presents

Real Estate Bankruptcies: Single Asset Real Estate Rules and Lessons From General Growth

Navigating Unique Issues for Defaulting Commercial Real Estate Companies

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
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PART I

DEVELOPMENTS IN

GENERAL GROWTH PROPERTIES, INC.

Special Purpose Entities

Special Purposes Entities:

- The goal of “special purpose entities” (“SPEs”), also called “bankruptcy remote entities” is to isolate a borrower’s primary asset that secures a loan from the financial affairs of the borrower’s affiliates.
- Organizational documents have specific provisions that attempt to reduce the possibility of a bankruptcy filing by the SPE including provisions that require the SPE to maintain a separate existence from the parent and other affiliates.
- This structure is used to provide a lender with a level of comfort that the insolvency of a party related to the borrower which may have complex lender/creditor relationships will not render the borrower insolvent or cause the borrower to file for bankruptcy protection if the related party files for bankruptcy.
- This comfort level was shaken as a result of a recent decision in the *General Growth Properties** case in the Bankruptcy Court for the Southern District of New York.

* *In re General Growth Properties, Inc.*, No. 09-11977 (ALG), 2009 WL 2448423 (Bankr. S.D.N.Y. Aug. 11, 2009).

General Growth Properties

Quick Facts of General Growth Properties ("GGP")

- Second largest mall owner/operator in the United States with more than 200 malls in 44 states.
- As of December 31, 2008, GGP Group reported $29.6 billion in assets and $27.3 billion in liabilities.
- Aggregate consolidated indebtedness of $24.85 billion:
    - $18.27 billion secured project level debt consisting of convential mortgage debt, securitized mortgage debt and mezzanine debt.
    - $6.58 billion unsecured debt consisting of trade payables and corporate bonds as well as a Term ($1.99 billion) and Revolving ($590 million) Credit Facility at the corporate level.
- Unable to refinance maturing debt as a result of the credit crisis -- on April 16, 2009, GGP and over 350 subsidiaries filed for bankruptcy protection, including over 165 SPEs.

General Growth Properties

Bankruptcy Filing

- Property level SPEs had standard organizational documents that required the consent of independent managers for a voluntary bankruptcy filing.
- There was no requirement under the SPE organizational documents requiring notice of the replacement of managers to the existing independent managers or the lenders.
- Shortly before the bankruptcy filing, GGP removed and replaced the existing independent managers (supplied by Corporation Service Company) from the boards of 159 project level entities.
- The newly appointed independent managers voted in favor of the bankruptcy filing for a majority of project level entities.
- GGP informed existing independent managers of their replacement concurrent with the bankruptcy filing.

General Growth Properties

Bad Faith Filing?

- Certain lenders moved to dismiss the project level bankruptcy filings on grounds that they were made in bad faith. Case law in the Second Circuit suggests that a bad faith filing requires both:
    - (1) Objective futility of the reorganization process, and
    - (2) subjective bad faith.
- In GGP, because many of the subject debtors were in fact solvent, it was difficult to argue that the debtors could not successfully emerge from bankruptcy.
- Instead, certain lenders argued that (i) filing was premature and (ii) a plan could never be confirmed over lenders' objection.

Objective Bad Faith: Premature Filing?

- Bankruptcy cases have been dismissed where the debtor was not in financial distress, where the prospect of liability was speculative and there was evidence that the filing was intended to obtain a litigation advantage.

General Growth Properties

Objective Bad Faith: Premature Filing? (Cont.)

- The Bankruptcy Code does not require debtor to be insolvent, but requires some level of financial distress.
- The GGP Court found that certain of the debtors that were the subject of the motions were in varying degrees of financial distress.
- The GGP Court noted GGP's and its financial advisors' efforts to try to restructure or refinance its debt and their inability to do so in light of the financial crisis.
- Ultimately, the GGP Court said it "declines the invitation to establish an arbitrary rule … that a debtor is not in financial distress and cannot file a Chapter 11 petition if its principal debt is not due within one, two or three years."
- The GGP Court noted, though, that this did not mean "that every stand-alone company with ample cash flow would necessarily act in good faith by filing a Chapter 11 petition three years before its only debt came due."

