

Case Study

How Tarragon Corporation Was Able to Overcome a Deed Restriction in a 363 Sale

By Ilana Volkov and Felice Yudkin

On Jan. 12, 2009, 800 Madison Street Urban Renewal, LLC (800 Madison), along with several other affiliates of Tarragon Corporation (the Debtors), filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. As of the commencement of the bankruptcy cases, Tarragon Corporation was a prominent real estate developer, owner and manager with consolidated assets and liabilities of approximately \$840 million and \$1 billion, respectively. Tarragon Corporation's common stock was publicly traded on the NASDAQ Global Select Market.

Like many other large real estate developers in the United States, the Debtors' operations, financial condition and liquidity were adversely affected by the financial crisis of 2007 and its aftermath. The Debtors resorted to Chapter 11 to implement a restructuring of their balance sheet.

Less than 18 months later, despite continued adverse market conditions, the Debtors emerged from Chapter 11 pursuant to the terms of a Second Amended and Restated Joint Plan of Reorganization (the Plan). The terms expressly contemplated the liquidation of certain assets, the proceeds of which would be the primary source of recovery for the Debtors' unsecured creditors. The lynchpin of the

creditors' recovery under the Plan was the intended sale of the real property owned by 800 Madison.

As it turned out, the sale of 800 Madison's property was not without significant obstacles. The property was subject to a Redevelopment Agreement with the City of Hoboken (NJ) that arguably required 800 Madison to have included affordable housing dwelling units at the property. When 800 Madison sought to sell the property free and clear of those affordable housing requirements, the City of Hoboken interposed an informal objection. The sale and corresponding recovery to unsecured creditors would be jeopardized unless that objection were overruled or resolved.

THE PROPERTY AT ISSUE

800 Madison owned a 217-unit residential apartment, commercial and parking complex in Hoboken (the Property). This was one of Tarragon Corporation's marquis properties in its rental portfolio.

In 2007, well before the commencement of the bankruptcy cases, Bank of America, N.A. (BofA) agreed to provide 800 Madison with a loan in the original principal amount of \$74 million to finance the development of the Property. That loan was secured by a mortgage on the Property as well as an assignment of rents. After the bankruptcy filings and as a result thereof, 800 Madison did not have access to that pre-petition financing to fund the remaining construction work. Although 800 Madison had obtained authority to use BofA's cash collateral on an interim basis to fund critical operating expenses during the Chapter 11 cases, the interim authority to use cash collateral was intended as a bridge to the approval of a post-petition financing arrangement with BofA, and did not provide 800 Madison with sufficient funds to

complete construction of the Property.

During the course of the Chapter 11 proceedings, the Debtors entered into a settlement agreement with BofA pursuant to which all of the latter's claims in the cases were resolved, maturity dates on various loans made by BofA were extended and BofA agreed to provide post-petition financing for 800 Madison. Pursuant to the settlement agreement, BofA agreed to forbear from exercising any rights against the Property until Dec. 31, 2010. However, if the Property remained unsold after that date, BofA could either: 1) request relief from the automatic stay to pursue an uncontested foreclosure of the property; or 2) require 800 Madison to conduct a sale of the Property pursuant to 11 U.S.C. § 363.

THE AFFORDABLE HOUSING RESTRICTION ON THE PROPERTY

The Northwest Redevelopment Area of the City of Hoboken (which includes the Property) was designated by the City as an area in need of redevelopment. Accordingly, in September 1999, the Hoboken City Council authorized a developer's agreement, as amended, for the Northwest Redevelopment Area (the Redevelopment Agreement). The original redeveloper selected by the City of Hoboken assigned its right, title and interest in the Redevelopment Agreement as it related to the Property to Block 88 Development, LLC (Block 88), the prior owner of the Property and sole member of 800 Madison. In that assignment, Block 88 guaranteed that 23% of the total units authorized for construction "will be affordable under the rules and regulations of the NJHMA and/or HUD ..." As the City of Hoboken was aware, the Property was constructed and leased upon its completion as a market-rate building, and did not contain affordable housing units. To meet the requirement of

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providing 23% affordable dwelling units, Tarragon and Ursa Development Group, LLC (representing the majority ownership of several parcels in the Northwest Redevelopment Area) proposed to develop a different property in the Northwest Redevelopment Area. There arose a dispute as to whether the City of Hoboken accepted that proposal.

After construction of the Property was completed during the pendency of the bankruptcy proceedings, 800 Madison requested that the City of Hoboken issue a certificate of completion certifying that the Property satisfied the obligations under the Redevelopment Agreement including the affordable housing requirements. 800 Madison posited that it had satisfied all its requirements under the Redevelopment Agreement, but the City of Hoboken refused to issue a certificate of completion. A certification of completion would have provided a buyer with the comfort of knowing it was acquiring the Property free from any potential affordable housing requirements.

