation or accept the plan.
- The plan must be "feasible"; this means that the debtor must show that there is a reasonable likelihood that it will be able to make all plan payments.

Chapter 11 Plan: Cramdown

- A plan may be confirmed even if an impaired class rejects the plan through a process called "cramdown."
- So long as at least one impaired class accepts the plan, a court will confirm the plan despite the rejection by one or more impaired classes, if:
  - (1) the plan does not unfairly discriminate; and
  - (2) the plan is fair and equitable with respect to any dissenting impaired class.

Chapter 11 Plan: Cramdown (cont'd)

- Secured creditors – Generally found to be "fairly and equitably" treated if:
  - Each secured creditor retains its lien to the extent of its secured claim and receives present value of deferred cash payments;
  - The collateral is sold with the lien attaching to proceeds; or
  - Each secured creditor receives the "indubitable equivalent" of its collateral.
- Unsecured creditors – Generally found to be "fairly and equitably" treated if:
  - Creditors in the class receive (over time) cash payments equal to present value of their unsecured claims; or
  - Junior classes receive nothing under the plan.

Chapter 11 Plan: Reinstatement of Secured Debt

- To avoid a “no” vote (or comply with cramdown requirements) with respect to secured debt (particularly debt on terms favorable to the debtor), the debtor may cure all defaults and reinstate such debt as debt of the reorganized company.
  - If successful, the secured creditors will be deemed “unimpaired” and may not vote.
  - Some defaults, however, cannot be cured and therefore the debt will be “impaired.”
  - An argument exists that certain nonmonetary defaults that cannot be cured might result in damages for pecuniary loss but not “impairment.”

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Robert A. Klyman is a partner in the Los Angeles office of Gibson, Dunn & Crutcher and Co-Chair of Gibson Dunn's Business Restructuring and Reorganization Practice Group. In his international practice, Mr. Klyman represents companies, lenders, ad hoc groups of secured and unsecured creditors, acquirers and boards of directors in all phases of restructurings and workouts. His experience includes representing lenders and bondholders in complex workouts; advising debtors in connection with traditional, prepackaged and 'pre-negotiated' bankruptcies; counseling strategic and financial players who acquire debt or provide financing as a path to take control of companies in bankruptcy; structuring and implementing numerous asset sales through Section 363 of the Bankruptcy Code; and litigating complex bankruptcy and commercial matters arising in chapter 11 cases, both at trial and on appeal.

Turnarounds & Workouts named Robert Klyman to its 2016 list of Outstanding Restructuring Lawyers, honoring 12 attorneys as leaders in the bankruptcy field. In addition, Mr. Klyman has been widely and regularly recognized for both his debtor and creditor work as a leading bankruptcy and restructuring attorney by *Chambers USA* (where clients recognized him as "incredibly smart, commercial, [having] terrific business judgment, and … extremely hard-working and reachable at any time," "great in court," "a great strategist" and "incredibly technically sound"); named as one of the world's leading Insolvency and Restructuring Lawyers by *Euromoney*; recognized as one of 8 bankruptcy lawyers of the year by *IFLR1000* in 2020, listed in the K&A Restructuring Register, a leading peer review listing, as one of the top 100 restructuring professionals in the United States; named as a 'Top Bankruptcy M&A Lawyer' by *The Deal's Bankruptcy Insider*; named as one of the 12 outstanding bankruptcy lawyers in the nation under the age of 40 (in 1999, 2000, 2002 and 2004) by *Turnarounds & Workouts*; and one of '20 lawyers under 40' to watch in California by the *Daily Journal*. Mr. Klyman also has been selected regularly by his peers for inclusion in *The Best Lawyers in America©* in the field of Bankruptcy and Creditor Debtor Rights.

Mr. Klyman developed, and for 20 years co-taught, a case study for the Harvard Business School on prepackaged bankruptcies and bankruptcy valuation issues. He has also taught classes on bankruptcy dealmaking and strategy at the University of Michigan Business School, Massachusetts Institute of Technology's Sloan School of Management and UCLA Law School. Mr. Klyman is also a member of the ABA Subcommittee that drafted the ABA Model Bankruptcy Asset Purchase Agreement. He also regularly serves as a panellist presenting cutting edge issues in restructuring and bankruptcy.

Mr. Klyman received both his J.D. from the University of Michigan Law School in 1989 and his B.A. degree from the University of Michigan in 1986.

Mr. Klyman is admitted to the California Bar. Prior to joining Gibson Dunn, Mr. Klyman was a partner at the firm of Latham & Watkins for more than 17 years.