General Growth Properties

Objective Bad Faith: Considering the Interests of the Group as a Whole

- The GGP Court noted that a bankruptcy filing of a wholly-owned subsidiary is appropriate where the parent company has filed in good faith and the subsidiary is crucial to the parent company's reorganization plan.
- The organizational documents provided that Independent Managers have a fiduciary duty of loyalty and care similar to that of a director of a Delaware corporation.
- Under Delaware law, directors of a solvent corporation (even if operating in the zone of insolvency) have to consider the interests of the shareholders in exercising their fiduciary duties; if the company is insolvent, directors also have duties to creditors.
- From a group perspective, the bankruptcy filings were appropriate in light of the shareholders' financial problems.

General Growth Properties

Subjective Bad Faith

- Lenders argued that a failure to negotiate with them prior to filing and replacing the Independent Managers was evidence of bad faith.
- The Court found that the Bankruptcy Code does not require a debtor to negotiate and that the debtors had made repeated futile attempts to restructure/refinance.
- The Court found that dismissal of independent directors, while surreptitious, was permitted by the organizational documents and there was no notice requirement.
- The Court found no subjective bad faith where the filing was to preserve value for the debtors' estates and creditors. The Court noted that experienced restructuring professionals all concluded that a bankruptcy filing was necessary and, under these circumstances (acting with professional advice), it is hard to say the Board acted with subjective bad faith when it authorized the bankruptcy filing.
- Creditors may have been inconvenienced by the bankruptcy filing, but the Bankruptcy Code seeks to create a proper balance and is also designed to protect creditor's rights. Here, lenders were granted adequate protection, including post-petition interest on their loans.
- The GGP Court denied the motions to dismiss.

General Growth Properties

Substantive Consolidation

- The GGP Court made clear that its decision did not order the substantive consolidation of the subsidiaries" with its parent's assets; *i.e.*, the parent and subsidiaries remained separate and distinct entities and the Court upheld the SPE structure.
- The Court's express statement of non-consolidation actually supports the SPE structure and the separateness of parent and subsidiary in such a structure.

Adequate Protection

- The Court conditioned the lending of money from one debtor estate to another debtor estate based on providing (a) adequate protection to the lenders of the debtor transferor, and (b) adequate protection from the debtor transferee to the debtor transferor.
- Adequate protection took the form of interest payments to lenders, payment of operating expenses for the properties, and replacement liens for the lenders.

GGP's Plan of Reorganization

- Pursuant to settlements reached with GGP's lenders, the GGP's plan of reorganization for the SPE Debtors restructured over $13.5 billion in secured loans for over 100 properties.
- Secured debt holders generally agreed to maintain the current, nondefault contract rate of interest across all the loans and extended the loan's maturity dates (the average maturity date, weighted by the size of the loans, was extended to 2016), in exchange for certain concessions by the Debtors, including GGP agreeing to catch up on unpaid amortization during the Chapter 11 cases, and pay increased amortization on all loans, as well as restructuring fees.
- By virtue of the settlement being Court approved, lenders were able to be aggressive in bargaining for better control over the SPE. For example:

  (a) The settlements require that each SPE have at least two independent directors not affiliated with the SPE and approved by the lenders; lenders also granted the right to consent to any new or replacement independent director if not employed by a corporate service provider.

GGP's Plan of Reorganization (Cont.)

(b) In connection with possible future bankruptcy filings for an SPE, the organizational documents utilized provisions under the Delaware Limited Liability Company Act (18-1101 *et. seq.*) which narrowed the scope of a director's fiduciary duties.

(c) Independent directors were required (i) to consider only the interest of the SPE as a standalone entity; and (ii) to consider the interests of creditors of the SPE and not consider the interest of the member or any direct or indirect beneficial owner of the member.

(d) Lenders were provided advance relief from the automatic stay under section 362 of the Bankruptcy Code in the event of a subsequent bankruptcy filing.

