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From the Bankruptcy Courts: How The Bankruptcy Act of 1994 Affects Secured Creditors and Mortgagees in Business Cases

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Author's Note: For the past fifteen years, I had written this column with my coauthor, mentor, and dear friend, Benjamin Weintraub. It is with great sorrow that I inform our readers of Mr. Weintraub's recent death at the age of eighty-nine. His contributions to the law since the 1930s—as lawyer, scholar, and teacher—were truly remarkable. His extraordinary knowledge, wit, and good judgment will live forever in his many published writings.

HOW THE BANKRUPTCY ACT OF 1994 AFFECTS SECURED CREDITORS AND MORTGAGEES IN BUSINESS CASES

The Bankruptcy Reform Act of 1994, which was enacted on October 22, 1994, has made numerous changes to both business and consumer bankruptcy law. With few exceptions, these statutory changes are applicable only in bankruptcy cases commenced on or after the date of enactment. The Reform Act amended many sections of the Bankruptcy Code, as well as certain bankruptcy-related sections of Title 18 and Title 28 of the United States Code.

The purpose of this article is to provide a general summary of some of the key provisions of the Reform Act that should be of particular interest to secured creditors and real estate mortgagees who are creditors of business debtors.

Expediting Hearings on Relief From the Automatic Stay

To avoid a problem that existed under the former Bankruptcy Act when courts could have delayed for several months ruling on a motion for relief from the automatic stay while collateral was depreciating, the Bankruptcy Code requires that the court hold either a preliminary or final hearing within thirty days after the filing of a motion for relief from the stay. Until the 1994 amendments, the Code provided that—if the hearing on relief from the stay is preliminary—the court must *commence* the final hearing within thirty days after the conclusion of the preliminary hearing. However, the Code did not impose a deadline for concluding the final hearing. Thus, the bankruptcy court could commence the final hearing but delay conclusion of the hearing beyond the thirty-day period.

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The 1994 Reform Act amended Section 362(e) of the Code to require that the final hearing on the motion for relief from the stay be *concluded* within thirty days after the conclusion of the preliminary hearing. This period may be extended only on consent of the parties or for a specified time that the court finds is required by compelling circumstances.

Purchase Money Security Interest as a Preference

Section 547(c)(3) of the Code protects a purchase money security interest against attack as a preference if the security interest is perfected within a specified time after receipt of the goods. Until the 1994 amendments, the time period for perfecting the security interest was ten days. This provision was originally designed to conform to the Uniform Commercial Code, which gives a creditor ten days after the debtor receives the goods to perfect a purchase money security interest in order to obtain priority with respect to certain prior perfected security interests and judicial liens.[1]

An amendment to Section 547(c)(3) has changed this ten-day period to twenty days. The reason for this change is to conform to the current version of the Uniform Commercial Code in most states—as amended since 1978—that provides for a twenty-day grace period for purchase money secured creditors to perfect their interests in order to benefit from the UCC's grant of priority over certain other secured creditors and judicial lienors.

Continued Perfection

The Reform Act amended Sections 362(b) and 546 to remove any doubt that actions taken by a secured creditor to continue perfection of its security interest—such as by filing a continuation statement under the Uniform Commercial Code[2]—do not violate the automatic stay and are effective to maintain the perfected status of the security interest.

Single Asset Real Estate

In response to complaints that owners of real estate frequently file Chapter 11 petitions for the purpose of stalling foreclosure sales without any reasonable prospect—or even intention—of filing a confirmable plan of reorganization, the Reform Act includes a provision making it more difficult for some of these cases to remain under the protection of the Bankruptcy Code.

A new term, "single asset real estate," has been added to the Code to mean real property constituting a single property or project (other than residential property with fewer than four units), which generates substantially all of the debtor's gross income and on which no substantial business is being conducted by the debtor other than the business of operating the real estate—but only if the noncontingent, liquidated

[1] See U.C.C. Sections 9-301(2), 9-312(4).

[2] See U.C.C. Section 9-403.

secured debts do not exceed $4 million. Section 362(d) of the Code previously included two grounds for seeking relief from the automatic stay. The Reform Act added a third ground applicable only to single asset real estate. If a mortgagee moves for relief from the stay to foreclose its lien on single asset real estate, the Code now provides that the automatic stay against the mortgagee will be limited to ninety days after the order for relief, unless within that time the debtor files a Chapter 11 plan "that has a reasonable possibility of being confirmed within a reasonable time," or the debtor has commenced monthly payments to every mortgagee equal to interest at the market rate on the value of the mortgagee's interest in the real estate. The court may extend the ninety-day period for cause.

