AMERICAN BANKRUPTCY INSTITUTE

2021 Bankruptcy Battleground West

Real Estate in 2021 and Beyond: Trends from the Pandemic

Sponsored by FTI Consulting, Inc.

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CONCURRENT SESSION

2021

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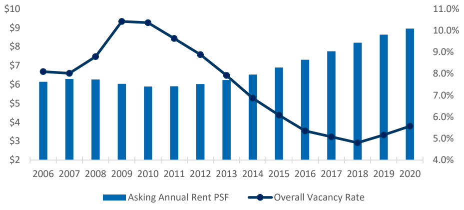
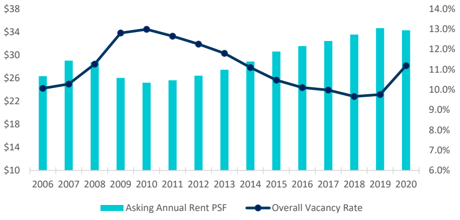
U.S. Rents and Vacancy Rates

- Office and retail properties have experienced mild declines in asking rents in 2020 compared with the prior year that were accompanied by an increase in vacancy albeit not yet very significant
  - The impact of the pandemic on these sectors has not been fully realized given longer-term nature of the leases
  - Performance varies greatly particularly within retail sub-segments
- Industrial rent and vacancy trends have continued throughout 2020 powered by strong demand for warehouse and cold storage facilities. The slight increase in vacancy is likely attributed to a significant increase in property supply in this sector.

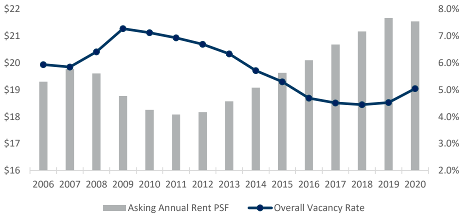
Industrial



Office



Retail



Source: CoStar, FTI analysis

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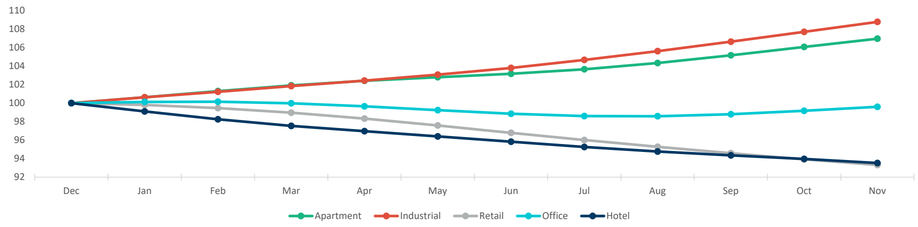
Transactional Price Trends by Property Type

The pandemic has caused value divergences between different property types. Price discovery however has been limited due to low transactional volumes.

RCA CPPI Monthly, 2020



RCA CPPI Annual Index, 2001-2019

Source: Real Capital Analytics ("RCA")
RCA Commercial Property Price Indices ("CPPI") are a suite of transactional price indices that measure price movements across markets and property types using repeated sales methodology.

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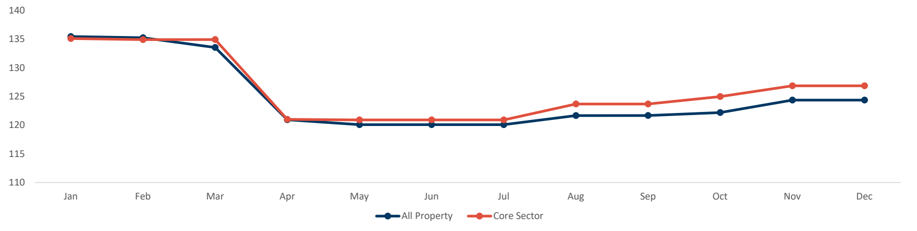
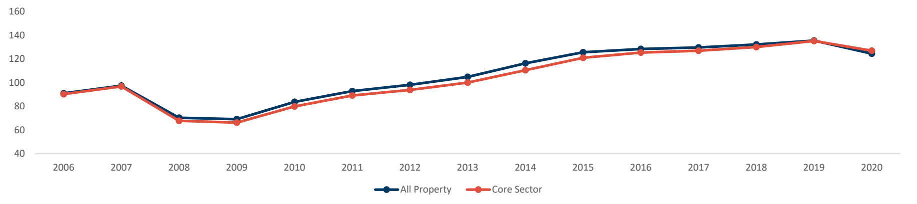
Appraised Value Trends by Sector

Appraisal-based indices focused on larger properties demonstrate somewhat greater reduction of value in 2020 compared with the transactional and broader-based indices.

Green Street Advisors CPPI Monthly, 2020



Green Street Advisors CPPI Annual Index, 2006-2020



Source: Green Street Advisors
Green Street Advisors' Commercial Property Price Index is a value weighted, appraisal-based index that places emphasis on high quality properties.
All Property CPPI weights: retail (20%), office (17.5%), apartment (15%), health care (15%), industrial (10%), lodging (7.5%), net lease (5%), self-storage (5%), manufactured home park (2.5%), and student housing (2.5%). Retail is mall (50%) and strip retail (50%). Core Sector CPPI weights: apartment (25%), industrial (25%), office (25%), and retail (25%).

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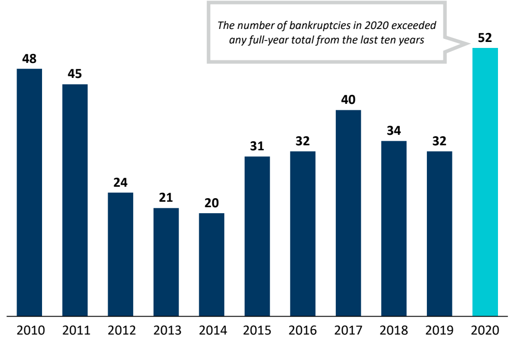
A record level of retailers have been forced into bankruptcy; most of these retailers were vulnerable pre-COVID-19

- 2020 will likely be one of the worst years for retail bankruptcies in recent history
- COVID-19 accelerated **online shopping** and the **casualization of apparel**, putting further pressure on struggling retail sectors
- Many of the bankruptcies have occurred in industries or for companies that were already vulnerable or distressed (e.g. department stores)

Announced U.S. retail bankruptcies



Notable 2020 retail bankruptcies

JCPenney, RTW Retailwinds, Art Van, John Varvatos, Tuesday Morning, Lucky Brand, Pier 1 Imports, Tailored Brands, Stage, Century 21 Stores, Ascena Retail Group Inc., Neiman Marcus, J.Crew, GNC, Stein Mart, Brooks Brothers, Bluestem, Francesca's, Guitar Center

Source: S&P; Forbes; FTI analysis
Note: S&P Global Market Intelligence bankruptcy coverage is limited to public companies or private companies with public debt where either assets or liabilities at the time of the bankruptcy filing are greater than or equal to $2 million, or private companies where either assets or liabilities at the time of the bankruptcy filing are greater than or equal to $10 million

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COVID-19 will have permanent implications on the retail marketplace