(e) The ultimate parent of the SPE agreed to provide a "non-recourse carve-out guarantee" (also known as a "bad boy" guarantee) that would, in addition to customary recourse provisions (*i.e.*, fraud, misappropriation, misapplication, *etc.*) provide the lenders with full recourse to the parent entity if the SPE (i) files a subsequent voluntary bankruptcy case; (ii) fails to have an involuntary bankruptcy case dismissed within 180 days; (iii) makes an assignment for the benefit of creditors; (iv) admits that it is insolvent or cannot pay its debts as they become due; or (v) intentionally interferes with the lender exercising remedies after an event of default. *See* Part II.C, *infra*, for a general discussion of "bad boy" guarantees.

GGP's Plan of Reorganization (Cont.)

- Recently, Simon Property Group ("Simon") has offered to provide exit financing for the remaining part of GGP which is still in bankruptcy.
- Simon has offered to backstop a $1.5 billion credit facility, waive a $12.5 million fee and limit its governance rights. It also has agreed to invest $2.5 billion and its partner, Paulson & Co., would put in another $1 billion.
- GGP has proposed a plan of reorganization which provides that Brookfield Asset Management, Fairholme Capital Management and Pershing Square Capital Management would put up in excess of $6.5 billion to finance GGP's exit from bankruptcy. This plan required GGP to issue almost $1 billion in warrants.
- Simon's proposal does not include a similar warrant provision; Simon has stated that eliminating this provision would provide at least $895 million in benefits to shareholders.
- The saga of how the remaining part of GGP will exit bankruptcy is still not fully written.

PART II

REAL ESTATE BANKRUPTCY ISSUES

A. Cash Collateral and DIP Financing

- Obligations to lend to a debtor under prepetition loan agreements terminate when a bankruptcy petition is filed. The debt due thereunder is automatically accelerated.
- A bankruptcy filing triggers the imposition of the automatic stay, which will prevent a lender from exercising remedies and foreclosing on its collateral.

Cash Collateral

- Post-petition, the debtor may continue to use, sell or lease its property in the ordinary course of business and without court approval, unless the property is encumbered. If the property is encumbered, the lender is entitled to adequate protection.
- If a debtor seeks to use cash collateral (*i.e.*, rent or deposits), the lender must either consent to such use or court approval is required.
- Court approval for the use of cash collateral will be obtained if the debtor provides "adequate protection" to the lender.
- Adequate protection can take many forms, including periodic cash payments or the grant of additional or replacement liens to offset the decrease in the value of the lender's interest in the collateral.

A. Cash Collateral and DIP Financing (Cont.)

- A cash collateral issue sometimes litigated is the ownership of rents.
- Most assignments of rent in commercial real estate financings are structured as absolute assignments to lenders with a license granted back to the borrower to collect the rents until an event of default occurs.
- Such provisions are not usually interpreted as conveying title in rents to lenders.
- In jurisdictions that find an absolute assignment, the rent is found to be owned by the lender and not part of the bankruptcy estate.
- However, courts will typically construe such an assignment and corresponding license as a "conditional absolute assignment" that constitutes a security interest only.
- In such a case, the rents will be considered cash collateral and the lender will either have to consent to their use by the debtor or the court will have to authorize the use.

Forms of Adequate Protection

- A sufficient equity cushion in the property.
- No deterioration in value of the collateral since the bankruptcy filing date.

A. Cash Collateral and DIP Financing (Cont.)

Post-Petition Financing

- Aside from using cash collateral, a debtor will frequently require some additional type of financing to "prime the pump" during the pendency of the case. In other words, new capital is required.
- A debtor -- faced with varying degrees of financial distress -- will not be able to obtain credit on an unsecured basis. There may not be an unencumbered asset to lend against. There also may not be sufficient equity in collateral to attract a lender to lend money on a junior secured basis.
- In such a case, a debtor will seek authorization to incur debt that is secured by a senior or equal lien on property of the estate that is subject to an existing lien -- this is commonly referred to as "priming."
- In order for a post-petition lender to obtain such a priming lien, the court must determine that there is no other alternative source of financing, the financing is required and that there is adequate protection being provided to the holder of the existing lien.
- A "priming" litigation usually involves whether the prepetition lender has an equity cushion in its collateral, or whether the new loan will enhance the value of the collateral beyond the amount actually loaned.

