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**THOU SHALT RECOVER:
TEN COMMANDMENTS FOR THE REAL ESTATE PROFESSIONAL
NAVIGATING BANKRUPTCY**

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Thou Shalt Recover:
Ten Commandments for the Real Estate Professional Navigating Bankruptcy

This article is a general primer and overview of substantial bankruptcy case issues typically encountered by real estate professionals representing creditors of a bankrupt (or soon to be bankrupt) debtor. The intent is to assist creditors in maximizing their recoveries in a typical Chapter 7 or 11 bankruptcy case,¹ and range from pre-bankruptcy planning through the automatic stay and case confirmation/closing, including notes on bankruptcy related litigation and adversary proceedings. Where state law matters are relevant to the discussion, we resort primarily to Texas state law as a sample for the majority position where appropriate.²

I. Commandment 1: “*Thou Shalt Not Violate the Automatic Stay*”

Immediately upon the filing of a bankruptcy petition, Section 362(a) of the Bankruptcy Code generally provides that the filing of the petition operates to stay:

- (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
- (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
- (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
- (4) any act to create, perfect, or enforce any lien against property of the estate;
- (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
- (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
- (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor...

11 U.S.C. § 362(a).

The purpose of the automatic stay is, at least in part, to give the debtor a “breathing spell” from its creditors and to protect against a race to the courthouse by creditors seeking to collect on unpaid debts. This “breathing spell” further enables the bankruptcy court to enter any appropriate orders to effectuate control over assets of the debtor, and gives the court and

¹ These two Chapters of the Bankruptcy Code pertain to business reorganizations and liquidations, as well as liquidations for individuals, and therefore constitute the vast majority of cases pertinent herein. This article does not specifically treat Chapter 13 (individual plan) cases, although many of the same concepts and rules apply there as well.

² Such matters arise frequently, for in the absence of a controlling and compelling federal interest, state law defines property interests in bankruptcy. *Barnhill v. Johnson*, 503 U.S. 393, 397-398 (1992).

creditors of the debtor an opportunity to take a look at the debtor's financial condition before liquidation or reorganization takes place.³

The scope of the automatic stay is broad. All proceedings are stayed, including arbitration, administrative, and judicial proceedings.⁴ The stay also prohibits the enforcement of pre-petition judgments against the debtor or property of the estate,⁵ and any act to create, perfect or enforce a lien against property of the estate or of the debtor.⁶ Critically, the automatic stay precludes any act to obtain possession of property of the estate, or to exercise control over estate property, as well as any act to collect, assess, or recover any pre-petition claim from the debtor.⁷ This language is sufficiently broad to cover a wide variety of routine and informal acts of collection including telephone calls, demand letters, or other forms of communication or harassment directed to the debtor.⁸ It even goes so far as to preclude a creditor's setoff of debts owing to the debtor as of the bankruptcy filing against claims against the debtor.⁹

While the scope of the automatic stay is extremely broad, there are certain recognized exceptions to the stay, most of which are based upon certain policy considerations.¹⁰ The most obvious example is that the stay does not preclude the commencement or continuation of criminal proceedings against the debtor.¹¹ Most relevant to creditors of a debtor in a real estate industry are the following exceptions: (i) the perfection, or the maintenance or continuation of perfection, of interests in property (under certain circumstances); (ii) acts to obtain possession of nonresidential real property when a lease has terminated; (iii) the creation or perfection of statutory liens for ad valorem taxes; (iv) the enforcement of a judgment for possession obtained before the bankruptcy filing against a residential debtor lessee; and (v) enforcement of police and regulatory powers by governmental agencies, which may including environmental matters.¹² The automatic stay does not operate against litigation involving the debtor if the claim at issue is one which the debtor, and not a creditor, is prosecuting.¹³

Under appropriate circumstances, a creditor may obtain relief from the stay, by way of termination, annulment, modification, or a conditioning of the stay. Section 362(d)(1) of the Bankruptcy Code sets out the most generalized basis for relief from the stay, providing that relief may be granted "for cause, including lack of adequate protection of an interest in property of

³ See *Hunt v. Bankers Trust Co.*, 799 F.2d 1060, 1069 (5th Cir. 1986); *Hillblom v. Continental Air Lines, Inc. (In re Continental Air Lines, Inc.)*, 61 B.R. 758, 775 n.36 (S.D. Tex. 1986).

