

How Lenders Can Learn To Love Bankruptcy

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December 3, 2025

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🕒 I write about commercial real estate negotiations, deals and legal issues.



Bankruptcy is certainly not an ideal outcome for any real estate loan. If a project's in trouble, though, bankruptcy has its benefits, even for lenders.

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Real estate and other lenders know they should dread bankruptcy. If a borrower files bankruptcy, loan payments will usually stop, interest accruals may suffer, any foreclosure proceeding or other exercise of legal rights will screech to a halt, and the bankruptcy court will sometimes rewrite the lender's loan documents to reduce the interest rate and make part of the loan unsecured. None of those things are good. Therefore it makes sense for lenders to hate the process and to try to prevent their borrowers from filing bankruptcy.

That is, however, an oversimplistic view of how the bankruptcy system affects lenders. In fact, the bankruptcy process can produce some compelling benefits for lenders.

To start with, bankruptcy judges don't have the patience of state court judges who handle foreclosure proceedings. Once a bankruptcy judge realizes the borrower has little or no equity in its asset, the judge will often allow a lender to push ahead with an expedited auction of the asset. Bankruptcy leaves much less room for the

procedural skirmishing, creative theorizing, and delay that occurs in state court foreclosure proceedings, especially in states like New York where judges supervise the entire foreclosure process. Bankruptcy can shorten a three-year New York foreclosure process to well under a year. That avoids two years of deterioration of the collateral, uncertainty, and accrual of interest and real estate taxes. The lender can also avoid the distraction caused by other creditors trying to assert claims.

Once the bankruptcy court approves an auction sale, that sale can easily wipe out troublesome interests in the asset, delivering the cleanest possible title to the purchaser. An unambiguous court order can resolve problems and help the sale achieve the highest possible bid under the circumstances.

If the sale is consummated through a Chapter 11 plan of reorganization, it typically avoids the transfer taxes that would apply in a tax-crazed jurisdiction such as New York. Those transfer taxes exceed 3% of the sale price of the property although the computations can be complex. In a foreclosure sale, the buyer may be required to pay the transfer taxes. If a bankruptcy sale can eliminate them, buyers may bid a bit more.

A carefully tailored sale through a plan of reorganization can also eliminate New York's mortgage recording tax on the buyer's financing, which is 2.8% of any new principal indebtedness. Again, elimination of that burden can increase foreclosure bids. Together, transfer taxes and mortgage recording taxes can add up to a significant percentage of the purchase price and an extremely significant percentage of the next owner's equity investment. Preventing those taxes can meaningfully improve foreclosure bids and help the lender achieve a better result at foreclosure.

For those and other reasons, lenders should recognize that bankruptcy isn't necessarily a bad thing. It can sometimes be bad, but creative lenders and their counsel should be able to give borrowers and their principals incentives to deliver to lenders the benefits of bankruptcy without being overly exposed to the burdens and risks. Exactly how to achieve that represents the subject for another article. As with so many other risks in lending, though, it starts by fine-tuning the nonrecourse carveouts.

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