Bankruptcy Issues for Landlords, Contractors, and Real Estate Buyers – Part 2: Claims and Claimants

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As real estate lawyers, we run into questions involving bankruptcy of our landlord clients' tenants, of our contractor clients' customers, and of the owners of real estate our clients want to buy. In this series of articles, we will attempt to address some of the issues faced by those clients in each of those situations, and some of the peculiarities which come up when the state and federal laws involved don't mesh well.

While most laws involving real property are specific to the state in which the property is located, bankruptcy law is federal, applying in all states and handled through special federal Bankruptcy Courts. This means that the same federal bankruptcy law has to fit with the real property laws of each state, which vary. And as anyone who has owned real estate in other states as well as Pennsylvania knows, Pennsylvania real estate law is not even close to the uniform or standard laws adopted in many other states. This creates certain issues in bankruptcies in Pennsylvania which involve real estate, as many bankruptcies do.

In our first article, we discussed the Automatic Stay, which is the legal device used by bankruptcy debtors to stop lawsuits and other collection activities by creditors, and we suggested several methods of how to work around it. As we noted in that article, the bankruptcy of someone who owes you money does not mean that you have to give up any hope of ever collecting from them, and let them walk away. It does mean you have to change where and how you pursue the debt, and follow a new set of rules to do so.

Although there may be times when you can work around the Automatic Stay, particularly when it comes to regaining possession of your property, with matters such as unpaid rent, loans in default, or claims for damages, you will most likely have to file a "Claim" with the Bankruptcy Court and navigate through the bankruptcy process in order to have a chance of getting paid.

A "Claim" is defined by the Bankruptcy Code in Section 101(5) as "a right to payment, whether or not such right is reduced to judgment, liquidated,

unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." There are two primary methods by which a claim becomes part of a bankruptcy case: (1) The debtor, when he files his Petition, is required to file a list of known creditors, both secured and unsecured. These are found in the "Schedules" which accompany the debtor's Petition, and the debtor's Petition will not be accepted by the Court as complete without them. (Remember, the debtor's Petition can be accessed online with an account at "pacer.gov", as discussed in our previous article). (2) The creditor, after receiving notice of or otherwise becoming aware of the debtor's bankruptcy filing, files a Proof of Claim.

A Proof of Claim simply consists of a statement by a creditor of the basic facts of its alleged "right to payment", including the nature of the right (i.e. breach of contract, damages to property, etc.), the amount claimed, and whether it is "secured" or "unsecured". These facts are noted on a standard form, available from the Court's website, which is then filed with the Clerk of Bankruptcy Court, along with supporting documentation (i.e. a copy of a state court judgment, loan documents, the lease, etc.).

The necessity and timing of filing Proofs of Claims varies depending on what Chapter of the bankruptcy code the debtor has filed under. In a Chapter 7 liquidation case, each creditor must file a proof of claim in order to be eligible for payment from whatever pool of money is gathered by the Court and the Trustee during the bankruptcy case. However, when a Chapter 7 case is filed as a "No Asset" case, which many personal bankruptcies are, no proofs of claim need be filed due to the Court's belief that no distribution will be made. In an "Asset" Chapter 7 case, the Court will set a date by which all claims must be filed.

Creditors cannot avoid participation in the Bankruptcy process simply by refusing to file a Proof of Claim. Regardless of whether a Proof of Claim is actually filed, that creditor's claim will be considered to have been discharged by the bankruptcy, and the creditor may thereafter never again pursue the debtor for its claim, so long as the creditor had actual or constructive notice of the Bankruptcy. By the same logic, the failure of a debtor to list a creditor on the Schedules will not prevent the creditor's debt from being discharged, so long as the creditor had actual or constructive notice of the bankruptcy. Consequently, any agreement between a debtor and creditor to refrain from listing is also void.