In view of the narrow definition of "single asset real estate"—it does not include property with more than $4 million in liens—this amendment should not affect most cases involving real estate. However, in cases involving single asset real estate, it remains to be seen how courts will apply monthly payments to undersecured mortgagees. According to the Supreme Court's decision in *In re Timbers of Inwood Forest*,[3] undersecured mortgagees are not entitled to postpetition interest on their claims. Does the 1994 amendment to Section 362(d) overrule *Timbers* as it relates to single asset real estate? Or, is it intended that postpetition payments to mortgagees under Section 362(d)(3) be applied to reduce the principal balance of the mortgage? Another open question is whether the new provision will influence courts to give the debtor the full ninety-day period in which to file a Chapter 11 plan before granting relief from the stay. In essence, the new provision may benefit debtors by giving them ninety days to file a plan in situations that may have led bankruptcy courts in the past to grant relief much earlier in the case. It will be interesting to see how the new Section 362(d)(3) is applied in future court decisions.

Assignments of Rents

The Reform Act finally resolved the issue of whether a recorded assignment of rents taken together with a recorded real estate mortgage is effective to give the mortgagee a lien on postpetition rents if the assignment of rents was not "perfected" under state law by a request for the appointment of a receiver, sequestration, or some other enforcement step. An amendment to Section 552 of the Code gives the mortgagee with an assignment of rents a security interest in postpetition rents without the need to "perfect" under state law. The postpetition rents will constitute cash collateral under Section 363(a) that can be used by the debtor only with consent or a court order providing the mortgagee with adequate protection.

[3] 484 U.S. 365 (1988).

It is important to note, however, that the Reform Act amendments include two limitations on the mortgagee's rights to postpetition rents. First, the trustee's avoiding powers may be used to avoid the lien on rents. Therefore, if a hypothetical bona fide purchaser or judicial lien creditor would have superior rights because the assignment of rents was not recorded prior to bankruptcy, the trustee may avoid the lien on rents.[4] Second, the court may order that the security interest does not attach to all or some of the postpetition rents on the basis of the equities of the case.

Hotel Revenues

Prior to the Reform Act, a number of courts had treated hotel and motel revenues as accounts receivable of the debtor's business, not as "rents" or "proceeds" of the real estate.[5] As a result, postpetition revenues have not been subject to the lien of a mortgagee, despite a recorded mortgage on the hotel and a perfected security interest in rents and profits of the hotel. In view of the importance of encouraging hotel financing by assuring protection of liens on revenues, the Reform Act amended Section 552(b) of the Code so that accounts or payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties will be treated as rents. As rents, these revenues will be protected by the Code provisions protecting cash collateral.[6] It should be noted, however, that the court has broad discretion to deprive the secured creditor of its interest in rents on the basis of the equities of the case. As pointed out in the legislative history, the court should balance the protection of secured creditors against "strong public policies favoring continuation of jobs, preservation of going concern values and rehabilitation of distressed debtors."[7] In addition, the legislative history emphasizes that such operating expenses as cleaning and repair services, utilities, employee payrolls, and the like may be charged against hotel revenues.

Rights of Leasehold Mortgagees

Prior to the Reform Act, Section 365(h) of the Code provided that a lessee of real property may elect to "remain in possession of the leasehold" if the lessor files a bankruptcy petition and rejects the unexpired lease. In recent decisions, this provision has been construed narrowly to protect only the lessee's possess-

[4] See 11 U.S.C. § 544(a).

[5] See, e.g., In re General Associated Investors Ltd. Partnership, 150 B.R. 756 (D. Ariz. 1993) (revenue derived from rental of rooms and from facilities such as food and banquet rooms located in a resort were not "rents, profits, or proceeds" within the meaning of Section 552(b)). Compare, e.g., In re Days California Riverside Ltd. Partnership, 27 F3d 374 (9th Cir. 1994) (hotel room charges in California are "rents," but revenues derived from the sale of food and drink and from other services provided by the hotel are "accounts," not rents).

[6] See 11 U.S.C. §§ 363(a), 363(c)(2).

[7] 140 Cong. Rec. H10768 (October 4, 1994).

ory rights. For example, courts have held that the lessee may not assign its rights or enforce restrictive covenants in the lease.[8] Issues regarding the rights of a subtenant, leasehold mortgagee, or other party with an interest in the leased premises have been raised but left unanswered. These issues have been of particular interest to creditors of lessees who rely on leasehold mortgages to secure their loans.

These concerns resulted in substantial amendments to the language of Section 365(h). Under the amended section, the lessee retains its rights under the lease—to the extent that these rights are enforceable under state law—including the right of use, possession, quiet enjoyment, subletting, assignment, or hypothecation. If the property is in a shopping center, rejection of the lease will not affect the enforceability under state law of any provision in the lease pertaining to radius, location, use, exclusivity, or tenant mix or balance. Most importantly for leasehold mortgagees, the amendments protect certain other parties by including within the meaning of "lessee" any successor, assignee, or mortgagee permitted under the terms of the lease.

