A LEGAL PERSPECTIVE

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WHAT YOU NEED TO KNOW IF YOUR TENANT FILES BANKRUPTCY

Author's Note: I have put off writing this article for quite some time because significant bankruptcy reform legislation has been proposed in at least the last four Congressional legislative sessions. If this legislation passes in the form in which it is currently drafted, some of the actions recommended in this column may be subject to change. If the bankruptcy legislation is enacted I will provide an update in this column as quickly as practicable.

To paraphrase the comedian Al Franken "How would my tenant's bankruptcy affect me, Al Franken?" Bankruptcies are a reality in our industry and every bankruptcy filed by any tenant of yours, no matter what the circumstance, affects you and requires you, at a minimum, to at least take precautionary steps.

The most recent statistics available (for the quarter ending June 30, 2001), indicate that the number of bankruptcies filed has hit an all time high. We are seeing bankruptcies tracking the economic downturn which we really have been watching through all of 2001. (The statistics from the balance of 2001 showed a furious pace of increases in bankruptcies.) Thus, you need to be aware of what to do when you find out a tenant has filed bankruptcy.

As a precursor you need to understand that there are several different types of bankruptcies your tenants might file. The most common types of bankruptcy are Chapters 7, 11 and 13.

Currently, a Chapter 7 is an attempt to discharge all unsecured debt and some or all of the secured debt. Secured debt is a debt for which collateral has been pledged in exchange for the debt such as a mortgage loan on a home, title loan on a vehicle or even a purchase money security interest in items you might buy on a credit card at a store like Sears or Best Buy. Secured debts are generally dischargeable under Chapter 7 so long as the debtors are willing to surrender the secured asset to the creditor. As a side note: some states require that you notify these types of creditors before you perform a lien sale. However, the largest debt component of a Chapter 7 is usually the unsecured debts, i.e. an unsecured Master Card or Visa Card, doctors bills, unpaid back rent for an apartment or even a delinquency owed to Self-Storage facility for non-payment of rent or other damages the operator may have suffered as a result of having the tenant in the Premises. At the end of the Chapter 7, assuming that there are no assets for the Trustee to liquidate and distribute to creditors you will not receive any of the money due to you. Your debt is discharged and you can take no action in the future to collect the debt.

Conversely, a Chapter 13 is often referred to as a “wage earner plan” where the debtor files a petition for bankruptcy which prevents creditors from collecting the debt, but plans to repay some percent, sometimes up to a 100% of the past due debt, to his/her creditors over a period of years known as the “bankruptcy plan”. If you get a notice about a Chapter 13 and you follow the procedures for filing a proof of claim correctly you can expect to see some of the money the debtor owes you paid back to you over a period of time. (3-5 years). A debtor may not file a Chapter 7 more often than once every six years, however Chapter 13s can be filed more often. While the courts may intervene on serial

filings, there is no real statutory limitation on the number of times a debtor can file a 13.

A Chapter 11 is a business reorganization somewhat similar to what you have been reading about involving Enron or K-Mart. These are cases where the debtor is trying to reorganize and remain in possession of its assets, typically a business type debtor. Since businesses use Self-Storage facilities, you may find yourself involved in this complicated form of bankruptcy. In a Chapter 11 or 13 the debtor is expecting to pay you and all their other creditors some percentage of cents on the dollar of the past due debt over a period of time and may intend to stay in your facility. The debtor in a Chapter 11 or 13 is required to remain current in their post bankruptcy petition debt or you can force them to leave by a Motion for Relief from Stay. Unfortunately, nationally less than ten percent of debtors who enter into Chapter 11 come out of Chapter 11 with a discharge. Most Chapter 11's are either converted to another chapter such as 7 or the debtor's assets are liquidated and the bankruptcy ends up being dismissed.

Beyond the first basic steps described in this column bankruptcy absolutely requires the assistance of your attorney. Bankruptcy is counter-intuitive; the result which you would expect to occur often does not and bankruptcy law is full of pitfalls. If you make one wrong step into one of those pitfalls you could end up involving yourself in the case in ways that are extremely undesirable. An example of these pitfalls is an non-affiliated creditor is not allowed to accept more than $600.00 payment toward a debt within 90 days prior to the filing of the bankruptcy. Affiliated or related creditors have an even longer time limit. Any money paid above and beyond that $600.00 is considered preferential and the Bankruptcy Trustee will seek those funds returned to the debtor's estate for distribution to all creditors. If you choose to ignore the Trustee's demand for repayment you will be sued by the Trustee as part of the bankruptcy in Bankruptcy Court.