Robert Klyman

Mr. Klyman's representative transactions include:*

- The Sports Authority (a leading sport goods retailer with 425 leases and more than $1 billion in debt) as debtor in its bankruptcy case.
- Freedom Communications (the owner of more than 70 newspapers and television stations) as debtor in its bankruptcy case (restructured approximately $1.1 billion in debt).
- Leap Wireless Communications, Inc. as debtor in its bankruptcy case (restructured approximately $2.6 billion in debt and more than 100 leases).
- A major Atlantic City hotel and casino company as debtor in its bankruptcy case (restructured approximately $1.5 billion in debt).
- The Yucaipa Companies in the acquisition of the Fresh & Easy Grocery chain, including approximately 100 retail lease locations.
- Representing Lynn Tilton and her affiliated Patriarch entities in the chapter 11 cases of the Zohar Funds, three Cayman-island based CLO hedge funds.
- A landlord with a master lease covering more than 200 locations with a single financially distressed tenant.
- An ad hoc group of bondholders representing approximately $2 billion of debt issued by iHeart Communications, Inc.
- An ad hoc group of bondholders representing approximately $2 billion of debt issued by an international telecommunications company.
- An ad hoc group of lenders representing approximately $1.5 billion of senior debt issued by Garrett Motion.
- Blue Torch Capital as debtor in possession financing lender to Exide Technologies.
- An international lender in its $3 billion rescue financing loan to the CIT Group, Inc.
- A major Indian bank in the restructure of its loan to a US manufacturing facility through a US bankruptcy proceeding.
- US Airways, in its acquisition of American Airlines through a plan of reorganization.
- Natrol (an international vitamin manufacturer and distributor) in the 363 sale of its assets to Aurobindo Pharma for $132.5 million plus assumed liabilities.

Robert Klyman

Mr. Klyman's representative transactions include:* (Continued)

- Frontline Ltd., the largest shipping company in the world, in the acquisition of one of its biggest competitors through a plan of reorganization where Frontline exchanged its shares trading on the Oslo stock exchange for more than $1.5 billion in debt.
- Greystar Real Estate Partners in its acquisition of a 222-unit condominium complex through a chapter 11 plan of reorganization.
- Machine Zone, a leading developer of video games, in its sale to AppLovin.
- Foster Farms, in its acquisition of a chicken rendering plant from Pilgrims' Pride through a 363 asset sale.
- Other acquisitions through plans of reorganization and 363 asset sales, including Great Atlantic & Pacific Tea Company, a grocery store chain with more than $2 billion of debt, Allied Holdings, Inc., the largest car and truck hauler in North America, and OCZ Technology Group, a leading flash drive manufacturer.

Mr. Klyman also has extensive litigation experience at trial and on appeal, including:

- Successfully serving as lead trial attorney in contested confirmation hearings and other contested matters, including representing lenders who held both equity and debt in chapter 11 debtors;
- Successfully representing private equity funds and boards of directors in a wide range of industries against claims for breach of fiduciary duties, breach of contract and equitable subordination brought by chapter 11 debtors, chapter 7 trustees and litigation trusts; and
- Obtaining a total defense verdict in the precedent setting trial – and successfully handling the Third Circuit Court of Appeal argument – involving subordination and recharacterization of loans and damages for breach of fiduciary duty (In re Submicron Corporation, 432 F.3d 448 (3d Cir. 2006)).

- *Includes matters handled prior to joining Gibson, Dunn & Crutcher LLP*

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Allison Kidd is a partner in the San Francisco office of Gibson, Dunn & Crutcher. She is a member of the firm's Real Estate Group.

Ms. Kidd's practice encompasses a wide variety of commercial real estate transactions and land use/development matters, including; acquisitions and dispositions; construction and permanent financings; joint ventures; acquisitions, dispositions and financings of loan portfolios; and the processing of entitlements. Her clients include institutional lenders, borrowers, developers, opportunity funds and institutional and non-institutional investors, and her matters involve a variety of asset types such as office buildings, hotels, shopping centers, residential condominiums, undeveloped land, multi-family and mixed-use projects and other commercial and residential properties.

Ms. Kidd received her J.D. and Master of Public Policy, with an emphasis on urban development policy, from the University of California, Los Angeles, in 2008. Ms. Kidd received her B.A., *magna cum laude*, from Columbia in 2001.

Ms. Kidd is admitted to practice in California.

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Michael Neumeister is a partner in the Los Angeles office of Gibson, Dunn & Crutcher. He is a member of the Business Restructuring & Reorganization Group and the Corporate Department.