Key factors driving change

52	20%+	37%	33%
retail bankruptcies in 2020, the highest number in the last ten years	estimated reduction to mall footprints over the next five years	YoY increase in U.S. eCommerce sales in the 3rd quarter of 2020	projected retail online market share by 2030, compared to 16% in 2019

Examples of landscape shifts

- Major retailers are announcing permanent store closures and changes in anticipation of the continued shift to online sales
- For example, Macy's plans to close 125 stores over the next three years, and Neiman Marcus plans to revamp its store cost structure as it pivots to eCommerce post-bankruptcy

macy's

Neiman Marcus

- Real estate firms including Simon Property Group and Brookfield Property Partners have been active buyers / pursuers of retailers including Brooks Brothers, Lucky Brand, and JC Penney
- These landlords can provide stability in their malls by keeping major anchors and protecting co-tenant clauses

Brooks Brothers

LUCKY BRAND

JCPenney

Source: Retail Dive; Debtwire; Coresight; S&P; Moody's, FTI analysis

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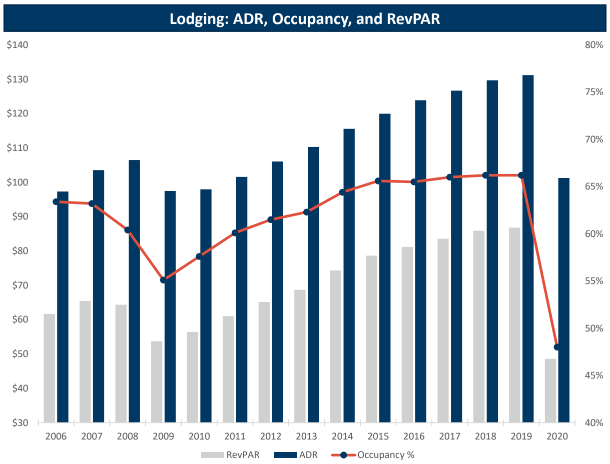
Hospitality – The Most Vulnerable Property Sector During the Pandemic

- The impact of the pandemic on the hospitality sector has far exceeded the effect of the Great Recession
- In 2020, ADRs decreased ~23% and occupancy declined by more than a quarter compared with the prior year
- As a result, RevPAR dropped by over 44.0%
- Longer-term implications of changing consumer behavior: market capitalization of Airbnb exceeds $100B and is greater than that of Marriott, Hilton, Hyatt, and InterContinental combined
- Different segments of the hospitality industry have been affected differently:
    - Most severe impact – luxury and full- services hotels
    - Significant impact – select-service
    - Moderate impact – limited-service and upscale extended-stay
    - Lowest impact – economy extended-stay
- Group travel hotels have experienced the greatest revenue declines while "drive up" resort destinations have held up the best



Source: STR, HVS, FTI analysis

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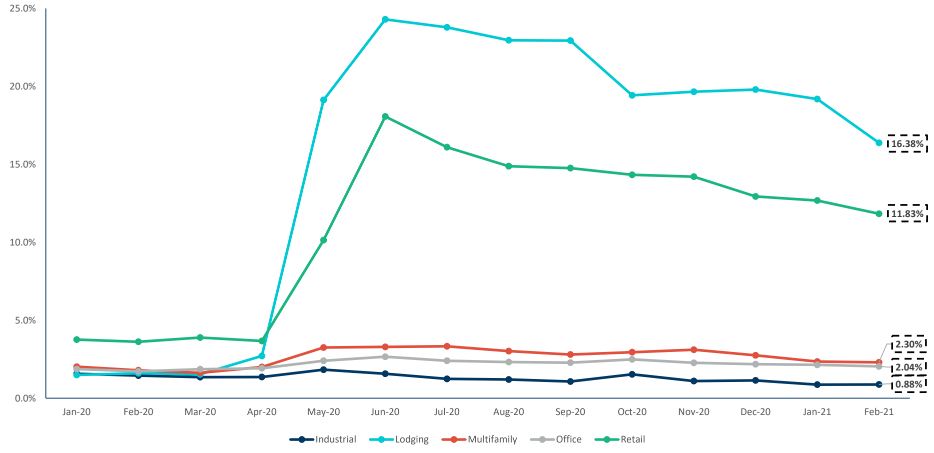
CMBS Delinquency Rates

CMBS delinquency rates have increased for all property types compared to the pre-pandemic historic lows, except for Industrial. Delinquencies have sky-rocketed and remain highly concentrated among Lodging and Retail properties.



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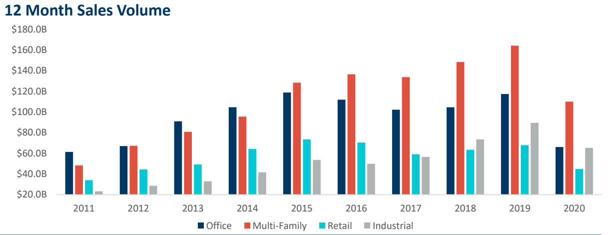
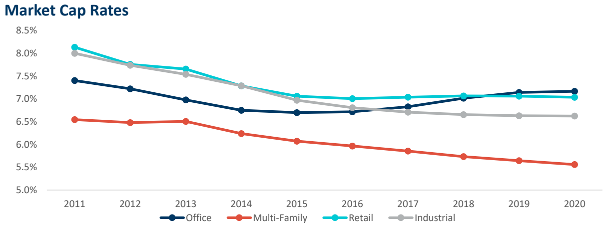
Source: Trepp, FTI analysis
Note: Data through 1Q'21

Commercial Property Sales Volume and Cap Rates

- Sales volumes decreased across the board from 2019 to 2020 by:
  - Office – 44%
  - Multi-family – 33%
  - Retail – 34%
  - Industrial – 27%
- Capitalization rates appear to have been staying at approximately 2019 levels, except for multi-family, which has experienced further gradual cap rate reduction, reflecting the investors' continuing interest in this sector and relatively limited new supply





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Source: CoStar, FTI analysis

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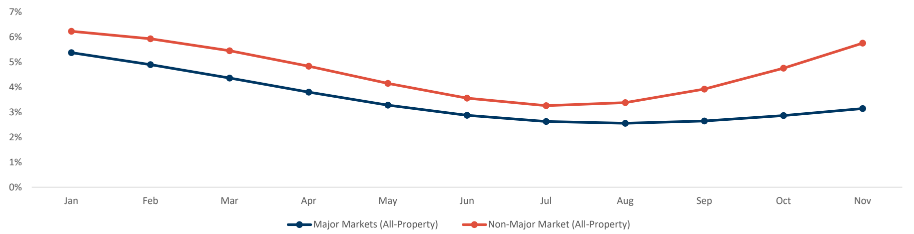
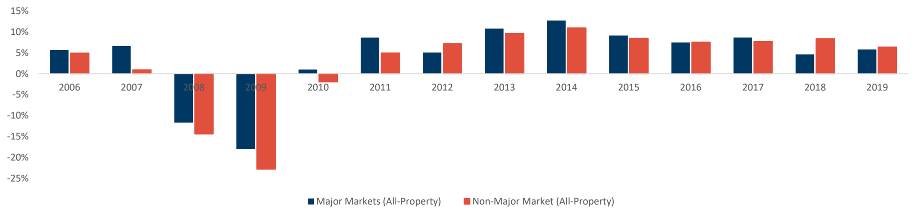
Major vs Non-Major Market Comparison

Non-Major Markets outperformed Major Markets on a year-over-year basis throughout 2020, diverging further towards year end.