The first thing you need to know about bankruptcy is the Automatic Stay provisions. Any time a bankruptcy is filed, as soon as the stamper hits the paper at the Clerk of Court's office, an Automatic Stay is invoked. This is an order of the court, as indicated by the definition, automatically issued which prevents any creditor from doing anything to try to collect the debt or exercise any other contract rights while the bankruptcy is pending, unless special approval is sought from the court. This is important to note, if you get a notice of bankruptcy or even hear that one of your tenants has filed bankruptcy you must stop everything you are doing to collect the debt, at least until you confirm that the tenant has not filed. For instance, if you are sending out bills, late notices, or lien sale notices you must stop. In Chapters 11 and 13 you may send bills for any debt <u>incurred after the date of petition</u> although it may not be collectable if the debtor sends you notice that it is rejecting its lease with you. However, under all Chapters you may not do anything to try to collect even one cent of the money that accrued prior to the date of the filing. If you are in the middle of your notice working toward lien sale, or advertising of intent to sell, or even ready to perform your lien sale, even if you get notice the morning of the lien sale, you must stop the lien sale and seek an order from the court called relief from the automatic stay, if appropriate.

When you find out about a bankruptcy stop everything and figure out where you are in the bankruptcy process before doing anything else. For instance determine the chapter of bankruptcy filed and whether the debtor is still your tenant or if this is a debt from tenant who is out of the facility, then call your attorney. You should receive a notice after finding out about the bankruptcy telling you the type of bankruptcy, normally a 7, 11 or 13, giving you some deadlines and a date for the meeting of creditors. At the end of the process you will be writing off some amount of a debt and may need to seek the court's permission to remove the debtor's property from your facility by seeking relief from the automatic stay.

The next thing you ought to do is gather all the information on the debt that you may have. Specifically, how much you are owed, how long has that debt been accruing, and what type of payments you have received in at least the last ninety days prior to the filing of the bankruptcy. This way you may at least know that you will or will not be subject to a preferential claim action.

You also need to determine if there are any potential exceptions to discharge which your attorney can raise. Exceptions to dischargeability are set forth in the Bankruptcy Code which sets forth certain types of debt which cannot be discharged in bankruptcy. Unfortunately you have to raise the objection, or if not, the debt will be discharged anyway. One common objection in bankruptcy that prevents discharge of your debt is the allegation of fraud. Fraud is generally difficult to prove because it is an intent based claim and, it is difficult to prove what was going on in someone's mind at the time they entered into the transaction. However, there are a few simple examples of fraud of which you should be aware in determining whether or not a claim of non-dischargeability is worth pursuing in bankruptcy. 1) If you received any check payments that were returned for nonsufficient funds and those payments have not been made good, the bankruptcy courts tend to presume that bounced checks represent, at least for the amount of the check, a fraudulently obtained debt. 2) If someone misrepresented to you their identity for the purpose of avoiding detection in your credit check or background check such that you ended up leasing to them eventhough if you had known the truth about them you would not have leased to them, the debt maybe found to be a debt obtained fraudulently. Therefore, in certain limited situations (there are over 30 of these types of exceptions in the Bankruptcy Code, however many child support, student loans and tax type exemptions would be inapplicable to a self-storage application) you may be able to file an objection to the discharge and if your objection is upheld by the Court the debt to your facility would be held non-dischargeable and would survive the bankruptcy. However, if you file an objection to discharge that is found not to be well taken by the court, not only would your debt be included and discharged as

part of the bankruptcy, but you would be potentially responsible for the attorneys fees and other costs incurred by the debtor in defending the action. Obviously this is a result which is not preferable. Often, rather than filing a dischargeability complaint you can work out an agreement with debtor's counsel if you have a non-dischargeable debt to get some or all of the debt stipulated to be non-dischargeable or get some sort of payoff arrangement to avoid the risk of filing the Complaint to Determine Dischargeability and losing and being responsible for debtor’s attorney fees.

Self-Storage operators must also be vigilant once they have received notice of a bankruptcy. You should not simply allow the debtor to remain in the Premises without paying rent ad infinitum. In a Chapter 11 or 13 the debtor is required, if they wish to remain in the Premises, to remain current in their obligations post-petition. While you may lose or only get paid a portion of the money owed from the debtor accrued prior to the date of the bankruptcy filing, from the date of filing forward the debtor is supposed to remain current in rent with you, and if they are not you should seek approval from the court to remove them, which I will discuss below. In a Chapter 7 situation if the debtor does not voluntarily vacate you must seek approval from the court to remove them either by lien sale or eviction as discussed below.