When you file a Proof of Claim, often the most important information that you will provide on the claim form is whether your claim is "secured" or "unsecured". Creditors in a bankruptcy case are broadly classified into two categories: secured creditors and unsecured creditors. A secured creditor is one whose claim is collateralized by property belonging to the debtor, such as a house, car, or other personal items. As a general rule, in order to be considered "secured", a creditor must have taken all legal steps necessary to perfect his lien or other security interest in the collateral at least 90 days prior to the filing of the Bankruptcy Petition. In addition, the value of the collateral must be equal to or greater than the value of the claim, in order for the claim to be considered "fully secured".

Once the value of a secured claim is established, the Bankruptcy Code requires the Trustee to maintain that value on behalf of the creditor. Collateral can depreciate over time, so the Trustee must take steps to insure that the value of the collateral available to pay the secured claim does not fall below the claim's value during the course of the bankruptcy case, which can often take many months. When a creditor possesses a first lien mortgage on a large piece of valuable real estate, the trustee often does not need to do anything. However, if a creditor has, for instance, a second lien on a piece of used equipment, the fair market value of which is subject to rapid depreciation as the collateral continues to be used, the trustee may be required to provide the creditor with Adequate Protection.

Adequate Protection of the value of a secured creditor's collateral usually takes one of three forms. First, the trustee can make periodic cash payments to the secured creditor to account for the depreciation in the value of the collateral. Second, the trustee can grant the secured creditor additional or replacement liens on other pieces of the debtor's property which has equity in it. Third, the trustee can grant the secured creditor the "indubitable equivalent" of his lien. This is the catch-all option and can be anything from a surrender of the collateral itself to a guarantee of the claim value by a third party. Regardless of the form which adequate protection takes, the trustee's obligation to provide and maintain the value of the secured claim is one of his paramount duties. If adequate protection cannot be provided, then the secured creditor will be entitled to Relief from the Automatic Stay.

Unlike secured claims, unsecured claims against a debtor do not rely upon any interest in any particular property of the debtor, and these must be paid out of any funds accumulated by the Trustee from the collection and sale of

any property of the debtor which is not subject to a lien by a secured creditor, or which is not exempt. Furthermore, the Bankruptcy Code recognizes a distinction between various types of unsecured claims, depending on the nature of the legal right which gives rise to the claim. Claims which are distinguished in this way are referred to as "Priority Unsecured Claims".

The Priority system effectively ranks all the unsecured claims according to how important they are, in the judgment of the Bankruptcy Code. None of the claims which fall into a lower-priority category may be paid until all those claims which fall into a higher category have been paid in full. The Priority system reflects the policy choices of Congress, and does not follow any logical efficient rules. Rather, the Priority system simply characterizes some claims as more "worthy" of being paid than others. The Priority system ranks unsecured claims as follows:

1) Trustee's expenses.
2) Alimony and Child Support.
3) Administrative Expenses (including post-petition taxes, attorneys' fees, and costs).
4) Claims by employees for unpaid wages.
5) Claims by employees for contributions to employee benefit plans.
6) Claims by farmers for agricultural products purchased and not paid for.
7) Claims by consumers for goods and services paid for and not delivered.
8) Taxes.
9) Unpaid obligations of banks to the Federal Reserve and FDIC.
10) Claims for personal injuries resulting from drunk driving.
11) Everything else (General Unsecured Claims).

It is often unfortunately the case that the General Unsecured Claims against the debtor receive pennies on the dollar from a distribution at the conclusion of the bankruptcy case, if anything at all. If there are insufficient funds remaining in the debtor's assets to pay any particular category of unsecured claims in full, then each claim in that category will be paid according to the value of its claim in proportion to the total value of the claims in that category (*pro rata*). Any claims in a category which fall below the category which was only partially paid will not be paid at all.

Due to harsh nature of the Priority system, it is important to consider the type of claim you may have against the debtor, and to fill out the Proof of Claim form carefully before filing it with the Bankruptcy Court. An attorney with expertise in the Bankruptcy field will be able to help you

understand the type of claim, how to file it, and when and how much you can reasonably expect to be paid from the bankruptcy.
In our next article, we will be addressing how to deal with a bankruptcy debtor who still wishes to reside in your property while they are in Bankruptcy, or else wishes to continue to do business with you after they file for bankruptcy protection.
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