CPPI YoY Monthly Trends through 2020



CPPI YoY Annual Trends since 2006



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Source: Real Capital Analytics ("RCA")
RCA describes the major markets as Boston, New York City, Washington D.C., Los Angeles, San Francisco, and Seattle

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Major and Non-Major Market Acquisition Trends

Acquisition volumes have generally dropped to a similar degree among major and non-major markets (except for Non-Major Urban Apartments). Suburban Office has outperformed CBD Office in both major and non-major markets.

Apartment and Office Acquisition Trends, Q2-Q3'20

Apartment		Volume ($b)	YOY Change
6 MM	Urban	2.8	-59%
	Suburban	8.0	-59%
Non-Major	Urban	1.9	-47%
	Suburban	28.6	-57%

Office		Volume ($b)	YOY Change
6 MM	CBD	5.5	-74%
	Suburban	7.5	-58%
Non-Major	CBD	1.8	-75%
	Suburban	11.9	-56%

Source: Real Capital Analytics
Note: "6 MM" – Six Major Metros.

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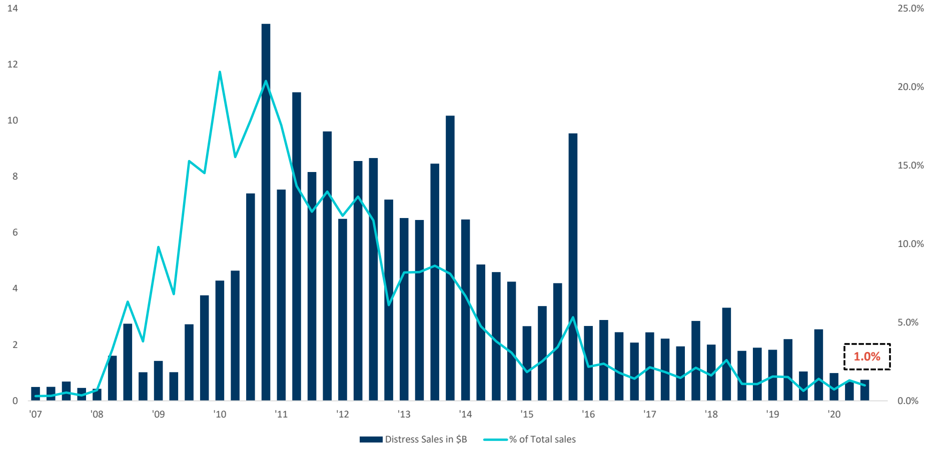
Distressed Asset Sale Trends

Distressed asset sales have been virtually flat and minimal throughout 2020 as borrowers and lenders have reached forbearance agreements and other short-term accommodations. The market has not yet experienced distressed sales resulting from the effects of the pandemic.



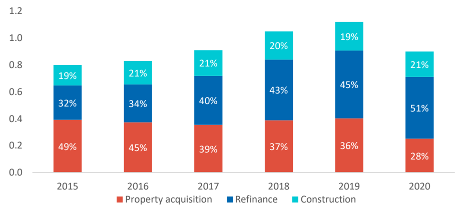
Source: Real Capital Analytics ("RCA"), FTI analysis
Note: Data through 3Q20
RCA categorizes distress through announcements of bankruptcy, default, court administration, or liquidation, and includes CMBS loans transferred to special servicer.

Lending Environment

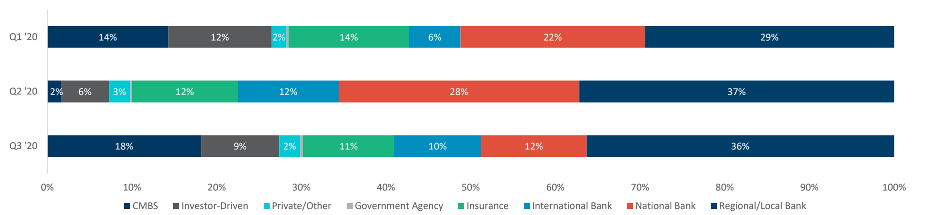
Debt financing, though somewhat reduced, remains available, with over half used for refinancing.

- CRE financing generally remains available, but the allocations have changed significantly, and availability varies greatly by property type
- Refinancing represented 51% of all capital flows during Q1-Q3 of 2020, a stark contrast from the lack of liquidity in the 2008-2009 crisis
- CMBS originations have rebounded after the Q2'20 slump but regional / local banks remain the single largest source of financing while national banks have significantly retreated

Capital Flows (in trillions), Q1 '20 – Q3 '20



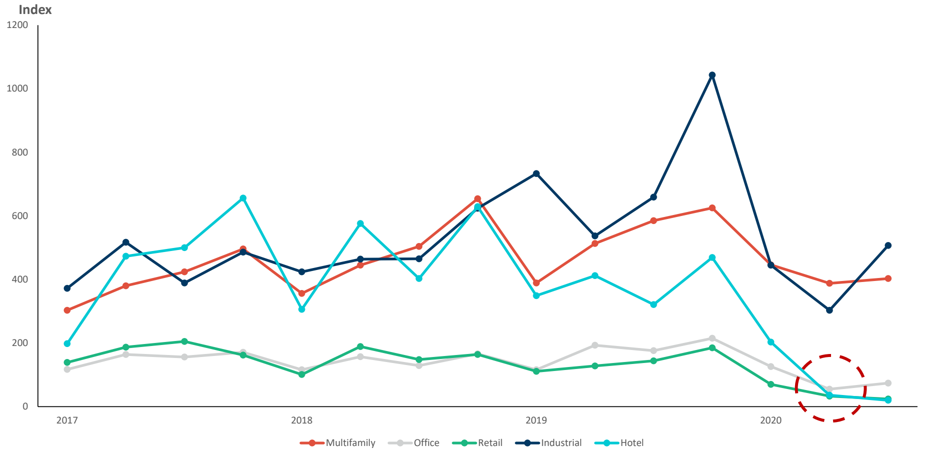
Composition



Source: Real Capital Analytics, FTI analysis
Note: Data through 3Q'20

CRE Loan Origination Volume

According to the Mortgage Bankers Association data, all loan originations fell in 2020. Hotel loan origination volumes have decreased by almost 96%, followed by retail at 87% from 4Q '19 to 3Q '20. Industrial loan originations appeared to be rebounding.