In the situations discussed above, you can go to the Court and seek Relief from the Automatic Stay so that you can get possession of your space back. Without sounding like a broken record this is a procedure that must be undertaken by your attorney; however, you should know enough to call the attorney and tell them that you need a Motion for Relief From Automatic Stay filed because you are either not receiving current rent under the Chapter 11 or 13 or that the tenant remains in the premises under a Chapter 7. Your attorney will file the appropriate paperwork with the court asking the court to allow you to take whatever actions are necessary to regain possession of your Premises because you are suffering an undue hardship as a result of the tenant being in the

Premises and not following the Order of the Court by remaining current in rent or by remaining in the Premises while under the protection of a Chapter 7. After a certain amount of time has passed the Court will lift the Automatic Stay for the express purpose of allowing you to take possession of the premises. Relief from Stay does not mean that you will be allowed to collect the debt owed to you, only that you have obtained leave to either evict or exercise the lien sale remedies. However if the money gained from the sale, is a sizeable amount this money may belong to the debtor's estate not the Self-Storage operators.

The final issue you should know about in this mini bankruptcy primer is proof of claims. The court notice will tell you whether or not the court is accepting proof of claims. In Chapters 11 and 13 at some point the court will always seek proof of claims. Often in Chapter 7s when estimates are that there will be no funds available the Court does not bother asking you to spend the time filing a proof of claim. A proof of claim is a specific court issued form on which you list the amount of the pre-petition debt that you are owed. These forms have very specific requirements for how you demonstrate to the court that the money is in fact due and owing including breaking out any interest or late fees etc., and they require you to classify the type of debt. There are also requirements that other supporting documents be attached to the proof of claim and often a proof of claim has to be filed with multiple copies. However, a proof of claim is the only way to protect your right to any sort of distribution that will be made by the bankruptcy court or the bankruptcy trustee. While it may seem like a futile exercise and while you will wait, often quite a long time, between the time that you file your proof of claim and the time in which you would see any money out of a bankruptcy, it is the only way that you will get some if not all of the money from the debtor that was owed to you pre-petition. You often do not know how much money you will receive at the time you file the proof of claim but it is a good policy to properly file proof of claims when ever called upon to do so. There are proof of claim filing deadlines; if you miss those dates, your proof of claim may not be honored or will be treated as a "late filed claim". It is important to pay

attention to those dates and get your proof of claim filed as quickly as possible, properly completed, and properly documented.

The most important consideration when discussing bankruptcy is to be vigilant prior to the bankruptcy. If you are allowing your tenants to get four and five months behind before you are taking the kind of action that would “drive them” into a bankruptcy, shame on you. In forty-seven of the fifty states you have lien sale rights sometime shortly after the end of the first month of delinquency. If you are prosecuting your lien sales promptly and efficiently you should not often get into a situation where a debtor is behind by more than two months before they file a bankruptcy, which is obviously a less bitter pill to swallow than four or five months of rent. Further, if you have properly screened tenants by performing credit checks, or have a system in place to assist you in getting paid when the tenant “forgets” to pay you such as automatic fund transfer from bank accounts or automatic debiting of credit cards, you will substantially reduce not only the amount you could potentially lose in bankruptcy but the amount of time and money you will spend in dealing with your attorney and debtor’s counsel once a bankruptcy has been filed by one of your tenants.

Finally, it really is worth saying again what was said at the beginning of this article. As soon as you hear a rumor, let alone receive a notice that your tenant has filed bankruptcy stop everything that you are doing to collect the debt, stop billing, proceeding under a lien sale, notices of default, certified mail, advertising, or sale, and gather the information about the debt you have including the proof of claim, your tenant file, the type of debt, whether or not there have been any bounced check, etc., and see your lawyer. This is truly an area were the pitfalls to handling the matter yourself are too great and too dangerous.

Jeffrey Greenberger is a partner in the law firm of Katz Greenberger & Norton LLP in Cincinnati, Ohio and is licensed to practice in the states of Ohio and Kentucky. This column is for the purpose of providing general legal insight into the self storage field and should not be substituted for the advice of your own attorney. Mr. Greenberger's practice focuses primarily on representing the owners and operators of commercial real estate including self storage owners and operators. Mr. Greenberger is the legal counsel for the Ohio Self Storage Owners Society, Inc., and the Kentucky Self Storage Association, Inc., as well as a regular presenter at Inside Self Storage Trade Shows. You can send your questions, comments, or suggestions for future topics to Jeffrey Greenberger at jjg@kgnlaw.com or mail them to Jeffrey Greenberger c/o Katz Greenberger & Norton LLP, 105 E. Fourth Street, Suite 400, Cincinnati, Ohio 45202 or you can reach Mr. Greenberger at (513) 721-5151.