Mr. Neumeister has a wide array of experience in representing clients in bankruptcy and restructuring matters in many different industries. His representations have included representing debtors and lenders in in-court and out-of-court restructurings, and buyers in large and small bankruptcy sales. Mr. Neumeister also has a broad range of experience litigating bankruptcy and other distressed debt issues in bankruptcy court, state court, and in courts of appeal.

Mr. Neumeister is currently a member of the Financial Lawyers Conference, the American Bankruptcy Institute, Turnaround Management Association, and the Los Angeles County Bar Association. Mr. Neumeister was recognized in *The Best Lawyers in America*® 2021 Ones to Watch in Bankruptcy and Creditor Debtor Rights / Insolvency and Reorganization Law. He has also been named a "Rising Star" in the field of Bankruptcy & Creditor/Debtor Rights by *Super Lawyers Magazine* since 2013.

Mr. Neumeister received his Juris Doctor in 2010 from the University of Southern California Law School, where he graduated as a member of the Order of the Coif and served as a Senior Content Editor for the *Southern California Law Review*. While in law school, Mr. Neumeister also held a judicial externship with the Honorable Sandra S. Ikuta of the United States Court of Appeals for the Ninth Circuit. He received his Bachelor of Arts degree with honors in 2006 from the University of California, San Diego.

Mr. Neumeister is admitted to practice in the State of California.

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Matthew G. Bouslog is of counsel in the Orange County office of Gibson, Dunn & Crutcher LLP where he practices in the firm's Business Restructuring and Reorganization Practice Group. Mr. Bouslog specializes in representing companies in complex restructuring matters. Mr. Bouslog frequently represents debtors, creditors, and other interested parties in out-of-court and in-court restructurings, distressed acquisitions, and bankruptcy-related litigation. A significant number of Mr. Bouslog's matters have involved cross-border implications.

In addition to Mr. Bouslog's restructuring expertise, he has represented lenders and borrowers in real estate finance and other finance-related transactions.

Before joining the firm, Mr. Bouslog served as a judicial clerk for the Honorable Robert N. Kwan of the United States Bankruptcy Court for the Central District of California. While in law school, he served as a judicial extern for the Honorable Thomas B. Donovan of the United States Bankruptcy Court for the Central District of California and for the Honorable Stephen V. Wilson of the United States District Court for the Central District of California.

Mr. Bouslog received his Juris Doctor degree in 2011 from the UCLA School of Law, where he was elected to the *Order of the Coif* and was a member of the Moot Court Honors Program. He earned a Bachelor of Science degree *magna cum laude* in Business Management from Brigham Young University in 2007.

Mr. Bouslog is admitted to practice law in the State of California.

Matthew G. Bouslog

Mr. Bouslog's bankruptcy representations have included the following:

- *Crossroads Systems, Inc.* – Counsel to prepackaged chapter 11 plan sponsor in acquiring controlling interest in the reorganized debtor and preserving approximately $140 million in Net Operating Losses
- *SunEdison, Inc.* – Counsel to stalking horse bidder in acquiring SunEdison's "solar materials" division for $150 million
- *The Standard Register Company* – Debtor counsel to printing and communications company with operations in the U.S., Mexico, and Canada; completed $300 million sale and confirmed chapter 11 plan
- *Arcapita Bank B.S.C.(c)* – Debtor counsel to Bahraini investment bank with offices in Bahrain, London, Singapore, and the U.S.; confirmed chapter 11 plan that restructured over $2.5 billion in debt in first-ever restructuring of a Shari'ah-compliant entity in what was named as the American Lawyer's Global Finance Deal of the Year Grand Prize Winner, was awarded the prestigious Innovation in Finance Law award by the Financial Times, and was named as the M&A Advisor's Cross-Border Deal of the Year in the "Over $1 Billion" category
- *Natrol, Inc.* – Special transactional counsel to vitamin and supplement manufacturer in $155 million sale
- *THQ Inc.* – Debtor counsel to video game developer with operations in the U.S., Canada, Europe, and Asia; completed sales of assets totaling approximately $70 million and confirmed chapter 11 plan
- *Lehman Brothers Finance, AG* – Counsel to Swiss banking affiliate of Lehman Brothers Holding Inc. in its chapter 15 case and in connection with $12.5 billion claim against Lehman Brothers Holding Inc.
- *Yarway Corporation* – Counsel to chapter 11 plan sponsor, which contributed $325 million to establish section 524(g) asbestos settlement trust
- *Tribune Co.* – Counsel to former shareholders and board members in multi-district litigation involving claims for breach of fiduciary duty and claims to avoid payments of more than $1.5 billion in connection with pre-bankruptcy leveraged buyout