Source: Mortgage Bankers Association, FTI analysis
Note: Data through 3Q'20
Index is scaled to 2001 Avg quarter - 100

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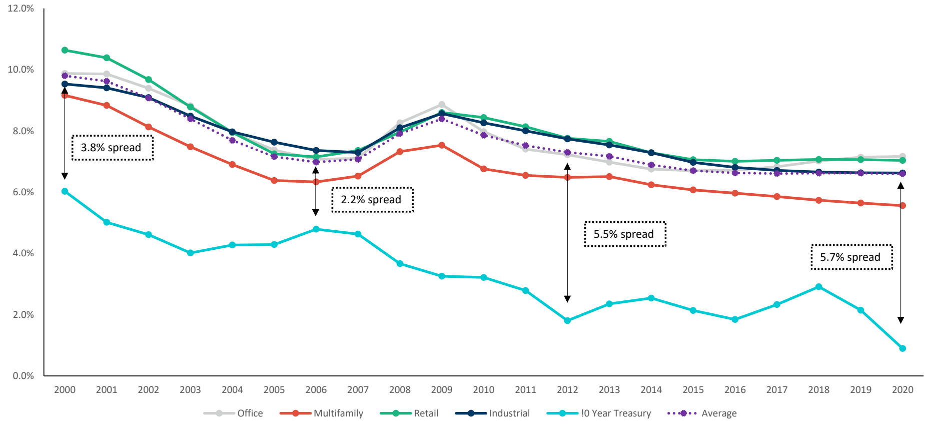
Capitalization Rate Spread over 10 Year Treasury

The capitalization rate spread over the 10-year Treasury has expanded from 4.5% in 2019 to 5.7% in 2020 for average cap rates across property types, driven primarily by the declines in the 10-year Treasury yields.



Source: CoStar, Federal Reserve, FTI analysis
10 Year Treasury based on average month end data.

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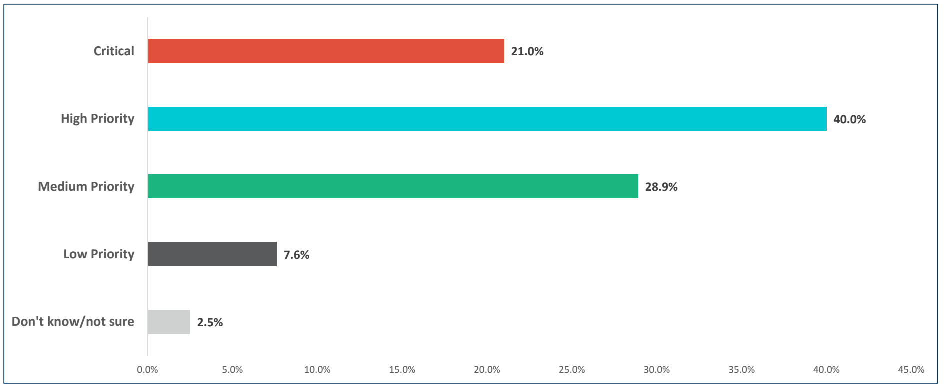
Remote Work - CFO Survey Selected Results

Question

Please indicate how the CFO and finance function are prioritizing a remote workforce in the next 12-18 months.



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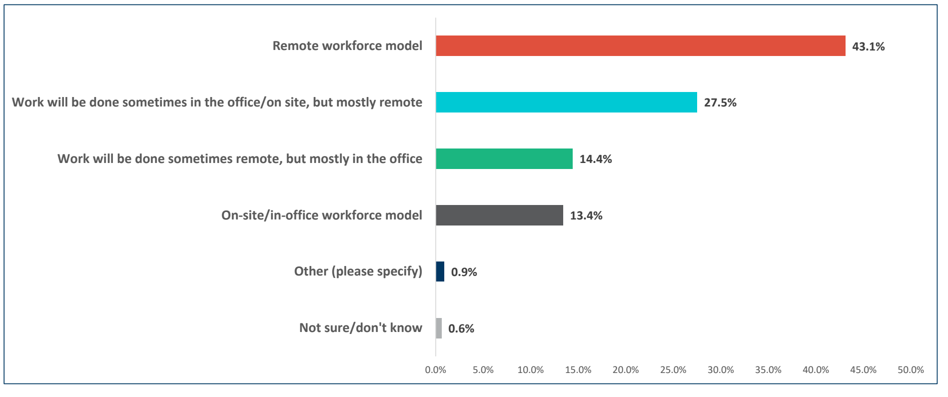
Source: Results from an online survey of 325 CFOs and finance executives conducted by FTI Consulting and CFO Research of Argyle Advisory & Research Services in August 2020.

Remote Work - CFO Survey Selected Results (continued)

Question

Please indicate which of the following models of work you expect members of your team to adjust to.



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Source: Results from an online survey of 325 CFOs and finance executives conducted by FTI Consulting and CFO Research of Argyle Advisory & Research Services in August 2020.

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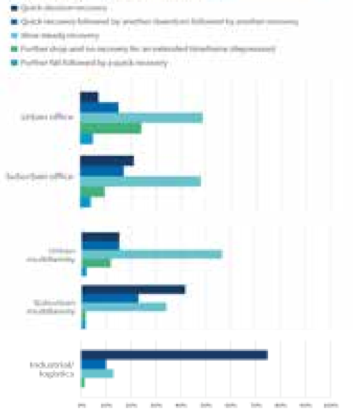
CRE Investor Expectations - REFI / FTI Real Estate Survey Selected Results

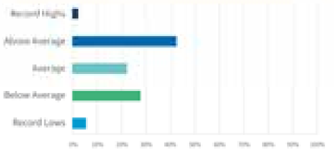
Question #1

What is your general expectation for the shape of the recovery from pre-Covid 19 to post-Covid-19 for the following types of asset valuation?



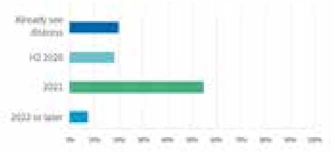
Question #2

Where do you expect to see 2021 transaction volume assuming we have a cure/vaccination by the end of 2020?



Question #3

When do you expect to see distress?
(Foreclosures, bankruptcies, etc.)



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Source: This FTI Survey was conducted over a two-month period in partnership with REFI's July 2020 Global Investors Virtual Summit and included 64 U.S. based CRE investment professionals

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Virtual Bankruptcy Battleground West
March 9-10, 2021

Prepared by Brian L. Davidoff
Greenberg Glusker LLP, Los Angeles, CA.

Real Estate in 2021 and Beyond: Trends from the Pandemic

1. Current Events

A. Mall Shakeout

Clothing stores,restaurants, gyms and other businesses find themselves in a $52 billion and growing hole, of unpaid retail rent that's been missed since April 2020, according to CoStar Group Inc. TIAA Real Estate Account, run by the giant Teachers Insurance and Annuity Association of America, said in a Nov. 10 filing it received more than 1,000 requests from tenants for rent relief, primarily among retailers, with most asking for deferrals of less than six months. As of October, 14% of U.S. malls were delinquent on their mortgages, almost double the high after the financial crisis, according to an analysis of mortgage bonds by research firm Trepp.

It is rare for real estate investment trusts that own malls or shopping centers to file bankruptcy because REITs have more conservative debt levels than many retailers. They also have multiyear leases across a wide variety of tenants.

But rescuing malls will be unusually complicated because the properties have intricate webs of financing that have only grown more elaborate with time. Interest groups ranging from lenders to shareholders to tenants to holders of complex mortgage bonds are wrangling over how to fix the situations, and for many large property owners, bankruptcy will be the only option, restructuring professionals said.

