

2013 IN REVIEW: KEY PUERTO RICO DECISIONS FOR INSOLVENCY PROFESSIONALS

BANKRUPTCY, INSOLVENCY AND REORGANIZATION GROUP LEGAL ALERT

January 2014

Overview

INSIDE THIS ISSUE

- 1 Overview
- 1 Individuals
- 2 Security Interests over Rents
- 3 Adequate Protection
- 4 Relief from Stay
- 5 Other Important Decisions

During 2013, our federal courts tackled important insolvency and bankruptcy related issues that affect the balance among lenders, individuals, and corporate debtors. This alert summarizes the areas affected by some of these decisions, and the impact on lenders and debtors.

Individuals

The legal landscape for individual debtors changed substantially during 2013, with decisions that will make it more difficult for individuals to confirm a chapter 11 plan over the objections of creditors, a guideline and clarification for homestead exemptions in bankruptcy, and determinations on the types of expenses individuals may justifiably incur as adequate protection.

Confirmation of Individual Chapter 11 Plan. In general terms, the absolute priority rule provides that if a class of unsecured creditors rejects a debtor's plan and is not paid in full, junior creditors and equity interest-holders may not receive or retain any property under the plan. Recent litigation in the federal courts nationwide has raised the issue and created a split among courts as to whether the absolute priority rule applies in Chapter 11 cases filed by individuals. In a case of first impression in this district, the Bankruptcy Court concluded that the absolute priority rule applies to individual Chapter 11 debtors. *In re Lee Min Ho Chen*, Case No. 11-08170 (BKT), Docket No. 211. This is an important decision for debtors and creditors, marking a major shift in the leverage of undersecured lenders and unsecured creditors in the negotiation and confirmation of an individual debtor's chapter 11 plan. The ruling is significant in that, among other things, it now is virtually impossible for individual debtors to confirm a plan over the objection of an undersecured lender or other major unsecured creditors, as confirmation would require the debtor to do one of the following: (a) pay in full the lender's unsecured deficiency claim (as well as all other unsecured claims) and all senior claims; or (b) surrender all of the debtor's non-exempt pre-bankruptcy property. This decision is expected also to weigh heavily in the pre-bankruptcy planning for individual Chapter 11 debtors, as the ability to confirm a Chapter 11 plan now will depend to a substantial degree on such debtor's ability to obtain its lender's consent and acceptance of such plan.

Homestead Exemption. Puerto Rico's Home Protection Act No. 195, enacted on September 13, 2011 (as further amended, the "PR Home Protection Act"), creates a homestead exemption for an individual's primary residence that allows such individual to, if properly claimed and not waived, exempt his/her residence from

"The legal landscape for individual debtors changed substantially during 2013..."

“...[T]hrough a series of decisions during 2013...the Bankruptcy Court addressed the mechanics for (i) perfection of a lien on rents under Puerto Rico law; and (ii) the perfection and extent of liens over rents generated after a bankruptcy petition is filed.”

creditors and their collection efforts. On January 25, 2013, in a decision entered in seventeen bankruptcy cases simultaneously (*In re Pérez Hernández*, Case No. 11-09608 (ESL)), the Bankruptcy Court addressed and detailed the legal requirements to claim the homestead exemption under the PR Home Protection Act; determined that the exemption, if claimed properly, applies in bankruptcy cases; and addressed the Act’s recent amendments and waivers of the same. This decision is important for individual debtors as it provides a clear framework of the pre-bankruptcy steps that the individual must take to claim a homestead exemption under the PR Home Protection Act and the steps the individual must take as part of its bankruptcy filing and schedules of assets and liabilities to ensure such exemption applies in bankruptcy. The decision also clarifies for individual debtors what exactly is exempted. Finally, the decision is also important for creditors, since its detailed guide of the various pre and post-bankruptcy requirements to claim the exemption provides a basis for creditors to object to an individual’s homestead exemption if not properly claimed as detailed in this decision.

Adequate Protection. In the case of *In re Manuel Mediavilla and Maydin Meléndez*, Case No. 130-02802 (MCF), the Court addressed the type of payments that individuals may make as adequate protection from a lender’s collateral. The Court substantially limited the monthly budget for a debtor’s expenses to those that relate to preserving or maintaining the lender’s collateral and limited the living expenses that could be paid. ■

Security Interests In Rents

Lenders with mortgages on income-producing properties are also often secured by a lien over the rents generated by the real estate. The relevant statutory law does not clearly specify the requirements to perfect such liens and, until recently, there have been few cases providing guidance on the issue. However, during 2013, the Bankruptcy Court addressed, through a series of decisions, the mechanics for: (i) perfection of a lien on rents under Puerto Rico law; and (ii) the perfection and extent of liens over rents generated after a bankruptcy petition is filed, through a series of decisions. *In re National Promoters and Services, Inc.*, Bankr. Case No. 12-01076 (ESL) (Opinion and Order of September 9, 2013); *In re Manuel Mediavilla, Inc.*, Bankr. Case No. 13-02800 (MCF); and *In re Manuel Mediavilla and Maydin Melendez*, Bankr. Case No. 13-02802 (MCF) (Opinion and Order of October 22, 2013).



