REAL ESTATE BANKRUPTCIES: A PEDAGOGICAL SUPPLEMENT FOR TEACHING BANKRUPTCY FROM A COMMERCIAL REAL ESTATE PERSPECTIVE

Jocelyn Evans, College of Charleston, SC.

ABSTRACT

This article is a teaching addendum that can be used as a textbook supplement for upper level real estate courses. It examines the implications associated with the 2005 Bankruptcy Abuse and Protection Act (BAPCPA) for real estate firms. Perusal of real estate text books reveal that very little coverage is given to the most important change in the bankruptcy code over twenty five years. The article, therefore, describes the components of the law that are unique to the real estate industry and presents a module that helps the instructor conceptualize, design, and execute a bankruptcy component for their class.
INTRODUCTION

After listening to four successful commercial real estate professionals, it became clear that market indicators are pointing toward resurgence in real estate bankruptcy filings. The speakers commented that the severe downturn in the late eighties created several real estate bankruptcies. In fact, their observation is supported by existing academic research.

Roulac (1994) states that, “in the real estate sector, the later 1980s had been signaled by unusually strong booms followed by exceptionally sharp bust”. The bust was paralleled by a spike in real estate related bankruptcies. Several real estate investment trusts failed and filed for bankruptcy in the late 1980s and early 1990s due to large management fees, high non-occupancy rates, excessive leverage, overcapacity, little property diversification, and rising cost of capital and illiquidity (Pagliari, Scherer and Monopoli, 2005). In the latter part of 2007, a similar decline in property values occurred.

If property cycles are expected to be recurring events, bankruptcy for real estate firms will also be continuous. Consequently, students that graduate without understanding the inherent risk of investing in real estate, particularly during downward economic cycles, as it relates to the bankruptcy code are at a competitive disadvantage. It is important for students to have an adequate understanding of the social, legal and economic environment in order to successfully perform in the real estate industry, especially given the increasing volume of real estate related bankruptcies in 2008 and the persistent real estate cycles as denoted by Grenadier (1995a). In fact, non-performing real estate loans, leases and construction loans have historically been at the epicenter of the banking crisis according to Roulac (1994).

Real estate professionals stated bankruptcy is an option that builders, investors, and other commercial professionals should learn about even if they don’t intend to pursue it. They stated that work-out specialists who understand the nuances of the revised bankruptcy rules are needed by their firms, commercial banks, and investments banks. A finance student who has an understanding of the rights, remedies, and strategies of successfully handling real estate transfers involving bankruptcy complications are at a competitive advantage in
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the market place. He also recommended the students to pursue real estate law as a career and for faculty to gain knowledge in the area to become expert witnesses in legal cases. They states that investors and developers acquire property from a bankruptcy estate.

The American Bankruptcy Institute had a 2007 Bankruptcy Battleground West Conference on how, as the money markets tighten and interest rates rose, the real estate market to implode (Bosworth, 2005). Participants at the conference discussed and debated the conditions of the commercial real estate market and explored the economic and legal conditions that are driving the wave of real estate bankruptcies. The panel debated how the Bankruptcy Code amendments may influence and affect the strategies of constituents in real estate bankruptcies (www.westlegalecentrearswell.com/program_guide/course).” To my knowledge, a similar discussion has not occurred in the real estate academy.

The absence of in-depth discussions on bankruptcy for real estate firms creates a gap pedagogically given that the number of real estate bankruptcies soared in the 1980s and early 1990s in addition to the recent national real estate crisis in 2008 (Evans and DeLaurell, 2006). In fact, in the late 1980s and early 1990s, private equity real estate investment trusts were often financially distressed. Yet, even though the real estate industry has experienced cyclical busts in both the commercial and residential markets, it is surprising that minimal discussion in real estate academic text books has been given to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) that was signed into law on April 20, 2005, and became effective October 17, 2005. Although the code has changed numerous times, the 2005 changes have the most sweeping implications for commercial real estate businesses. This article describes the important aspects of BAPCPA for the real estate industry.

One strand of academic research in real estate focuses on finance and legal statutes in the sense that real estate assets are treated as financial contractual obligations. Black and Rabianski (2003) also state that finance, lending and investment are an important aspect of the real estate profession and academic curriculum. In their attempt to define a body of knowledge for real estate, in 1996 and 1997, the authors created a list of the most
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important topics as identified by academics. Even though risk/return analysis and financial market cycles were identified as key issues, none of the respondents stated that student knowledge of the bankruptcy code and its most recent changes are important topics for real estate education.