That's what CBL & Associates Properties Inc., which controls more than 100 retail properties including malls and shopping centers, found. The real estate investment trust spent months trying to restructure out of court before entering bankruptcy in November.

Pennsylvania Real Estate Investment Trust, the owner of about 30 retail properties in mid-Atlantic states, also filed for bankruptcy.

B. Current Conditions

In 2008, the economic distress was widespread, across the entire economy. This time, economic distress is more concentrated: hospitality and retail, for example, have been hit hard, yet delivery and shipping companies have thrived. So, there are clear "winners" and" losers" in this unique environment.

In 2008, the financial institutions were seen as the villains. This time, it is a villain-less cycle – except for perhaps the coronavirus, itself. Now, the financial institutions are part of the solution, i.e. through their involvement in the stimulus packages, such as the Paycheck Protection Program (PPP) and the Main Street Lending Program.

The Bankruptcy Courts have been somewhat helpful to borrower/debtors and the Consolidated Appropriations Act has made it a bit easier for landlord borrowers by giving them relief from bankruptcy preference laws for deferred rent payments.

On the other hand, Borrowers need to be realistic when making proposals to lenders. Unrealistic proposals will find their way to the bottom of a special servicer's "to do" list, simply because it is easier to make progress on proposals that are more likely to be approved. If a borrower wants to make rapid progress, shooting for the moon is not likely to be a good strategy.

2. <u>Single Asset Cases</u>

In the 1994 amendments to the Bankruptcy Code, Congress specifically defined "single asset real estate" in section 101(51B). The term 'single asset real estate' means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.

All elements must be satisfied before a debtor may be deemed a SARE debtor. *In re Scotia Pacific*, 508 F.3d at 220.

(1) First, the debtor must have real property constituting a "single property or project" other than residential real property with fewer than four units.

(2) Second, the real property must generate "substantially all" of the gross income of the debtor.

(3) Third, the debtor must not conduct business on the real property other than "operating the real property and activities incidental thereto."

A. <u>"Single Property or Project"</u>. The first element of the definition of a SARE debtor under section 101(51B) requires that the debtor owns "real estate constituting a single property or project, other than residential real property with fewer than 4 residential units[.]" 11 U.S.C. § 101(51B).

Drafters of section 101(51B) defined SARE to include two separate classifications in the disjunctive, single properties and single projects. Thus, the meaning of "single project" necessarily encompasses multiple parcels of real property held by a debtor which are beyond the meaning of "single property." *In re Rear Still Hill Road*, LLC, 2007 WL 2935483, *4 (Bankr. D. Conn. Oct. 5, 2007); *In Re McGreals*, 201 B.R. at 742-43; *In Re Philmont*, 181 B.R. at 224.

Courts have generally defined a "single project" as multiple parcels of real estate purchased, developed, or sold pursuant to a "common plan or scheme," linked together by "common usage" or in pursuit of a "common purpose." *McGreals*, 201 B.R. at 742-43 ; *Rear Still*, 2007 WL 2935483 at *5 ("properties must be linked together in some fashion in a common plan or scheme involving their use")

Cases have found multiple parcels of real property to constitute a "single project" pursuant to section 101(51B) based on representations and filings made by the debtor to regulatory authorities. For instance, in *Rear Still*, two contiguous parcels were found to constitute a "single project" based upon a unified application made by the debtor to the municipal planning/zoning board to develop the properties into single family residences.

In *Meruelo Maddux Properties, Inc*. (Case No. SV 09-13356-KT) judge Kathleen Thompson in the Cental District of California evaluated the following items to determine that separate LLCs were a single enterprise:

(4) consolidated cash management system swept into a single concentration account;

(5) payment of expenses of each debtor from those commingled funds;

(6) consolidated internal management team;

(7) consolidated business operations;

(8) use of proceeds from loan to property-level debtor in connection with IPO;

(9) financial statements filed with SEC on a consolidated basis;

(10) tax returns filed on a consolidated basis;

(11) cross-collateralized loans;

(12) single auditor and tax advisor;

B. <u>"Substantially All of the Income of the Debtor"</u>. The second element of the definition of a SARE debtor under section 101(51B) requires that the debtor's real estate "generate[] substantially all of the gross income of the debtor." 11 U.S.C. § 101(51B). Courts have held that the term "gross income" carries the same meaning as under section 61 of the Internal Revenue Code3 - "gross income means all income from whatever source derived." *In re Club Golf Partners, L.P.*, 2007 WL 1176010, *5 (E.D. Tex. Feb. 15, 2007).

Courts have focused on the source and nature of different streams of income received by the debtor. In *Club Golf Partners*, 2007 WL 1176010 at *5 the court explained that "the statute uses the verb 'generates,' denoting that it is the property itself, not the fruit of workers' labor and management services that is responsible for substantially all of the gross income." Therefore, if substantially all of the debtor's revenue is "the product of the efforts of management and workers conducted on the land, bringing in the customers and selling services and goods to them," such as at a golf course, the debtor does not satisfy the definition of a SARE debtor. Id.

Most cases that have considered the question have concluded that real property that generates no income does fall within the definition of SARE. *In re Kinard*, 2001 WL 1806039, *5 (Bankr. D.S.C. 2001); *In re Pensignorkay, Inc*., 204 B.R. 676, 682 (Bankr. E.D. Pa. 1997). *In re Oceanside Mission Assocs.*, 192 B.R. 232 (Bankr. S.D. Cal. 1996).

C. "No Other Substantial Business Activity". The third element of the definition of a SARE debtor under section 101(51B) requires that "no substantial business activity is being conducted by a debtor [on the property] other than the business of operating the real property and activities incidental." 11 U.S.C. § 101(51B).

In *Scotia Pacific*, the Fifth Circuit endorsed a widely accepted analysis as follows: [The definition should be interpreted] 'according to an active versus-passive criterion that inquires into the nature of revenue generation on and by the property, that is, whether the revenue is the product of entrepreneurial, active labor and effort – and thus is not single asset real estate – or is simply and passively received as investment income by the debtor as the property's owner – and thus is single asset real estate. . . . Real property that, for the generation of revenues, requires active, day-to-day employment of workers and managers other than or additional to the principals of the debtor, and that would not generate substantial revenue without such labor and efforts, should not be regarded as single asset real estate.' *Scotia Pacific*, 508 F.3d at 218. *Centofante v. CBJ Dev., Inc.* (*In re CBJ Dev., Inc.*), 202 B.R. 467 (B.A.P. 9th Cir. 1996).

In *In re Kkemko, Inc*. 181 B.R. 47, 51 (Bankr. S.D. Ohio 1995), the court held that a debtor who operated a marina was not a SARE debtor because it engaged in sufficiently active revenue generation outside merely managing or owning real property, including renting moorings, storing boats, providing showers and a pool to patrons, and selling concessions and gas. Similarly, full service hotels offering a wide variety of diverse amenities to their patrons are engaged in active revenue generation incompatible with the SARE designation. See *In Re CBJ Dev., Inc*., 202 B.R. at 473-74; *In Re Whispering Pines*, 341 B.R. at 136.

