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Current topics in bankruptcy

*What every California real estate
investor must know*

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Ben Young represents parties in insolvency matters. He has extensive experience in workouts, restructurings, bankruptcies, and assignments for the benefit of creditors. Ben is a Partner in JMBM's Bankruptcy Group, which is recognized by *U.S. News & World Report / Best Law Firms®* with a Metropolitan First-Tier Ranking (San Francisco) for Bankruptcy Litigation and Bankruptcy and Creditor Rights/Insolvency and Reorganization Law. He has been recognized as a "Northern California Super Lawyer" by *Super Lawyers Magazine* and *San Francisco Magazine*, 2012-2018 and by *Best Lawyers in America®*, Bankruptcy, 2016-2019.

Ben is a former Chair of the California State Bar's Insolvency Law Committee and a past president of the Northern California Chapter of the Turnaround Management Association. He is a 1982 graduate of Hastings College of the Law in San Francisco.

I. Goals

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- A. Buying distressed real estate out of bankruptcy
- B. Strategies for addressing under market leases
- C. How to protect yourself if your LLC partner files a bankruptcy
- D. The time bomb in a receivership order

II. Buying distressed real estate out of bankruptcy

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A. Pros and Cons

1. Power to sell the property free and clear of liens and encumbrances can be useful.
 - a. Strip off disputed junior liens, such as mechanics' liens
 - b. Potentially clean up title
 - c. In some cases, remove encumbrances, such as easements. See *In re Metroplex on the Atlantic, LLC*, 545 Bankr. 786, 795-796 (Bankr. E.D.N.Y. 2016).

II. Buying distressed real estate out of bankruptcy

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2. But process can be a challenge
 - a. Bankruptcy sales are auctions, so can be competitive bidding
 - b. Court hearing required, so process can be slow
 - c. Appeals can delay

II. Buying distressed real estate out of bankruptcy

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B. How it works

1. The offer

- a. Bid procedures – timing, increments, qualification
- b. Break-up fees

2. Hearing in bankruptcy court on notice to creditors

- a. Court's job is to confirm the highest and best offer
- b. Highest bid doesn't always win
- c. As a practical matter, court will take bids from any qualified buyer

III. Recent decisions affecting under market leases

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- A. Two competing bankruptcy powers
 - 1. Debtor has the power to reject leases
 - a. So Debtor landlord can reject a tenant's lease
 - b. Tenant in possession has the right to remain in possession
 - 2. Debtor has the power to sell the property free and clear

III. Recent decisions affecting under market leases

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- B. Can the debtor sell free and clear of a tenant's right of possession?
 1. Two courts of appeal have said yes. *In re Spanish Peaks Holdings II, LLC*, 872 F3d 892, 900-901 (9th Cir. 2017); *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp.)*, 327 F.3d 537 (7th Cir. 2003).
 - a. In *Spanish Peaks*, the court focused on the fact that the lease was junior to the mortgage on the property and there was no subordination and non-disturbance agreement, so the lease would have been wiped out in a foreclosure sale.
 - b. The tenant's remedy is to demand adequate protection of its interest in the property.

III. Recent decisions affecting under market leases

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- C. Does this mean bankruptcy can be used to strip off an under market lease?
 1. The tenant's right to adequate protection might make this power illusory.
 2. But if there is no SNDA, then tenant could be vulnerable.

IV. What happens if a member of an LLC files a bankruptcy case?

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- A. Is the debtor-member's membership interest property of the bankruptcy estate?
1. Some cases say yes. See *In re First Protection, Inc.*, 440 B.R. 821 (Bankr. 9th Cir. 2010); *In re LaHood*, 437 B.R. 330 (C.D. Ill. 2010); *In re Klingerman*, 388 B.R. 677 (E.D. N.C. 2008).
 2. Bankruptcy estate obtains all rights the debtor-member had.
 - a. Includes management rights, as well as economic rights.
 - b. Thus, your LLC partner could be a bankruptcy trustee.

IV. What happens if a member of an LLC files a bankruptcy case?

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B. What can you do to protect yourself?

1. Provisions in the operating agreement that modify the debtor-member's rights in the event of a bankruptcy filing usually will not be enforceable in bankruptcy.
 - a. Bankruptcy Code § 541(c)(1) invalidates ipso facto clauses.
 - b. So any provision that modifies the debtor member's rights based on insolvency, financial condition or bankruptcy will not be enforceable after a bankruptcy filing. See *In re Warner*, 480 B.R. 641 (Bankr. N.D. W. Va. 2012).

IV. What happens if a member of an LLC files a bankruptcy case?

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2. Solution is to structure the operating agreement as an executory contract.
 - a. An executory contract is a contract in which both parties have material unperformed duties.
 - b. Thus, to be an executory contract, the operating agreement must impose material ongoing obligations on all parties.
 - i. Capital contributions
 - ii. Management responsibilities
 - c. Some courts have held operating agreements to be executory contracts. *See In re Soderstrom*, 484 B.R. 874 (M.D. Fla. 2012).

IV. What happens if a member of an LLC files a bankruptcy case?

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3. Why is this important?
 - a. There is an exception to the invalidation of ipso facto clauses if the executory contract is one that can be performed only by the debtor. See Bankruptcy Code § 365(e)(2).
 - b. An LLC operating agreement likely falls with section 365(e)(2) because most LLC statutes do not allow assignment of management rights without consent.
 - i. Thus, if the operating agreement is an executory contract, the bankruptcy estate likely will not have any right to participate in management.
 - ii. Furthermore, the bankruptcy estate might not be able to assume or assign the operating agreement and thus would have very minimal rights. See *In re Catapult Entertainment, Inc.*, 165 F3d 747 (9th Cir. 1999); *In re EBC I, Inc.*, 380 B.R. 348 (Bankr. D. Del. 2008).

V. Recent developments affecting distressed projects

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- A. *In re Sino Clean Energy, Inc.*, 2018 WL 4055651 (9th Cir. August 27, 2018).
1. Order appointing receiver authorized receiver to replace the board, which the receiver did. The old board authorized a bankruptcy filing for the company.
 2. The court held the board had been properly removed and no longer had the power to authorize a bankruptcy filing. The petition was dismissed.
- B. Lesson
1. Lenders probably will put a similar provision in their receivership orders.
 2. Borrowers need to pay attention to what is in the receivership order, and if there is such a provision, object to it in the receivership court and, if the court signs the order, file bankruptcy before the receiver acts.

Questions?

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