THE MOTIVATION FOR A REAL ESTATE FINANCE TEACHING SUPPLEMENT

The popular press reports that corporate bankruptcies have increased due to the crumbling of the real estate market: real estate companies, builders, and suppliers are starting to fail subsequent to the collapse of the housing market. In 2008, the Herald Tribune reported that sixteen - seven builders/developers and nine suppliers/subcontractors - of twenty companies that filed for bankruptcy in Florida in the first half of 2008 are real estate related. Recent examples highlight the need for a section on bankruptcy in the real estate curriculum.

In July, 2008 SimDag, developers of the 52-story Trump Tower Tampa, filed for Chapter 11 bankruptcy in an attempt to reorganize its debts due to the slow market for condominiums. SimDag joined three other condo projects in bankruptcy. The bankruptcies are not only depressing the real estate market value of properties, but court documents show that creditors and early retail buyers could incur losses. SimDag sold individual condominiums for $6.5 million with a requirement of a thirty percent deposit, 1.95 million dollars. The developer puts fifty percent in escrow, but management used the other fifty percent to finance the development of the tower. Real Estate Blog, Mortgage, and Development News, July 5, 2008, “Trump Tower Tampa Declares Chapter 11 Bankruptcy”, www.therealestatebloggers.com

A slew of recent bankruptcies for Japanese developers have been documented. Sebon Corporation, a real estate developer that owns 85.25% of Asahi Homes, filed for bankruptcy protection. Also in Japan, in July, real estate and construction firms accounted for more
than a third of the country’s 1,131 bankruptcy cases. Teikoku Databank reported that the real estate sector had a 79 percent rise in bankruptcy filings from the previous year. The stated reasons were sluggish housing demand, rising material costs and tighter bank lending standards. The rise in bankruptcy filings is making banks and potential investors wary of increasing their exposure to real estate projects. Real estate firms have sold off buildings and land due to liquidity issues, which has in turn glutted the real estate market. Sebon’s filing comes less than two weeks after the fall of condominium developer Urban Corp.-Japan’s largest corporate failure this year-filed for protection against creditors in August 2008. International Herald Tribune, Business with Reuters, August 26, 2008, Japanese real estate shares sink amid bankruptcies. www.iht.com.


A BANKRUPTCY MODULE

The purpose of this article is to describe how instructors can incorporate bankruptcy into upper level real estate courses. The module consists of six parts. The module’s learning goals are a supplement to the learning goals in a commercial real estate, real estate valuation, real estate capital markets, risk analysis, or real estate finance course. The teaching supplement provides an in-depth discussion of the codes within the 2005 bankruptcy law that are unique to real estate firms.
Learning Objectives for Teaching Bankruptcy within a Real Estate Course

The learning goals are consistent with those that support AACSB’s goals for a business administration program.

1. The instructor should illustrate the incidence of real estate bankruptcy and relate it to property market fundamentals.
2. Student should have a basic knowledge of the federal bankruptcy law with respect to real estate transactions for commercial property managers and developers.
3. Students should gain an understanding of the different types of bankruptcy and an overview of the recent reforms to the changes to the code in 2005.
4. The instructor should provide a history of bankruptcy laws.
5. The students should have an in-depth understanding of uncertainty and the importance of the bankruptcy process to real estate valuation and capitalization rates.
6. The students should understand bankruptcy reforms and procedures with respect to means testing, motions/proceedings, exclusivity period, automatic stay, and preference amendments.
7. The student should be able to apply analytical reasoning skills when examining the impact of the bankruptcy process on the valuation of real estate firms.
8. The students should be able to consider the advantages/disadvantages of declaring bankruptcy given the alternatives to bankruptcy such as foreclosure.
9. The instructor should articulate the urgency of ethics for business decision making for distressed real estate firms contemplating bankruptcy.
10. Is the 2005 bankruptcy code too harsh in the sense that it does not facilitate real estate reorganization?

The Teaching Supplement for Real Estate Professionals

The new bankruptcy law was signed into Law by President Bush on April 20, 2005, and became effective on October 17, 2005. The new code eliminated much discretion within the bankruptcy court system for several real estate transactions. Therefore, it is important for university students who intend to become commercial real estate owners, managers or professionals to understand and be aware of the
changes to the bankruptcy code. The changes created gains for real estate landlords and banks that may have previously been forced to accept lower payments or non-desirable contractual terms, but losses for business tenants and real estate developers. Due to the substantial losses that bank lenders incurred during the 1980s and early 1990s, they applauded the change in the bankruptcy code that reduced the lessee’s ability to delay rent, interest, or principal payments associated with the automatic stay provision. The aspect of the code that applies to real estate professionals is outlined.