D. Relief from the Automatic Stay in SARE Cases

Section 362(d)(3) provides that relief from stay shall be granted:

> with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of an order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later –
>
> (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time;
>
> or (B) the debtor has commenced monthly payments that – (i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate

(other than a claim secured by a judgment lien or by an unmatured statutory lien); and (ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate[.]

Most courts that have considered the issue have held that section 362(d)(3) provides an additional basis for relief from stay in SARE cases, rather than preempting the bases provided in section 362(d)(1, 2, and 4).

(1) The Filing of the Plan Requirement.

In *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assoc., Ltd.*, 484 U.S. 365 (1988), the Supreme Court held that, in order to avoid stay relief under section 362(d)(2) by showing that a property was "necessary to an effective reorganization," a debtor had to demonstrate that there was "a reasonable possibility of a successful reorganization within a reasonable time." The standard for interpreting § 362(d)(3)(A) is nearly identical to the standard for determining whether or not property is 'necessary for an effective reorganization' under § 362(d)(2)(B). *In re Windwood Heights, Inc*., 385 B.R. at 837

(2) The Interest Payment Requirement.

In the event that a SARE debtor cannot, within ninety (90) days of the petition date, propose a plan with a reasonable possibility of confirmation within a reasonable time, the debtor can avoid relief from stay if it commences certain monthly payments to secured creditors pursuant to section 362(d)(3)(B). The payments must be "in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate." 11 U.S.C. § 362(d)(3)(B)(ii). Despite the prohibitions on use of cash collateral imposed by section 363(c)(2), the debtor may make these payments with funds generated from rents or other income generated by or from the real estate securing the creditor's claim. 11 U.S.C. § 362(d)(3)(B)(i).

The interest payments required by section 362(d)(3)(B) are not made on the full, unpaid principal balance of the debtor's indebtedness to the secured creditor. Rather, section 362(d)(3)(B) requires the debtor only to make interest payments "on the value of the creditor's interest in the real estate." 11 U.S.C. § 362(d)(3)(B)(ii). Considering that section 506(a) of the Bankruptcy Code uses almost identical language for purposes of claim bifurcation, it seems like section 362(d)(3)(B)(ii) will implicate many of the same valuation issues raised by section 506.

3. **Statutory Update**

A. Eviction Moratoria

Pursuant to an executive order signed by Governor Newsom, local municipalities can enact protections for commercial tenants through March 2021, although that date will almost certainly be extended. CA has extended the moratorium on residential evictions through June 30, 2021.

Commercial eviction (and repayment) issues throughout California are governed by local ordinances enacted by cities and counties. The County of LA's moratorium is in effect through February, but is being revisited on a month-to-month basis and likely will be extended. The county rules apply in all unincorporated areas and any city within the county that doesn't have its own rules. The County rules are the baseline, although cities can impose stricter protections. The City of LA moratorium is in effect indefinitely, so long as Governor Newsom's executive order referenced above is in effect. Said otherwise, the City of LA rules apply through March 2021 for now.

B. <u>CARES ACT Provisions Benefitting Depository Institutions</u>

Temporary Relief from Troubled Debt Restructurings. Under Section 4013 of the CARES Act, during the period beginning on March 1, 2020 through the earlier of December 31, 2020 or 60 days after the termination date of the national emergency concerning the COVID–19 outbreak declared by the President, a financial institution may elect to suspend the requirements under U.S. GAAP and federal banking regulations for loan modifications related to the COVID–19 pandemic that would otherwise be categorized as a TDR, including impairment accounting. This TDR relief is applicable for the term of the loan modification, but solely with respect to any modification, including a forbearance arrangement, an interest rate modification, a repayment plan, and any other similar arrangement that defers or delays the payment of principal or interest, that occurs during the applicable period for a loan that was not more than 30 days past due as of December 31, 2019. The relief provided by Section 4013 does not apply to any adverse impact on the credit of a borrower that is not related to the COVID-19 pandemic.

The CARES Act provides relief to financial institution lenders for loan modifications that would be considered to be TDRs, thereby incentivizing lenders to engage with borrowers about loan modifications and providing additional flexibility for lenders to modify loans without triggering TDR accounting treatment.

C. <u>The Consolidated Appropriations Act of 2021 (Public Law 116-260)</u>.

(1) <u>Availability of PPP Loans</u>

CARES Act II does makes PPP Loans available to some debtors:

> "(a) IN GENERAL.—Section 364 of title 11, United States Code, is amended by adding at the end the following: ''(g)(1) The court, after notice and a hearing, may authorize a debtor in possession or a trustee that is authorized to operate the business of the debtor under section 1183, 1184, 1203, 1204, or 1304 of this title to obtain a loan under paragraph (36) or (37) of section 7(a) of the Small Business Act (15 U.S.C. 636(a)), and such loan shall be treated as a debt to the extent the loan is not forgiven under section 1106 of the CARES Act (15 U.S.C. 9005) or subparagraph (II) of such paragraph (37), as applicable, with priority equal to a claim of the kind specified in subsection (c)(1) of this section."

This language makes PPP Loans available to subchapter V, chapter 12 and chapter 13 debtors — but excludes by omission all other chapter 11 debtors.

Under the new provision, which amends § 364 of the Bankruptcy Code, a qualifying debtor may apply for and obtain authority to receive a PPP loan, which, if not forgiven, will be treated as a "superpriority" administrative expense in the chapter 11 proceeding, which means it will come ahead of all administrative expenses in the case. If such an application is made, the bankruptcy court is required to hear it within seven days of the filing and service of the application. In addition, the debtor's plan of reorganization may provide that the PPP loan, if not forgiven, may be paid back under the terms on which it was originally made, which are favorable.

The Act also clarifies the treatment of pandemic relief payments received by a debtor in bankruptcy. Although Section 541 of the Code generally provides that all of a debtor's assets become property of their bankruptcy estate upon the commencement of a bankruptcy case, the CAA excepts federal COVID-19 relief payments received by the debtor from the bankruptcy estate. This will result in reducing the asset pool available to satisfy debts owed to creditors of the bankruptcy estate.

The CAA however provides that those debtors who are eligible for PPP Loans will only be when the Small Business Administration (SBA) decides that is the case.

(2) Leases

Section 365(d)(4)(A) of the Bankruptcy Code provides in part that the debtor must assume or reject a non-residential real property lease within 120 days of filing bankruptcy or the date of an order confirming a plan of reorganization – whichever is earlier. The debtor may get a 90-day extension if it can show good cause to do so, but any further extensions are subject to court approval and the lessor's consent.

The CAA extends the assumption or rejection period from 120 days to 210 days with no court approval. Lessee debtors now have an additional three months of breathing room, and landlords now face an equally-extended period of uncertainty. A debtor can extend the period even further – and additional 90 days up to 300 days in total– if the bankruptcy court finds good cause to do so.

This change to the Bankruptcy Code will sunset in two years, but will continue to apply in subchapter V small business chapter 11 cases commenced before the sunset date of December 27, 2022.