Despite having received several expressions of interest for the Property, the cloud of the affordable housing requirements prevented interested parties from signing a definitive contract for sale. 800 Madison analyzed whether the Property could be sold free and clear of the affordable housing restriction pursuant to Section 363(f) of the Bankruptcy Code. However, bankruptcy courts traditionally have held that a debtor cannot sell property free and clear of in rem interests that "run with the land." See, e.g., *In re 523 East Fifth Street Housing Preservation Development Fund Corp.*, 79 B.R. 568 (Bankr. S.D.N.Y. 1987). In that case, the bankruptcy court held that a trustee could not sell property free and clear of a restrictive covenant between the owner and City of New York limiting the use of the property to low-income housing.

THE CONTRACT FOR SALE OF THE PROPERTY

Beginning in May 2010, the Property was extensively marketed by a nationally recognized broker, Cushman & Wakefield. After several false starts with potential buyers, 800 Madison entered into an agreement with CBRE Strategic Partners 5 U.S. I, LLC (the Purchaser) to serve as the "stalking horse" bid. The Purchaser agreed to pay \$96.5 million for the Property conditioned on receiving free

and clear title to the Property. 800 Madison filed a motion with the Bankruptcy Court seeking authority to sell the Property free and clear of liens, claims, encumbrances and interests under the Redevelopment Agreement and affordable housing requirements.

800 MADISON'S RELIANCE ON LANGUAGE IN THE REDEVELOPMENT AGREEMENT

In view of the impediments to the sale of the Property free and clear of the restrictive covenant under Section 363(f) of the Bankruptcy Code, 800 Madison argued in the sale motion that the Redevelopment Agreement provided the requisite language to eliminate the affordable housing requirement in that the sale was an "action in lieu of" a foreclosure proceeding. The Redevelopment Agreement stated, in pertinent part, as follows:

Notwithstanding any of the provisions of the Agreement, including but not limited to those which are or are intended to be covenants running with the land, the holder of any mortgage shall in no way be obligated by the provisions of the Agreement to construct or complete the Project or to guarantee such construction or completion.

A holder of a mortgage shall include any such holder who obtains a title to the Modified Project Area or any part thereof as a result of foreclosure proceedings, or action in lieu thereof, and including (a) any other party who thereafter obtains title to the Modified Project Area or such part from or through such holder, or (b) any other purchaser at foreclosure sale other than the original holder of the mortgage itself.

Such language is typical of agreements that contemplate the development of multiple parcels by a designated developer within a close geographic proximity in that it is designed to enable developers to attract project financing by assuring prospective lenders that, in the event they make a development loan and are forced to exercise remedies with regard to their real estate collateral, they (or a purchaser through a foreclosure sale or "action in lieu thereof") will succeed to title free from any restrictions that run with the land. Additionally, such language avoids putting a lender in the untenable position of having to effect a foreclosure of its collateral and

then having to acquire other land within the same redevelopment area on which to construct affordable housing units.

In the sale motion, 800 Madison asked the court to treat the settlement agreement with BofA as "an action in lieu of" a foreclosure sale, entitling a buyer to take title to the Property free and clear of the affordable housing restrictions. That is because the court-approved settlement with BofA entitled BofA to request stay relief to pursue a foreclosure of the Property or to compel 800 Madison to sell the Property in a Section 363 sale. In lieu of foreclosing on the Property, BofA required that 800 Madison pursue a Section 363 sale to ensure a more expeditious and cost-effective resolution of its secured claim. As such, 800 Madison argued that the Section 363 sale of the Property constituted "an action in lieu of" foreclosure, thereby enabling a buyer to take title to the Property free and clear of the affordable housing requirements. It is unknown whether the Bankruptcy Court would have agreed with 800 Madison's analysis, as the issue was ultimately resolved.

A SUCCESSFUL RESOLUTION TO A CHALLENGING ISSUE

Contemporaneously with its pending sale motion, 800 Madison commenced a lawsuit against the City of Hoboken to compel the issuance of a certificate of completion. After filing that lawsuit and extensive settlement discussions that ensued, a settlement was reached that enabled 800 Madison to obtain a certificate of completion for the Property. As a result, the deal closed on May 23, 2011 and provided over \$11 million of net sale proceeds that were available to pay outstanding administrative claims and will be available for distribution to unsecured creditors.

After a payment to BofA on account of its mortgage, and payment of settlement amounts to the City of Hoboken and Tarragon Corporation's partners in the Property, the Debtors are projected to receive approximately \$10 million from the sale that will be utilized to pay outstanding administrative expense claims that were deferred pursuant to the Plan and provide a source of recovery to unsecured creditors.