A. Cash Collateral and DIP Financing (Cont.)

- Terms generally found in post-petition financing orders include:
  - If the prepetition lender and the post-petition lender are the same, the allowance of the lender's prepetition claim and validity of the lien, subject to a challenge period for a creditors' committee or another party in interest objecting to the claim and/or validity of the lien. The financing order may also provide for the payment of the prepetition debt either through the concept of a "roll-up" or the periodic pay down of prepetition debt as collateral is collected.
  - Providing for the ability to automatically include attorneys' fees and other lender expenses in the post-petition loan and providing for payment of post-petition interest.
  - The granting of liens on post-petition assets and, sometimes, prepetition assets to support the new loans.
  - In addition to the granting of liens, providing for a super-priority administrative expense claim, which would have priority over all other claims.
  - Providing affirmative covenants such as maintenance of the property, payment of taxes and financial reporting.

A. Cash Collateral and DIP Financing (Cont.)

- Providing negative covenants such as operational performance tests and prohibiting other secured financing or requests to use cash collateral. Also, covenants restricting major transactions without lender consent.
- Approving a budget to control expenses.
- Providing for events of default triggered by operational performance or bankruptcy events (*i.e.*, the appointment of a chapter 7 trustee or the conversion of the case) and for the modification of the automatic stay to enforce remedies upon default. The financing order may also include bench marks to control the pace of the bankruptcy case such as a deadline to sell assets or file a plan of reorganization.
- Providing for the automatic perfection of liens and security interests without the necessity of filing perfection documents.

B. Leases and Other Executory Contracts

- Court order needed to assume or reject leases.
- The debtor has the opportunity to decide whether to assume (affirm the agreement) or reject (terminate) the lease.
- If assuming the lease, the debtor must assume it in total -- cannot “cherry pick” favorable provisions and reject unfavorable provisions.
  - There may be litigation over whether a master lease with schedules is one lease or multiple leases.
  - In order to assume a lease, the debtor must “cure” all existing defaults, compensate the non-debtor party for damages and provide adequate assurance of future performance (*i.e.*, demonstrate the ability to continue to perform under the lease).
- *Ipso facto* clauses: contractual provision that triggers a default or a right to terminate the lease upon a party’s bankruptcy filing -- not enforceable.

B. Leases and Other Executory Contracts (Cont.)

- Debtor can also assume and assign the lease to a third party.
  - The assignee becomes obligated to perform in accordance with the lease.
  - The debtor must make a showing that the assignee is capable of performing the obligations under the lease. If it does, the landlord must accept performance from the assignee.
  - This is an opportunity for the debtor to realize value for the estate (i.e., if the rent payable is under market).
  - Provisions in leases restricting assignment, as a general matter, are not enforceable.
- **Shopping Center Leases**
  - There are special provisions in the Bankruptcy Code dealing with the assumption and assignment of shopping center leases. In such a case, the debtor must provide adequate assurance that:
    - The source of rent and financial condition and operating performance of any assignee is to be similar to the debtor when it entered into the lease.
    - Any percentage rent due under the lease will not decline substantially

B. Leases and Other Executory Contracts (Cont.)

  - Any assignment of the lease is subject to the provisions in the lease, including provisions governing radius, location, use or exclusivity provisions, and will not breach any provisions contained in other leases, financial agreements or master agreements relating to the shopping center.
  - The assignment will not disrupt any tenant mix in the shopping center.

Non-Residential Real Property Leases

- Debtor may assume this type of lease notwithstanding the occurrence of non-monetary defaults (i.e., "going dark" clauses) so long as the landlord is compensated for its pecuniary loss resulting from such default.
- The debtor has 120 days to decide whether to assume a non-residential real property lease; the court may extend this time period for an additional 90 days. Thereafter, the time can only be extended with landlord consent.
- A rejection claim arising from the rejection of a previously assumed non-residential real property lease is given administrative expense claim status.
  - Administrative claim is subject to a cap equal to the obligations due for the two year period following rejection.
  - Balance of the claim is an unsecured claim subject to a cap of the greater of one year or 15 percent, not to exceed three years of the remaining term of the lease.