(3) Rent Abatement for Subchapter V Debtors

Bankruptcy courts now may grant subchapter V small business debtors additional time to satisfy post-petition rent obligations if the debtor is experiencing pandemic-induced financial hardship. Before the CAA, debtors could extend post-petition rent obligations up to 60 day after the petition date. Bankruptcy courts could not extend that time period beyond 60 days. Section 365(d)(3). The CAA allows bankruptcy courts to extend the 60-day period to 120 days for subchapter V debtors. Subchapter V debtors that receive this extraordinary relief may also repay the delayed administrative rent over time under their subchapter V plan, rather than repay it in full upon plan confirmation.

Any claim arising from such extension shall be treated as an administrative priority expense for purposes of confirmation of a chapter 11 plan in a subchapter V small business chapter 11 case.

(4) Preference Protection for Landlords

The specter of preference recovery can make it difficult for landlords to grant forbearance or deferrals to lessees with the possibility of bankruptcy on the horizon.

For landlords of a commercial tenant, any "covered payment of rental arrearages" will be protected from avoidance as a preference. The CAA amends Section 547 so that any payments made by a debtor after March 13, 2020 that were deferred pursuant to an agreement with a commercial landlord or supplier of goods or services may not be recovered by the trustee. However, this exception to preference recovery does not apply to the payment of any fees, penalties or interest imposed as a result of the debtor's failure to make timely payment.

Under the new amendment, in order for rent arrearage repayments to fall within the definition of "covered payment of rental arrearages" that may not be avoided as preference, such a payment of arrearages (i) must be made pursuant to an agreement or arrangement entered into on or ***after*** March 13, 2020, between the debtor and a lessor to defer or postpone the payment of rent and other periodic charges under an unexpired lease of nonresidential real property; (ii) cannot exceed the amount of rental and other charges due under the lease agreement that was executed before March 13, 2020; and (iii) cannot include fees, penalties or interests greater than the amount of fees, penalties or interest scheduled to be paid under the lease agreement or that the debtor would owe if it was timely on its payments

It is important to note that the language of the amendment does not apply to lessors of personal property, such as machinery, equipment or furniture.

The CAA that the provisions will "sunset" two years from enactment of the legislation, on December 27, 2022.

4. Issues in Retail Bankruptcies

A. Practical Issues in Retail Cases

Covid-19 has impacted what happens in commercial real estate related bankruptcy cases in a number of different ways.

Prior to the pandemic, a landlord's usual strategy was pretty clear. If a tenant was in default, at least in California, landlords would move relatively quickly to send the notice to pay rent or quit, and once the time period expired, to file an unlawful detainer complaint with the court. Under the Ninth Circuit case *In Re Windmill Farms* 841 F. 2d 1467 (9^{th} Cir. 1988) if the landlord was able to do those 2 things before the tenant filed a bankruptcy, then the lease would be deemed terminated. So the idea was to make sure the lease was terminated before the bankruptcy filing.

Now, at least in Los Angeles county, there is still a moratorium on commercial evictions which ostensibly precludes even the service of the statutory notice to pay rent or quit. So the strategy of terminating the lease right away, is not available.

From a tenant's standpoint, it's a little bit of the reverse. Previously, a tenant that believed it had a lease that had value, even if the tenant was unable to pay current rent, would have to consider filing bankruptcy more quickly. Now, because of the moratoria, the tenant can perhaps be a bit more deliberate about that decision.

There has been a dramatic shift in leverage. Since Covid-19, and the government shutdown of many businesses, landlords have lost leverage and tenants have gained leverage. The reason is that there simply are no new prospective tenants, waiting in the wings to sign a lease for a space that becomes vacant. So even if a landlord can successfully remove a tenant, what good does that necessarily do for the landlord?

As a result, landlords that do not also have a lease guaranty from a very solvent third party that is not itself in bankruptcy, those landlords have had to be very realistic and shift their short-term goals. Playing hardball in a bankruptcy case in an effort to get the debtor tenant to give up the lease is no longer a useful strategy in most cases. And the big retail tenants are very aware that they have this newfound leverage.

U.S. commercial landlords have granted billions of dollars of rent relief to struggling storefronts as property owners strive to keep falling occupancy rates from triggering more severe financial consequences. With many commercial property tenants in dire financial straits due to the economic fallout from the coronavirus pandemic, landlords are reluctantly granting concessions on lease payments, lengthening payment terms, extending or shortening leases, lowering rents permanently and even forgiving past-due payments, according to real-estate advisers, property managers and lawyers. By providing the breaks following negotiations, landlords are hoping to avoid pandemic-induced tenant departures, keep properties occupied and rent payments flowing, while avoiding the larger losses that can come from evictions and increased vacancies in their shopping centers and malls. They are fearful of triggering lease provisions that kick in when key anchor retailers or a certain number of tenants leave a certain property, cutting rents for those that remain. Retail vacancies have been steadily on the rise and are expected to significantly increase.

B. Mothballing Motions

Bankruptcy Code Section 365(d)(3) provides: "The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title. The court may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but *the time for performance* shall not be extended beyond such 60-day period." 11 U.S.C. § 365(d)(3).

To be subject to extension, the obligation must arise during the 60-day period after the petition date. *In re Simbaki Ltd.*, 2015 Bankr. LEXIS 1142 *19 (Bankr. S.D. Tex. 2015): "The Bankruptcy Code prohibit[s] the Court from extending [debtor]'s time for performance of its rent obligation because it did not arise within 60 days after the order for relief."

If the Court extends the time, when is performance due? Legislative history to of § 365(d)(3) provides that "[a]t the end of this period, the amounts due during the first 60 days would be required to be paid." 130 Cong.Rec. S8994-95 (daily ed. June 29, 1984) (remarks of Senator Hatch).

Modell's Sporting Goods, Inc., and it affiliates filed for bankruptcy on March 11, 2020. Shortly thereafter the debtors filed a motion for an order pursuant to Sections 105 and 305 implementing the following 60-day "Bankruptcy Suspension" requesting the implementation of an "Operational Suspension and extending all deadlines that would otherwise occur during the Bankruptcy Suspension for 21 days thereafter; preventing any party from seeking any relief during the Bankruptcy Suspension; deferring the payment of rent; and keeping in place the automatic stay remains in place. The court ultimately gave several extensions, beyond the 60 days permitted in Section 365(d)(3). *In re Modell's Sporting Goods*, Case No. 20-14179, [Docket No. 115] (Bankr. D.N.J. March 23, 2020)

In *Pier 1*, about a month and a half after the debtors filed bankruptcy on February 17, 2020, the debtors filed an emergency motion for an order pursuant to Section 105 and 365(d): authorizing the debtors to temporarily cease making rent payments; deferring all motions for stay relief, to compel assumption or rejection of leases, or to seek payment of administrative claims for a period of 45-days after the end of the "Limited Operation Period." 1 *In re Pier 1 Imports Inc.,* Case No. 20-30805-KRH. The court granted the motion for a total of over 100 days holding that although the debtors have an obligation to pay rent in accordance with the lease, Section 365(d)(3) did not give landlords a right to compel payment. The court held rather that the landlords have an administrative claim under §§ 507(a)(2) and 503(b) that must paid on the effective date of a plan. The court also found that, to the extent that the landlords were entitled to adequate protection, they had received it in the form of the continued payments of related non-rent payments and the promise of future cure payments.

