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The Use of Chapter 11 to Prevent Commercial Foreclosures

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Commentators have been predicting that commercial real estate loans are the next wave of defaults that will occur in this economic downturn, similar to what has already occurred with defaults on subprime loans. Commercial loan defaults have already led to a significant increase in companies filing for bankruptcy. Chapter 11 business bankruptcy filings in the third quarter of 2009 increased 23 percent over the same period in 2008.¹ While legislation on the national and state level has yet to address foreclosures in the commercial context, businesses facing the threat of foreclosure should consider bankruptcy, and, in particular, a reorganization under chapter 11 of the Bankruptcy Code, as a tool to restructure their existing obligations. Chapter 11 is a powerful tool that businesses² can use to hold off the threat of foreclosure, while addressing all of the factors affecting a business' profitability. Chapter 11 allows a debtor time to formulate a plan to return to profitability, which may include shedding unnecessary assets or modifying the terms of existing obligations. A business that is committed to working within the rules established by the Bankruptcy Code has the chance to restructure its obligations such that a fresh start can be obtained instead of simply shutting its doors.

Purpose

For a business facing a foreclosure, a chapter 11 filing has the immediate effect of stopping that foreclosure action due to the imposition of the automatic stay, which is effective upon filing of the bankruptcy petition.³ The purpose of the automatic stay is to maintain the status quo and provide the debtor with breathing room, during which time the debtor has an opportunity to formulate a plan to repay his/her creditors.⁴ Obtaining court approval of this plan is the goal of the chapter 11 case, as the confirmed plan binds the debtor and all creditors, even creditors who opposed the plan.⁵ The importance of this plan to a debtor who is facing the loss of its assets cannot be overstated, because a debtor who can meet the

requirements for court approval of its plan can propose to keep these assets based on new loan terms established for its secured creditors.

The Rewriting of Loan Terms

In its simplest form, the bankruptcy code allows a debtor to rewrite the terms for its obligations and specify how and how much it will repay its creditors over a period of time.⁶ This allows a debtor to propose a change in the interest rate s/he is paying on any promissory note, obtain a more favorable amortization schedule, and even extend or eliminate any balloon payments which may exist. In order to obtain approval for such modifications, the debtor must show the court that the creditor or class of creditors has consented to such changes by casting an affirmative vote in favor of the debtor's plan.⁷ If the creditor or class of creditors has not voted in favor of the plan, the debtor may ask the court to approve the plan treatment for such class of dissenting creditors over their rejection of the plan, if the plan meets the so-called "cramdown" requirements of section 1129(b) of the Bankruptcy Code.

In general, section 1129(b) requires that the proposed treatment of the creditor's claim to be "fair and equitable." What is fair and equitable for classes of secured and unsecured claims is defined in section 1129(b)(2). While a term of art, a plan is "fair and equitable" with regards to secured creditors if the secured creditor "(1) retains its lien; and (2) receives 'deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property.'"⁸ Most of the litigation on this issue focuses on whether the secured creditor is receiving a market rate of interest and other market terms.⁹ In the context of loans secured by real estate, courts have typically allowed a debtor to amortize a debt and extend the maturity date over a longer period of time than when a debt is secured only by personal property. Upon confirmation of a debtor's

plan, the confirmed plan becomes the new contract between the debtor and the creditor¹⁰ and as long as the debtor adheres to its plan, the creditor is prevented from engaging in any state law remedies to otherwise collect upon its claim.¹¹

The Liquidation of Assets

Debtors looking to reorganize their affairs are not limited simply to proposing new loan terms for their creditors when formulating a plan. Debtors may also use a chapter 11 case to liquidate assets that are no longer beneficial or profitable to maintain. The debtor may propose to sell such property free and clear of liens, and distribute the proceeds of sale to creditors in accordance with the priorities of the Bankruptcy Code, before the plan is confirmed, or as part of the confirmed plan.¹² The debtor may also propose to liquidate, surrender, or convey assets to creditors to partially or wholly satisfy their claims. One such method primarily used during the economic downturn in the early 1990s that is making a resurgence in the current economic climate is the concept of “dirt for debt” whereby instead of receiving cash, creditors receive their collateral (the dirt) in partial or full satisfaction of their claim, as the indubitable equivalent of their claim.¹³ Debtors can also negotiate with creditors or ask the court to approve plans that surrender real estate assets to their creditors in a variety of ways, such as using deeds in lieu of foreclosure, or surrendering the property for foreclosure in exchange for an agreed upon or court determined credit against the debt.