B. Leases and Other Executory Contracts (Cont.)

- A rejection claim arising from the rejection of a lease that was not previously assumed is an unsecured claim, with the amount being capped at the prepetition rent due, plus the greater of one year's rent, or 15% of the rent reserved under the lease, not to exceed 3 years
- The debtor must continue to pay contractual rent post-petition until it decides whether to assume or reject the lease.
- When the debtor is a lessor and it seeks to reject a lease, the non-debtor lessee may treat the lease as being terminated or, if the term of the lease commenced, may retain its rights under the lease for the balance of the term and any renewals or extensions to the extent such rights are enforceable under non-bankruptcy law.

C. Recourse Guaranties

- Many commercial mortgage loans are structured as non-recourse loans -- the lender has recourse to the borrower only to the extent of the borrower's interest in the property and not to any other assets of the borrower.
- If all or part of the loan is guaranteed by the borrower's equity owners or another entity, the lender may sue the guarantor for the deficiency up to the amount of the guaranty.
  - In certain states, the "one action" rule will only permit a lender to commence a single action against a borrower to collect mortgage debt. This means that when a debt is secured by real property, the creditor will have to foreclose on the collateral before proceeding against the debtor's unsecured assets to recover on its deficiency claim. If the secured creditor does not foreclose on all of its collateral before seeking a money judgment on the underlying debt, it may be deemed to have made an "election of remedies" and found to have waived recovery from the balance of its collateral.
- Some loans have the benefit of a so-called "bad-boy" or "non-recourse carve-out" guaranty, as is the case in the GGP plan.
  - These are guaranties where the guarantor has agreed to pay any damages resulting from certain prohibited acts, such as waste, fraud or failure to pay real estate taxes or insurance premiums.

C. Recourse Guaranties (Cont.)

- Some “bad-boy” guaranties are also triggered by the borrowers bankruptcy filing - in such case, the guaranty is intended to give the lender recourse to the guarantor for all or a portion of the mortgage debt.
- This may be a deterrent to the borrower’s bankruptcy filing unless the guarantor is insolvent and will also need to file for bankruptcy protection.
- The “bad boy” guaranty issue came up in the Extended Stay bankruptcy case pending in the Bankruptcy Court for the Southern District of New York.

Extended Stay -- Quick Facts

- The largest owner and operator of mid-price extended stay hotels in the United States; it had 680 owned or leased properties in 44 states and 2 Canadian provinces.
- At the peak of the market in June, 2007, Blackstone sold Extended Stay to an investment consortium led by David Lichtenstein for a purchase price of $8 billion.
- The purchase price was financed through $600 million of equity and approximately $7.4 billion of debt.
- David Lichtenstein and Lightstone Holdings, direct and indirect equity holders in Extended Stay, executed “bad boy” guaranties in favor the lenders of up to $100 million of the debt. The guaranty was triggered in the event of a bankruptcy filing.
- On June 15, 2009, Extended Stay filed for bankruptcy protection.

C. Recourse Guaranties (Cont.)

- Extended Stay filed a prepackaged plan of reorganization on the bankruptcy filing date. The Prepack Plan provided:
  - Common equity interests would be extinguished without a distribution.
  - A new holding company ("NewCo") would be formed to hold the equity interest of the mortgage borrower.
  - NewCo would provide Lichtenstein with a $100,000,000 indemnity against liability under the "bad boy" guaranties arising by virtue of the bankruptcy filing.
  - Lenders who accept benefits under the plan would have to release Lichtenstein from all liability under the "bad boy" guaranties.
- After the bankruptcy filing, multiple lawsuits were brought against Lightstone and Lichtenstein in connection with, among other things, the commencement of the chapter 11 cases and the guaranties.
- The lawsuits against Lichtenstein and Lightstone are pending in State Court and will be test cases for the enforceability of "bad-boy" guaranties.
- When a director agrees to give a "bad boy" guaranty, potential conflicts of interest arise. A director may have a fiduciary duty to commence a bankruptcy case but will be conflicted because of the director's personal financial risk if the case is filed. In the State Court Extended Stay litigations, the issue has been raised as to whether the "bad boy" guaranty should be void on public policy grounds.