See also *In re True Religion Apparel Inc*. Case No. 20-1091 (CSS) [Docket No. 27] (Bankr. D. Del. April 13, 2020).

J. Crew Group Inc., filed for bankruptcy protection in the Eastern District of Virginia on May 4, 2020, the debtor sought court approval on the first day of its case to defer its sizeable obligations under its commercial leases. The court granted the retailer's request for a 60-day rent deferral, and it found and it found that no adequate-protection payments were required. The order was entered at a time when many stay-at-home orders had expired or were about to expire, and stores were already reopening. The court found that the timing of the debtor's filing did not "lessen the effects of the pandemic," and that the debtor would be permitted to "utilize the tools available under the Bankruptcy Code." *In re Chinos Holdings Inc*., Case No. 20-32181 (KLP) [Docket No. 23] (Bankr. E.D. Va. May 4, 2020)

Later cases have not always adopted the same position. See for example the bankruptcy case of Forever 21 Inc., in which the court denied a mothballing motion by an asset-purchaser to cease paying rent while maintaining possession of the stores, notwithstanding the crisis caused by the COVID-19 pandemic. *In re Forever 21 Inc*., Case No. 19-12122 (MFW) [Docket No. 1115] (April 1, 2020).

5. <u>Designation Rights</u>

The sale of designation rights involves the bankruptcy court's approval of the sale of the right to sell the assets (usually multiple leases) of the debtor. Designation rights are not specifically provided for or described in the Bankruptcy Code and have developed without a clear statutory underpinning. The sale of such rights is permitted pursuant to section 365(a) (which provides that the trustee has the right to assume or reject unexpired leases), notwithstanding the existence of "ipso facto" or "antiassignment" provisions in the leases, so long as the leases have first been assumed (see section 365(b)(2)). A bankruptcy court also may invoke section 105(a) (which permits a court to "issue any order, process, or judgment that is necessary to carry out the provisions of this title") to approve a sale of designation rights if the court deems such a sale to be in the best interests of the estate and its creditors.

Case law has approved the concept of the sale of designation rights. See, e.g., *Weingarten Nostat, Inc. v. Service Merchandise Co*., 396 F.23d 737, 743 (6th Cir. 2005) (two-step sale of designation rights approved by court); *In re Ames Dept. Stores, Inc*., 287 B.R. 112, 118-26 (Bankr. S.D.N.Y. 2002) (strongly endorsing sale of designation rights); *In re Ernst Home Ctr*., 209 B.R. 974, 985 (Bankr. W.D. Wash. 1997) (approving sale of designation rights as sale of "bonus value" of leases to estate, thus constituting property interest of estate pursuant to sections 363(b) and 541.

The court usually will issue an order confirming that all notice and procedural requirements were complied with; that the property was widely marketed and that the auction was properly conducted and produced the best price for the property; that the sale was in the best interests of the estate; that the purchaser was a non-insider; and that the purchaser has agreed to cure all monetary defaults under the leases and pay all costs and expenses on each of the properties from the closing date to the date of transfer. The court may allow the successful purchaser to transfer properties to itself, to transfer properties to others or to require the debtor to retain certain properties.

The purchaser of the designation rights pays the bankruptcy estate for the right to direct which leases will be assumed (and assigned) or rejected, and pays all the carrying costs of the properties during the bankruptcy proceeding.

Debtors and unsecured creditors committees generally favor the sale of designation rights because they can quickly and efficiently monetize a portfolio of leases and bring an immediate (and necessary) cash infusion to the debtor's estate.

6. <u>Landlord Section 363 Sales</u>

The landlord has the same three options with a lease when it files bankruptcy- reject, assume, or assume and assign. But the key difference is what happens to the tenant when the landlord rejects the lease. If a landlord rejects a lease, then under section 365(h) of the bankruptcy code, the tenant has 2 options (1) treat the rejection as a termination of the tenancy; or (2) if the tenant wants to stay in the premises, the tenant can elect to do so. The landlord does not have to perform any of its affirmative obligations under the lease other than allowing the tenant to retain possession; and the tenant must continue to pay rent. But the tenant has the right to offset the rent by any damages caused by the landlord's non-performance. The tenant cannot however affirmatively sue the landlord.

The case of *Spanish Peaks Holdings II, LLC* should be considered when a landlord files for bankruptcy. *In re Spanish Peaks Holdings II, LLC* 872 F.3d 892 (9th Cir. July 2017). Spanish Peaks developed a private high-end residential ski and golf resort in Big Sky, Montana. The debtor entered into a loan agreement secured by its real property. Subsequently, Spanish Peaks entered into a 99 year lease, as lessor, with one of its non-debtor affiliates for The Pinnacle at Big Sky Restaurant. The Pinnacle lease was significantly below market. The debtors filed a petition under chapter 7 and the trustee sought to sell substantially all of the debtors' assets free and clear under section 363(f) to the debtors' prepetition lender pursuant to section 363.

At the sale procedures hearing, Pinnacle opposed the sale and stated that if the lease was rejected, Pinnacle would elect to retain all of its rights under section 365(h). Subsequently, the trustee filed a motion to reject the Pinnacle lease. No timely objection was received, and the court granted the trustee's motion. At the sale hearing, the lender sought a determination that the sale was free and clear of the Pinnacle lease under section 363, and that section 365(h) did not apply to preserve the Pinnacle leasehold interests following the sale. The affiliates objected.

In making its decision, the bankruptcy court examined a split in the case law between courts holding that section 365(h) rights may be terminated in a section 363 sale, and courts holding that a tenant's rights under section 365(h) may not be ended by a sale free and clear.

The main case holding that section 365(h) rights may be terminated by a section 363(f) sale is the Seventh Circuit's decision in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC*. 327 F.3d 537 (7th Cir. 2003) under section 363(f) Under *Precision Industries*, any lessee could have its possessory interest ended, subject to receiving adequate protection, if requested.

On the other hand cases holding that section 365(h) trumps have noted that section 365(h) "evinces a clear intent" that a "tenant will not be deprived of his estate for the term for which he bargained."

The bankruptcy court in *Spanish Peaks* chose a different path. It found that a "case-by-case, fact-intensive, totality of the circumstances, approach, rather than a bright line rule" should guide whether section 363(f) or section 365(h) governs in any situation. In the case before it the bankruptcy court held that the property could be sold free and clear of the affiliates' section 365(h) possessory rights, based on findings that (i) the leases between the debtors and the affiliates were entered into at a time when all parties were controlled by the same individual, (ii) the Pinnacle lease provided for lease rates that were far below fair market rental rates, (iii) the Opticom lease was never recorded, and (iv) the affiliates neither sought nor obtained a nondisturbance agreement from the prepetition lender to protect their rights.

A key issues in the court's holding that section 363(f) trumps 365, was that the lessees did not take any actions to protect themselves either by seeking a nondisturbance agreement with the lender or by establishing a case for adequate protection.

Faculty

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