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Time to Consider What is Unique about When a Redevelopment Project Goes Into Default or Bankruptcy?

By Anne S. Babineau, Esq. and David H. Stein, Esq.

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Introduction

The challenges that have compelled municipalities to act to arrest and reverse negative conditions and encourage investment in redevelopment areas will increase as redevelopment projects face inflationary pressures and rising interest rates. Redevelopers may find their lenders enforcing protections embedded in loan documents, such as enhanced capital reserve requirements and loan covenants, performance guaranties and the like. If economic pressures become intense, and defaults are a possibility, redevelopers and their lenders, redevelopment entities[1], taxing authorities, and trade creditors will be driven to consider the unique issues presented when there is a default on a redevelopment project, including consideration of a bankruptcy filing to stave-off creditor lawsuits or real estate foreclosure, or to permit a recapitalization of a distressed redevelopment project in order to deliver the project to completion.

Unique Features of the Redevelopment Statute and Redevelopment Agreements

One of the most significant considerations for a redevelopment project facing financial distress will be the impact of the prohibition against transfers found in the Local Redevelopment and Housing Law, ("LRHL"), which requires all redevelopment agreements to include a "provision that the redeveloper shall be without power to sell, lease or otherwise transfer the redevelopment area or project, or any part thereof, without the written consent of the municipality or redevelopment entity."[2] This provision is the logical extension of the

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Legislature's grant of power to a redevelopment entity to contract with a redeveloper for the undertaking of work necessary to implement a comprehensive redevelopment plan. Such power necessarily involves the governmental entity's assessment of a redeveloper's financial capability and relevant experience, and thus there are customary redevelopment agreement provisions that prohibit speculation and restrict transfer.

Despite good reasons for restricting transfer, there has traditionally been a recognition that redevelopment agreements should include certain permitted transfers which are necessarily part of financing a project. Such transfers customarily include a mortgage and other lien or encumbrance for the purpose of financing the costs associated with, or incurred in connection with, the acquisition, development and construction of the redevelopment project. One of the permitted transfers in most redevelopment agreements is the authorization for a lender faced with

a financially distressed project to foreclose its mortgage and transfer the distressed project to a buyer, either as a successful bidder at a foreclosure sale or through a deed in-lieu of foreclosure. Upon a default, the lender, or an entity created by the lender, is customarily given the option to cure by assuming the project itself or transferring it, with the consent of the redevelopment entity, to another party who must assume the material obligations of the redevelopment agreement. Through either of these mechanisms, often a lender can be part of the achievement of the statutorily recognized goal of promoting the physical development that will be most conducive to the social and economic improvement encouraged by the LRHL, while at the same time enabling repayment of the secured obligation and trade debt, and restoring the project to a performing asset.

However, certain limitations on transfers of projects and redevelopment entity remedies, should also be considered. The party to whom a lender transfers usually cannot subsequently transfer the project to another party without that second party assuming the redevelopment agreement, and often all transfers beyond the first transfer must be approved by the redevelopment entity which must be satisfied with any proposed transferee. Also in some redevelopment agreements where the governmental entity's property is to be transferred to the redeveloper for the project, one of the governmental entity's remedies for default may include a right of reverter of such property, although such a reversion is almost universally subject to the first lien of the lender.

Bankruptcy as a Lifeline for a Redevelopment Project

A Chapter 11 bankruptcy proceeding and business reorganization may also be an option for dealing with a financially troubled project. Such a proceeding is intended to provide a brief respite from the immediate repayment of debts and ongoing obligations through a court supervised process ("Bankruptcy Code")[3]. A redeveloper's decision to file bankruptcy, however, will undoubtedly impact the underlying redevelopment project, and Bankruptcy Courts will need to contend with the varying interests of the redeveloper/debtor, the lender, the redevelopment entity, and trade creditors which provided materials and services to the project or the redeveloper/debtor.

Bankruptcy may be precipitated by timing or other issues under a redevelopment agreement or by a default under a loan agreement, and a potential debtor may elect to file a bankruptcy proceeding in order to gain the protections afforded by the automatic stay[4] found under the Bankruptcy Code. The application of the automatic stay provides for a statutorily imposed injunction which will serve to stop or suspend litigation, postpone any ongoing foreclosure actions initiated by a lender as a result of a loan default, as well as initiate collection and enforcement proceedings in an effort to permit an orderly process of reorganization through a Plan of Reorganization to be developed by the redeveloper/debtor.