2013 was a decisive year on issues regarding assignment of rents

Perfection of Pre-Petition Rents. In these decisions, the Courts concluded that a lender may perfect a lien over rents through two methods. First, the Courts found that a lien may be perfected through a collateral assignment of rents under the Puerto Rico Civil Code if the agreement is executed with a date certain. The “date certain” requirement is met when the agreement is in a public deed or its date is affixed in a private document before a notary public. Second, the Court found that lenders may perfect a lien over rents if the parties expressly agree in a deed of mortgage to make the mortgage lien extensive to the rents generated by the real property.

Perfection of Post-Petition Rents. The Courts also recognized the exception contained in Section 552(b) of the Bankruptcy Code that rents generated after the filing of a bankruptcy petition may be subject to any liens perfected on these rents prior to the filing of the bankruptcy petition. The Court found that the pre-petition

lien on rents extended to the post-petition rents because: (i) the security agreements contained express provisions making the lien extensive to prospective rents; and (ii) the security interest on the rents was perfected prior to the commencement of the bankruptcy case.

This series of decisions is important to lenders and debtors as it represents the few, if not only, decisions in this District that clarify the requirements for perfection of security interests over rents under Puerto Rico law and in those rents generated during a debtor's bankruptcy case. ■

Adequate Protection

To use collateral, the Bankruptcy Code requires debtors to provide, if the lenders requests, "adequate protection" to protect the lender's interest from a decline in value. However, the concept and requirements of adequate protection are not defined in the Bankruptcy Code. During 2013, the Bankruptcy Court issued at least three opinions directly dealing with "adequate protection" in the context of the use of the secured creditor's cash collateral: *In re: Builders Group & Development Corp.*, Bankr. Case No. 13-04867 (ESL), 502 B.R. 95 (Bankr.P.R. 2013); *In re: National Promoters and Services, Inc.*, Bankr. Case No. 12-01076 (ESL), 499 B.R. 192 (Bankr. P.R. 2013); and *In re: Manuel Mediavilla, Inc.*, Bankr. Case No. 13-02800 (MCF) (Order of December 11, 2013).

Adequate Protection for the Use of Rents. The Bankruptcy Court analyzed the concept of adequate protection within the context of income producing commercial real estate, and recognized that a secured creditor is entitled to adequate protection for its interest in both the real property and the rents produced by said property. This distinction is important as the Court recognized that any use of the rent collateral would be a diminution in value of the secured creditor's interest in the cash collateral and, therefore, a debtor must provide adequate protection for said use.

Determining Adequate Protection is Fact-Specific. A determination by the Bankruptcy Court as to adequate protection will hinge on the facts present in each case. In *Builders Group*, the Court held that the fact that the rental income was used to pay operating expenses of the property (a shopping center) by itself does not provide adequate protection for the secured creditor's interest in the cash collateral. In *Manuel Mediavilla, Inc.*, the Court denied the debtor's request for the use of cash collateral because a replacement lien over the monthly rents does not, by itself, constitute adequate protection. The Court also found that contrary to the debtors' position, payment of operating expenses and property taxes with the creditor's cash collateral is not by itself adequate protection for the creditor's interest in the rents.

These decisions are important to both debtors and lenders as they require, when cash collateral is produced by mortgaged income-producing properties, that the debtor provide adequate protection for *both* the mortgaged real property and the rents. Further, these decisions provide a guideline as to what constitutes adequate protection, types of expenses that may be incurred, and the evidence that each party needs to present to satisfy (or rebut) the burden of proof in a cash collateral dispute. ■

“During 2013, the Bankruptcy Court issued at least three opinions directly dealing with ‘adequate protection’ in the context of the use of the secured creditor’s cash collateral.”



Burden of proof is fact specific and falls on debtor

Relief from Stay

The protection of the automatic stay is broad in scope, staying litigation against the debtor and its property and other attempts to enforce or collect on prepetition claims. However, the protection of the automatic stay is not unlimited. A lender may move for relief from the automatic stay: (i) for cause, including lack of adequate protection; (ii) when there is lack of equity and the property is not necessary for an effective reorganization; and/or (iii) upon the expiration of certain time periods when a debtor's bankruptcy is considered a Single Asset Real Estate ("SARE") case.

SARE. The determination of whether a debtor qualifies as a SARE is based on an analysis of three factors: (i) whether the real property is a single property or project, other than residential real property with fewer than four residential units; (ii) whether the property generates substantially all of the debtor's gross income; and (iii) whether the debtor is involved in any substantial business other than the operation of its real property.