⁴ See 11 U.S.C. § 362(a) (1).

⁵ 11 U.S.C. § 362(a) (2).

⁶ 11 U.S.C. § 362(a) (4)-(5).

⁷ 11 U.S.C. § 362(a) (3),(6).

⁸ See 3 *Collier on Bankruptcy* § 362.03[8][a] (15th ed. rev. 2003).

⁹ See 11 U.S.C. § 362(a) (7).

¹⁰ See *Collier*, ¶ 362.05.

¹¹ See 11 U.S.C. § 362(b) (1).

¹² See 11 U.S.C. §362(b) (3), (6)-(7), (10), (17).

¹³ See, e.g., *Alpern v. Lieb*, 11 F.3d 689, 690 (7th Cir. 1993).

such party in interest.” Because of the fluid nature of the term “cause,” a bankruptcy court has significant discretion in determining whether sufficient cause has been established under the circumstances involved.¹⁴

A lack of adequate protection normally relates to a secured creditor’s interest in collateral. The Bankruptcy Code does not define the phrase “adequate protection.” However, lack of adequate protection is normally at issue where a secured creditor is undersecured and the collateral is depreciating in value due to the debtor’s continued use of it. Another example of lack of adequate protection is where the debtor fails to maintain casualty insurance in relation to the collateral. In other words, adequate protection generally relates to the extent to which a creditor deserves protection of and for the value of its collateral to the extent that such value is at risk due to the bankruptcy debtor’s continued use thereof.

A debtor may therefore avoid a lifting of the stay by offering to provide adequate protection. Section 361 of the Bankruptcy Code sets out certain examples of how adequate protection may be provided by the debtor to secured creditor. The examples include: (i) the making of periodic cash payments (to account for the diminution in value of the collateral); and (ii) the giving of additional or replacement liens; (iii) other relief that enables a secured creditor to realize the “indubitable equivalent” of the secured creditor’s secured claim.¹⁵ Courts have also found that a secured creditor’s security interest/lien is adequately protected where there is a significant equity cushion in the collateral, casualty insurance is maintained, and the debtor agrees to provide the secured certain financial information on a regular basis.¹⁶

Separately, under Section 362(d)(2) a party may also obtain relief from the automatic stay in relation to property where it shown that the debtor has no equity in the property and it is not necessary to the debtor’s reorganization.¹⁷ Both elements of this test must be met; satisfaction of only one of the elements will not suffice.¹⁸

The first element may be shown where either: (i) the property is encumbered by security interests/liens and, due to the property’s lack of value, there is no realistic residual interest left for the debtor; or (ii) the debtor’s estate holds merely bare legal title to the property whereas the equitable interest is vested in a non-debtor party, such as in the case of a constructive trust. In the first instance, a secured creditor proceeding down the path of low valuation faces some risk on the back end as to payment on its secured claim. In particular, as explained below, a claim is only entitled to treatment (and, hence, distributions) as a secured claim *to the extent* of the creditor’s secured value in the collateral. Therefore, rest assured that a debtor/trustee will attempt to use the same valuation later in the case when it comes to determining the allowed

¹⁴ See *In re Countryside Manor, Inc.*, 188 B.R. 489, 490-91 (Bankr. D. Conn. 1995); *In re Sonnax Industries, Inc.*, 907 F.2d 1280, 1285-86 (2d. Cir. 1990); see also H.R. Rep. No. 595, 95th Cong., 2d Sess. 343-44, reprinted in 1978 U.S. Code Cong. & Admin. News 6300.

¹⁵ See 11 U.S.C. § 361.

¹⁶ See *Collier*, ¶ 362.07[3].

¹⁷ See 11 U.S.C. § 362(d) (2).

¹⁸ See *In re Egea*, 167 B.R. 226 (Bankr. D. Kan. 1994).

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