[8] See, e.g., In re Carlton Restaurant, Inc., 151 B.R. 353 (Bankr. E.D. Pa. 1993) (preventing a tenant from assigning the lease); Home Express, Inc. v. Arden Associates, Ltd., 152 B.R. 971 (Bankr. E.D. Cal. 1993) (tenant could not enforce restrictive covenants).

Real Estate Taxes

In cases filed before the enactment of the 1994 Reform Act, the automatic stay prevents the attachment of a statutory lien on the property of the estate with respect to taxes accruing after the commencement of a bankruptcy case. Municipalities have expressed concern that the automatic stay impairs their revenue collecting capability while creating a windfall to mortgagees who would otherwise be subordinate to such tax liens. In response to this concern, Congress included in the Reform Act a new exception to the automatic stay in Section 362(b) for "the creation or perfection of a statutory lien for an ad valorem property tax imposed by the District of Columbia, or a political subdivision of a State, if such tax becomes due after the filing of the petition."[9]

Curing Defaults

Chapter 11 plans frequently provide for the curing of defaults and the reinstatement of the original terms regarding a debt or bond issuance. By curing defaults and putting the obligation back on its original track, the plan leaves the creditor unimpaired under Section 1124(2). The Reform Act amended the Code to provide that—if a Chapter 11 plan proposes to cure a default—the amount necessary to cure the default is determined in accordance with the underlying agreement and applicable nonbankruptcy law. This

[9] 11 U.S.C. § 362(b)(18).

amendment is unusual because it applies prospectively only. That is, any agreement made prior to the date of enactment is not affected by this change even if the bankruptcy petition is filed after the enactment of the 1994 Reform Act.

The amendment, which is contained in Section 1123, is substantially the same as other amendments made in Chapter 12 and Chapter 13. These changes appear to uphold default interest rate clauses to the extent that they are enforceable under state law. The legislative history indicates that the purpose of these amendments is to prevent windfalls for secured creditors as a result of the Supreme Court decision in *Rake v. Wade*,[10] where the Court required a Chapter 13 debtor to pay interest on interest and interest on late charges to cure a default on a home mortgage even though state law prohibited such interest and the agreement did not provide for it.

Debtor's Right to Return Goods

An amendment to Section 546 of the Code gives the trustee or debtor in possession—with consent of the vendor and if the court finds after notice and a hearing that it is in the best interests of the estate—the right to return goods shipped to the debtor prepetition. The vendor then offsets the price of the goods against its prepetition claim. An order authorizing the return of goods may be issued only if the trustee or debtor files a motion seeking such authorization within 120 days after the order for relief. Under the Code before this amendment, the return of goods to a vendor would be an impermissible payment of a prepetition claim unless the vendor has the right of reclamation.

An issue raised but unanswered by this amendment is how the return of goods under this section affects the rights of prepetition and postpetition lenders with security interests in the debtor's inventory. Once goods are delivered to the debtor before bankruptcy, a security interest in the debtor's inventory would attach to those goods. Such goods also may become the collateral that secures postpetition financing.[11] If the goods are subsequently returned to the vendor under the new provision, does the security interest remain with the goods? Or, is the new provision another avoiding power that permits the trustee to avoid prepetition or postpetition security interests in inventory by returning them for a full credit? Unfortunately, it will take future litigation to determine the answers to these questions.

Aircraft Equipment, Vessels, and Rolling Stock Equipment

Sections 1110 and 1168 of the Code provide special protection for certain secured creditors, conditional vendors, and lessors with interests in aircraft, certain aircraft equipment, vessels, or railroad rolling stock equipment. The Reform

[10] 113 S. Ct. 2187 (1993).

[11] See 11 U.S.C. §§ 364(c) and 364(d).

Act clarified and expanded these sections to provide that the rights of the secured creditor, conditional vendor, or lessor to take possession of such equipment may not be affected by the automatic stay, confirmation of a plan, the debtor's right to use property, or the injunctive powers of the court, unless the trustee cures defaults within certain time limits and, within sixty days after the order for relief, agrees to perform all obligations of the debtor.

Before the Reform Act, the Code provided that creditors with security interests in such equipment were protected by Sections 1110 and 1168 only if they have purchase money security interests. The 1994 amendments expanded these sections to provide the same protection for all lease financing arrangements and all secured financing—not only purchase money financing—if the equipment is first placed in service after October 22, 1994. In addition, under a new definition of "lease" contained in these sections, equipment placed in service before the date of enactment receives Section 1110 or 1168 protection if the lessor and the debtor have expressed in the lease or a contemporaneous writing that the agreement is to be treated as a lease for federal income tax purposes.