A redeveloper seeking bankruptcy protection is given the opportunity to formulate a Plan of Reorganization, to take steps to consider transfer of the project to another party, and/or to negotiate different repayment terms with its lender or attempt to refinance existing debt. In this scenario, the delay caused to the redevelopment project may be objectionable to the redevelopment entity, whose interest is focused on completion of the project in a timely fashion. Generally speaking, the timeline for a debtor to file a Plan of Reorganization within the confines of a bankruptcy proceeding is governed by statute, which provides for the filing of a Plan of Reorganization within the first 120 days of the commencement of the case.[5] Certain considerations exist for seeking reasonable extensions of the Plan process where meaningful progress has been demonstrated to the Bankruptcy Court, such as negotiations with creditors, consultation and regular reporting to the redevelopment entity, initiation of litigation, marketing of the project, securing loan commitments, achieving settlements, recommencing the project, or other criteria necessary to demonstrate to the Bankruptcy Court that a reorganization is in process. With the demands of so many interests at the onset of the bankruptcy case, a redeveloper must have a pre-filing plan of action in place prior to the actual filing of a bankruptcy in order to avoid the pitfalls which may arise in any given case.

During this same 120 day period, a redeveloper must consider how it will attempt to raise fresh capital,

refinance debt and cure existing defaults. More importantly, the redeveloper must also determine whether to assume or reject executory contracts. Redevelopment contracts can under the right circumstances be viewed as executory. Whether the redeveloper regards the contract as an asset that will be part of its Plan of Reorganization, or a burdensome set of obligations, will turn on the unique facts of each case. The Bankruptcy Code grants a debtor considerable latitude in making a decision as to when or if it will assume or reject an executory contract based upon its reasonable business judgment. The Bankruptcy Code affords a debtor the opportunity to assume or reject a contract "at any time before the confirmation of a plan." A debtor's discretion, however, is not unbounded and the Bankruptcy Code further provides that, "on request of any party to such contract or agreement," the Court "may order the [debtor-in possession] to determine within a specified period of time whether to assume or reject such contract or lease.[6] In determining whether to set a deadline, the Bankruptcy Court will often rely upon equitable arguments such as (i) the nature of the interests at stake, (ii) the balance of the harm to the parties, (iii) the goals to be achieved, (iv) the safeguards afforded the parties, and (v) whether the prescribed action to be taken is so in derogation of the statutory scheme that the decision may be said to be arbitrary.[7]

For the reasons discussed above, a Chapter 11 business reorganization could be a useful tool to assist redevelopers as they navigate the quantitative tightening and recent credit crunch felt throughout the commercial real estate market. Careful consideration should be given at the onset as to how the project is treated under the Bankruptcy Code as a "single asset real estate" case and whether strict timing requirements will apply to proposing a Plan of Reorganization which has a reasonable prospect of being confirmed within a reasonable amount of time.[8]

Conclusion

Whether considering how to resolve a default under the unique provisions of a redevelopment agreement or related loan agreement, or in the context of a contemplated bankruptcy, it is critical to have a team of skilled professionals who can navigate through the unique layers of issues surrounding the distressed project, restore loss of confidence between the parties, and resolve the pressing claims of creditors, especially given the public purpose of redevelopment to find a path forward that will preserve the project and alleviate other concerns which are an impediment to timely completion.

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1 A municipality may exercise the powers granted to it under the LRHL to implement a redevelopment plan itself, or it is also authorized to transfer the implementation powers to a redevelopment entity such as a redevelopment agency, a housing authority acting as a redevelopment entity, or a county improvement authority. N.J.S.A. 40A:12A-4. In this article any reference to "redevelopment entity" should be read to include the municipality itself exercising these powers or one of the referenced entities that the municipality can select.

2 N.J.S.A. 40A:12A-9.

3 See, 11 U.S.C. § 101 et. seq.

4 11 U.S.C. § 362(a)

5 11 U.S.C. § 1121

6 11 U.S.C. § 365(d)(2)

7 In re. Resorts International, Inc., 145 BR 412, 419-420 (Bankr. D.N.J. 1990).

8 11 U.S.C. § 362(d) (3)

Anne S. Babineau is a shareholder on the Real Estate/Redevelopment Team at Wilentz, Goldman & Spitzer, P.A., representing developers, investors, owners, tenants, and governmental entities, structuring transactions, obtaining government approvals, and counseling clients regarding tax abatement and property acquisitions and sales, all often in the context of public-private redevelopment partnerships.

David H. Stein is a shareholder and co-chair of Wilentz, Goldman & Spitzer, P.A.'s Banking and Financial Services Team and the Bankruptcy and Creditors' Rights Team. Mr. Stein focuses his practice on lending, work-outs, commercial litigation, business reorganization, foreclosure litigation, asset recovery and judgment enforcement matters.