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Role Of The Real Estate Lawyer In Ch. 11

Law360, New York (June 02, 2009) -- Real estate lawyers have a significant role as members of the legal team retained as counsel by an unsecured creditors committee (the "Committee") in the case of a Chapter 11 petition filed by a real estate investment trust or other entity with substantial real estate assets. This article describes and defines that role.

As companies face troubled times, an increasing number will enter into Chapter 11 bankruptcy proceedings. Pursuant to Section 1102(a)(1) of the Bankruptcy Code, after the filing of a petition in Chapter 11, the U.S. trustee appoints a committee of creditors holding unsecured claims.

Such committees (1) represent the entire unsecured creditor class, (2) have standing to be heard in court and to file pleadings, (3) will monitor and investigate the debtor's conduct, and (4) have authority to retain professionals who will be paid by the bankruptcy estate.

As a member of the team of professionals serving as counsel to the official Committee in the case of an REIT or other entity with large and/or numerous real estate assets, a real estate attorney would have several tasks.

The real estate attorney would be responsible for the due diligence for all leases — including space leases, ground leases and master leases — and contracts, including management agreements, brokerage agreements, reciprocal easement agreements (REA's), estoppel certificates, and subordination, nondisturbance and attornment agreements.

The value of the debtor's real property assets can be determined by reviewing the above-mentioned leases and agreements. For instance, termination rights, use restrictions, rent escalations and subleasing/assignment provisions in a lease could dramatically affect the price of the leasehold interests held by the debtor and/or the value of the fee property that is subject to the lease.

The value of the real property would be a factor in determining if there was equity in the assets of the debtor. Equity, the difference between the asset value and the amount of the secured debt on the asset, is what the unsecured creditors will rely upon for any recovery.

The analysis of the real estate lawyer would also include whether the debtor/landlord should reject, assume or assign the leases and/or contracts pursuant to Section 365 of the Bankruptcy Code.

Leases that are below market or pro-tenant might best be rejected by the debtor/landlord. At market, above-market or pro-landlord leases might best be assumed by the debtor/landlord or assigned in a sale to a prospective purchaser of the lease.

The real estate lawyer for the Committee would also review the key documents relating to a fee-owned asset, including any agreement purporting to create a security interest in the real property.

To the extent that a security instrument for any real property asset is deficient and does not, in fact, create a security interest (or is not properly perfected), the lender would be “unsecured” and the value of such asset would thus be available to be shared by all unsecured creditors.

In addition, an unsecured claim, unlike a secured claim, does not allow for post-petition interest payments or other reasonable fees, costs and charges (Section 506(b) of the Bankruptcy Code), thereby freeing up more money for the recovery of the unsecured creditors.

Thus, the real estate attorney would review all of the mortgages and deeds of the trust (and the steps taken to record the mortgages) to determine if there are legal flaws that would make such instruments unenforceable.

Such flaws might include the wrong property description or a state law legal deficiency (for example, at least one state requires a statement in the mortgage that the mortgage/lien will be defeased upon the full payment of the debt secured thereby).

In addition, if the mortgage was granted or perfected within 90 days prior to the bankruptcy filing, it may be subject to being set aside as a “preference” under Section 547 of the Bankruptcy Code.

To the extent that any real property is worth less than the debt it secures, then the creditor has both a secured claim (up to the value of the asset) and an unsecured claim (for the balance) (Section 506(a) of the Bankruptcy Code). The larger the unsecured claims and the smaller the secured claim, the better for unsecured creditors.

Accordingly, a real estate lawyer’s familiarity with appraisals and the methods used by appraisers to determine the appraised value will prove very valuable to the Committee.

The real estate lawyer would be involved in any determination of any avoidance actions in connection with preferences and/or fraudulent conveyances.

If the Committee is successful in avoiding certain liens and conveyances, such assets become available to be shared pro rata for the benefit of the unsecured creditors. Unrecorded mortgages/deeds of trust may be avoided.

Finally, the real estate lawyer, as a member of the Committee's legal team, would participate in (1) any asset sales involving real estate, (2) the review of real estate tax claims to determine whether objections might be filed, and (3) the formulation of the plan of reorganization for the real estate company debtor.

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