**When to Assume or Reject a Lease**

**Contractual Arrangement Section 365 (d) (4)**

A tenant in a bankruptcy proceeding has a right to assume or reject a lease. Sixty days after filing for a Chapter 11 petition, a decision to assume or reject a commercial real estate lease agreement must be made. After the 60 day period, the court assumes that the lease negotiation has reached no conclusion. Simultaneously, under the new law, the debtor real estate business has 120 days after filing an order for relief in which to attempt to negotiate a plan of reorganization with its creditors, tenants, investors and other stakeholders. With the judge’s consent, the management of the real estate firm may request one 90-day extension for cause. Prior to the law, judges used to routinely give real estate firms that filed for bankruptcy several extensions or stay of reliefs.

This change in the law is detrimental to troubled commercial real estate businesses with one or more commercial leaseholds because they often receive no additional time to market a lease and obtain value for the benefit of all stakeholders. Retailers, manufacturers and other firms may be forced to liquidate their businesses prior to ascertaining whether reorganization within Chapter 11 could be successful due to the additional negotiating power that commercial landlords now have over bankrupt tenants.

**Shopping retail leases**

Shopping center leases are subject to a different special set of bankruptcy rules. Business tenants, such as retail debtors who occupy space in shopping centers, must engage in more extensive pre-bankruptcy negotiations with their landlords (e.g., increased rent in
exchange for such consent). If not, real estate landlords can insist that their tenants’ businesses be sold or that the tenants’ case can be involuntarily converted from Chapter 11 reorganization to Chapter 7 liquidation.

**Limitations on Landlord’s administration claim**

If the debtor firm liquidates within Chapter 7 or rejects a lease that had been previously accepted, the commercial real estate landlord can obtain an administrative expense claim for the full amount of rent, taxes and other monetary expenses for the entire balance of the lease term. The administrative expense claim is limited to two years after the rejection date or the date the premises are surrendered to the landlord. The new law makes commercial real estate creditors responsible for proving the legitimacy of penalty provisions. For example, they have to answer why late fees are compensatory and not punitive.

**Single Asset Real Estate “SARE” Bankruptcies**

Streamlined Section 101 (51) (b)

The change in the law places pressure on debtor firms in a cash liquidity crisis to make progress within Chapter 11 bankruptcy cases to prevent secured creditors from foreclosing on their property. The change redefines “SARE” by eliminating the four million dollar limitation cap so that all large commercial real estate projects have to file bankruptcy under a streamlined process that often terminates the 90 day exclusivity period; single purpose entities with fewer than four residential units are excluded.

For many multimillion dollar single purpose real estate entities, 90 days simply is too short a time to restructure or refinance the lease, but beneficial to commercial real estate landlords. These commercial creditors have greater ability to obtain relief from the automatic stay either if no confirmation of a plan is obtained within 90 days or the debtor firm has not commenced to make monthly payments to each secured creditor.

**Designation of Lease Rights to a Third Party Section 365 (b) (1) (a)**

The changes in the code limit the debtor firm’s ability to assign their rights in a commercial lease to a third party to a 210 day
maximum. The replacement tenant must conform to all monetary and non-monetary obligations under the existing lease, but non-conforming use is more difficult to prove. For example, the designation of shopping center with respect to radius, location, use etc. has been widened in 365 (b) (3).

Streamlined Chapter 11 Process Section 1121 (d)–“drop dead” date

The new law states that the 120 day exclusivity period for “non-SARE” bankruptcies cannot be extended beyond 18 months after the entry of the order for relief. In large debtor firm bankruptcies, this places significant time pressure to negotiate consensual plans that will survive the voting process.

Preferences and Fraudulent Transfers Section 547 c and 548 (1) (a)

This amendment will lighten the evidentiary and financial burden (expert testimony) on a real estate firm that claims preferential status by eliminating the need to prove that a transfer was both in the ordinary course of its business and in accordance with the terms of the relevant industry. If not, the transaction will be considered as fraudulent. The “reach back” period for fraudulent transfers increased from one to two years.