Section 506(a)

Finally, debtors with property that has declined in value such that the loan is now underwater may also benefit from filing a chapter 11 case, if the property that has declined in value is still necessary for the debtor’s business in the future. Section 506(a) of the Bankruptcy Code bifurcates claims into secured and unsecured claims, treating a claim as secured only up to the value of the collateral securing the claim, with the remaining amount of the claim treated as an unsecured claim.¹⁴ This “cramdown” of a secured creditor’s

claim to the actual value of the collateral securing the claim in the plan allows the debtor to restructure the loan, and make payments based only on the current value of the asset, with the unsecured portion treated pro rata with the claims of other unsecured creditors.¹⁵ This is of particular benefit to a debtor who does not propose a plan to pay its unsecured creditors in full.

Conclusion

The decision to file a Chapter 11 is not an easy one for any business owner to make, nor is a chapter 11 case simply an easy method to avoid repaying debt. Debtors must submit themselves to the oversight of the Court, comply with the rules and reporting requirements imposed by the Bankruptcy Code and local rule, obtain prior approval before undertaking certain acts outside of the ordinary course of the debtor’s business, and make tough choices concerning the actions necessary to return the debtor’s business to profitability. However, in exchange for complying with these requirements, debtors are given an opportunity to deal with all of their creditors in one forum and formulate a plan to allow for the rehabilitation of their business. In this economic climate, as we see more commercial enterprises fail, businesses feeling the pressure of foreclosure should consider the remedies offered by the Bankruptcy Code. ♦

1. American Bankruptcy Institute, *Total Bankruptcy Filing up 336 Percent in Third Quarter*, Nov. 25, 2009, <http://www.abiworld.org/AM/Template.cfm?Section=Home&CONTENTID=59379>.

2. While primarily a tool for businesses to restructure their business affairs, individuals who need to restructure their financial affairs are also permitted to be Chapter 11 debtors. There has been a trend towards more individuals filing chapter 11 in recent years, as individuals have amassed debts in excess of the debt limits governing eligibility to file chapter 13 cases. See 11 U.S.C. § 108.

3. 11 U.S.C. § 362(a).

4. *Grady v. A.H. Robins Co.*, 839 F.2d 198, 200 (4th Cir. 1988); see also *Borman v. Raymark Indus., Inc.*, 946 F.2d 1031, 1033 (3d Cir. 1991) (The stay provides a debtor with a “breathing spell” and permits it to prepare a reorganization plan.); *Avellino & Bienes v. M. Frenville Co., Inc. (Matter of M. Frenville Co., Inc.)*, 744 F.2d 332, 334 (3d Cir.), cert. denied, 469 U.S. 1160 (1985) (citations omitted) (The automatic stay provision of § 362(a) is one of the fundamental protections provided to a debtor by

the Code.); *Lomas Fin. Corp. v. Northern Trust Co. (In re Lomas Fin. Corp.)*, 117 B.R. 64, 67 (S.D.N.Y. 1990) (The purpose of the stay is to provide the debtor with a “breathing spell.”).

5. 11 U.S.C. § 1141(a).

6. 11 U.S.C. § 1123(b)(5). The only obligation which may not be modified is “a claim secured only by a security interest in real property that is the debtor’s principal residence.” *Id.* This provides a commercial debtor with a significant advantage over consumer debtors who are prevented from modifying the terms of their home mortgages. *Id.*; 11 U.S.C. § 1322(b)(2).

7. 11 U.S.C. § 1129(a)(7)-(8).

8. *Travelers Insurance Co. v. Bryson Properties, XVIII (In re Bryson Properties, XVIII)*, 961 F.2d 496, 500 (4th Cir. 1992).

9. 7 *Collier on Bankruptcy*, § 1129.05[2][a] (15th Rev. Ed. 2005).

10. 11 U.S.C. § 1141.

11. *Id.* Unlike a case commenced under chapter 13 of the Bankruptcy Code, there is no co-debtor stay created upon the commencement of a chapter 11 case, except in very limited circumstances. As a result, creditors may undertake any state law remedies available to them against guarantors or other obligators on the debt. Confirmation of a debtor’s plan does not affect this, unless a bankruptcy court specifically enjoins or stays such action, which is an exceptional remedy.

12. 11 U.S.C. § 363; 11 U.S.C. § 1129(b).

13. See generally 11 U.S.C. § 1129(b)(2)(A)(iii); 7 *Collier on Bankruptcy*, § 1129.05[2][c] (15th Rev. Ed. 2005).

14. 11 U.S.C. § 506(a).

15. *Id.*; 11 U.S.C. § 1129(b).