In *In re: Sabana del Palmar, Inc I*, Bankr. Case No. 12-06177 (ESL) (Opinion and Order of December 5, 2012) and *In re: MJS Las Croabas Properties, Inc. I*, Bankr. Case No. 12-05710 (ESL) (Opinion and Order of December 5, 2012), the Court found that a factor in determining whether a particular project qualifies as a "single property" is the treatment that the lender gave to said projects at the time of the issuance of the credit facility. Lenders should be mindful in the contents and management of their loan and internal documentation at the time of financing as such information may prove useful when considering whether the real property qualifies as a SARE or not.

Effective Reorganization. Likelihood of effective reorganization, or possibility of reorganization within a reasonable time, are concepts that are normally associated with motions for relief from stay, as well as motions for

dismissal or conversion, as they provide a basis for such relief. Many courts have struggled with identifying particular factors for determining whether an effective reorganization can be accomplished or not.

In the cases of *In re: Sabana del Palmar, Inc. II*, Bankr. Case No. 12-06177 (ESL) (Opinion and Order of May 29, 2013) and *In re: MJS Las Croabas Properties, Inc. II*, Bankr. Case No. 12-05710 (ESL) (Opinion and Order of May 29, 2013), the Court analyzed the test for an effective reorganization, finding that no such reorganization was possible when: (a) the debtors property was fully encumbered and its sale would not generate enough funds to cover the secured creditor's claim (much less those of unsecured creditors); (b) the debtor's inability to fund its operation during or after bankruptcy other than through the use of the lender's collateral; (c) that any potential superpriority post-petition financing (which would prime the secured creditor's lien) would have been inconsistent with providing adequate protection to the secured creditor; and (d) whether the plan indeed had a reasonable possibility of being confirmed within a reasonable time, where the lender would have a vote in the secured and unsecured creditor class, or could make a section 1111(b) election under the Bankruptcy Code.

These decisions create a difficult and high burden for debtors to show the possibility of an effective reorganization, especially when the collateral in question has no equity and the debtor has no unencumbered funds. On the other hand, the decision is critical for lenders that are undersecured, providing a roadmap for relief from the automatic stay relative to over-encumbered collateral. ■

Other Important Decisions

Federal Deposit Insurance Corporation v. Emerito Estrada-Rivera, et al., Case Nos. 11-2113, 11-2433, United States Court of Appeals for the First Circuit (July 3, 2013) (in a case involving a loan originally granted by RG Bank, the First Circuit applied the “D’Oench-Duhme Doctrine”, preventing borrowers or guarantors from asserting as either a claim or defense against the FDIC (and, as other cases have held, in certain circumstances against banks that purchased from the FDIC) based on oral agreements or arrangements with the original lender).

Federal Deposit Insurance Corporation v. Empresas Cerromonte Corp., 2013 U.S. Dist. Lexis 138794 (D.P.R. 2013) (discussing defense of *exception non adimpleti contractus*-, providing generally that debtor is excused from performing if lender breached the credit agreement first – and finding that the obligation that the lender allegedly breached must have been included in a written and signed document given the integration clause in the loan documents; court also discussed the ability to modify alleged penalty clauses, finding that the defense is reserved for “extraordinary” or “extremely harsh circumstances”).

In re Rivera, 494 B.R. 101 (BAP 1st Cir. June 26, 2013) (discussing standards for ineligibility of individual debtor to re-file for bankruptcy for 180 days after dismissal of a prior bankruptcy case under Section 109(g)(2)); see also *In re Rubén Terrón-Hernández*, 2013 WL 6074164, Case No. 13-08012(ESL), Opinion and Order dated November 18, 2013.

In re Jeans.com, Inc., 502 B.R. 250 (Bankr. P.R. 2013) (court granted debtor’s motion requesting authorization to denominate critical vendor and detailed analysis to be used for such decisions).

In re Nieves, 499 B.R. 222 (Bankr. D.P.R. 2013) (explaining process and detail needed when creditor disagrees with the notice of cure payment under Federal Bankruptcy Rule 3002.1). ■

Note: Because of the general nature of this newsletter, nothing herein should be considered as legal advice or a legal opinion. For further information, please contact our bankruptcy, insolvency and reorganization lawyers.

Bankruptcy, Insolvency and Reorganization Group (Alphabetical Order)

Walter F. Alomar	Luis C. Marini
Alfredo Álvarez	Mauricio O. Muñoz
Juan A. Aquino	Edgardo Nieves
Hermann D. Bauer-Álvarez	Manuel A. Pietrantoni
Ubaldo M. Fernández	Alfredo Ramírez
David P. Freedman	Antonio L. Roig

✂

Nicole Berio	Janice Ramírez
Adriana Capacete	Marta Ramírez
Julian Díaz	Alberto Ramos
Laura Fémenlas	Laura Santana
Gilberto Gutiérrez	Omayra Sepúlveda
Viviana Miranda	Sheila Rodríguez
Karena Montes	Carolina Velaz
Aura Montes	Nayuan Zouairabani
Joamanda Morales	



O’Neill & Borges LLC
American International Plaza
250 Muñoz Rivera Ave.
Suite 800
San Juan, Puerto Rico 00918-1813
Tel.: 787-764-8181
Fax: 787-753-8944