Increased Reporting Requirements Section 521 (a) (1) B (v and vi)

The new code requires real estate businesses to provide monthly itemized income statements. Commercial tenants who file for bankruptcy often cease making rent payments. The bankruptcy code, however, obligates tenants to pay rent, late charges, and attorney fees when this occurs. In fact, accrued rent can be given priority over other debts. This is an important aspect of the code because tenants considering filing for bankruptcy often demand reduction in rent or the repayment of security deposits. It is important for investors and developers to understand this aspect of the code for negotiation and enforcement of legal rights. Security deposits held by a landlord are considered property of the debtor real estate firm’s bankruptcy estate.

Forced Conversion to Chapter 7 Easier Section 1112 (b)

The changes in the code increase a creditors’ ability to force the tenant or firm into Chapter 7 liquidation in lieu of reorganization.
within Chapter 11, which may lead to substantial or continuing loss leading to diminution of real estate property. Specifically, the new law minimizes gross mismanagement of real estate assets for four reasons: 1) the code prohibits transfer of ownership for a longer period of time prior to the filing; 2) serial bankruptcy filings as a part of a scheme to hinder, delay or defraud commercial real estate creditors is no longer allowed; 3) the code limits severance employment agreements; and 4) the code lowers the priority allowed to debt claims related to transactions with insiders.

**Heftier Legal Fees**

The burden on bankruptcy lawyers is at least doubled under the new statute. Besides merely gathering the facts from a client, an attorney must now “certify” that a client’s numbers are accurate. If they aren’t, both lawyer and client could face sanctions. So, in effect, your lawyer must do more fact-checking and investigation to assure that both your information and his/her own certification is above-board. This takes time, which translates into money.

Many lawyers are getting out of bankruptcy practice, not wanting to put their careers on the line for filing cases that don’t pay very well anyway. Moreover, a Minnesota Law firm has filed a legal challenge to the new bankruptcy law, claiming that it unnecessarily restricts the ability of bankruptcy attorneys to interact with their clients, and violates both the First and Fifth Amendments of the Constitution. The complaint alleges that the BAPCPA’s rules regarding “debt relief agencies” are so vaguely worded that attorneys are also included under the rules, which may limit their ability to advise their clients on how to proceed with bankruptcy petitions. (Martin H. Bosworth, ConsumerAffairs.Com, November 16, 2005)

**Mortgage Loans**

Another concern is the impact that a repayment plan will have on a filer’s ability to continue making mortgage payments. Prior to 2005, many people used Chapter 7 to avoid foreclosure on mortgages by freeing up funds to continue making their mortgage payments. Under the new law, this ability may be threatened by the means test that may force many would-be filers into Chapter 13 bankruptcy where a mortgage lender might have to compete with
unsecured creditors for repayment of a proportion of a mortgage loan. They must pass a series of means tests in order to liquidate their assets and extinguish non-mortgage debt within Chapter 7. If the debtors’ household earnings are greater than the median level in their state and if the disposable income over a five year period exceeds either $10,000 or twenty five percent of their unsecured debt, they must file for debt restructuring within Chapter 13. In addition, individual debtors must take a financial counseling course before the court accepts a bankruptcy filing.

The mortgagor may lose his/her property and the lender may not collect the entire loan in Chapter 13 because mortgage debt has equal priority with credit card and other non-mortgage debt. Another alternative is the home owner walks away from their home and their mortgage debt. The new bankruptcy law has increased the number of foreclosures and home owners’ willingness to walk away from their mortgage debt outside of the context of bankruptcy (see www.bloomberg.com and Addison, 2006).

CONCLUSION

Pre- and post-bankruptcy planning is essential because it is related to real estate decision making and the functioning of real estate markets. During the recent real estate market downturn, many firms are choosing bankruptcy as an exist strategy. The spike in bankruptcies has led to credit rationing to real estate firms by commercial banks and mortgage companies.

Since there is a close link between real estate and capital market valuation, from a management perspective, students need to understand the effect of bankruptcy on real property and mortgage valuation. Hence, finance students should discuss bankruptcy laws and their relevance to real estate corporate restructuring.
ADDITIONAL REFERENCES


About the Author

Jocelyn Evans joined the School of Business at College of Charleston, SC in 2005 and has progressed through a series of teaching and advising roles. She earned her B.S. at Barat College and proceeded to gain an M.B.A at Washington University along with a Ph.D. at the University of South Carolina. Evans prides herself in teaching finance classes to graduate and undergraduate students. She can be reached at evansj@cofc.edu