D. Asset Sales

- In Chapter 11, a debtor is authorized to operate its business and enter into transactions including the sale or lease of estate property in the ordinary course of the debtor's business.
  - A party with a lien on the property being used by the debtor may request that the court prohibit or condition the use of such property unless the party's interest is adequately protected.
- Where the transaction in not in the debtor's ordinary course of business, the Bankruptcy Code allows a debtor to sell or lease estate property outside the ordinary course, only with bankruptcy court approval. Often times, debtors seek to sell their assets free and clear of liens, with such liens attaching to the proceeds of sale.

<u>The Sale Process</u>

- Once a sale agreement is entered into with a potential purchaser, the debtor will seek bankruptcy court approval of the sale transaction with that potential purchaser, often referred to as a "stalking horse."
- Ordinarily, the sale is subject to higher and better offers by other potential purchasers at an auction. In such a case, the stalking horse will frequently request and be granted a "break-up" fee and/or expense reimbursement, which is a fee paid to the stalking horse if it is not the successful bidder to reimburse it for lost opportunity costs, and for expending the time and effort in negotiating and documenting the initial bid and sale agreement.

D. Asset Sales (Cont.)

- After the auction, the debtor will determine who the highest and or best bidder is; the successful bidder, if the sale is approved, will acquire the assets.
- In order to sell an asset free and clear of liens and claims, the debtor will need to show that at least one of the following grounds is satisfied: (i) applicable nonbankruptcy law permits the sale of such property free and clear of such interest; (ii) the interest holder consents; (iii) the sales price is more then the aggregate of all liens on the property; (iv) the interest is subject to a bona fide dispute; or (v) the interest holder could be compelled to accept a money satisfaction of such interest.
- A “free and clear” sale usually cuts off successor liability, but there is some controversy in certain states as it relates to dealing with tort claimants.
- Advantages of a sale outside of a plan context are primarily time (shorter) and cost (less expensive).

D. Asset Sales (Cont.)

- If a secured creditor is interested in the asset in which it has a lien, it may "credit bid" its claim -- *i.e.*, to set off its claim against the purchase price of the assets.
  - This allows a secured creditor to ensure that the debtor does not sell its collateral below the amount of the secured creditor's claim (absent the secured creditor's consent).
  - However, the Third Circuit in the *Philadelphia Newspapers* case** recently held that a debtor does not have to provide a secured creditor with the ability to credit bid its claim if the sale is being done in conjunction with confirmation of a plan of reorganization, as opposed to the sale taking place outside of a plan.

** *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010).

E. Plan Confirmation Issues

- In general, in order for a plan of reorganization to be confirmed:
  - The debtor must satisfy the "best interest of creditors" test, which means that creditors must be receiving under the plan at least what they would receive in a chapter 7 liquidation.
  - At least one impaired class of creditors must vote to accept the plan.
    - At least two-thirds in amount and over 50% in number of claims in a class must vote to accept the plan for the class to be an accepting class.
  - If a class of creditors does not vote to accept the plan of reorganization, the debtor may still seek confirmation over the rejection of that class of creditors (assuming at least one other impaired class has voted to accept the plan). This process is called "cram-down."
    - When a class of secured creditors has voted to reject the plan, the cram-down requirements are satisfied if the lender receives the value of its collateral either through a sale, through payment or by a note -- reorganization equity securities will not be sufficient.

E. Plan Confirmation Issues (Cont.)

- For unsecured creditors, the cram-down requirement is satisfied if the unsecured claim is paid in full (unlikely), the equity is not receiving anything under the plan or, in certain jurisdictions, the equity is contributing "new value" to the plan which justifies it retaining an interest under the plan.
  - How much new value justifies how much equity is a litigated issue.
- The plan must be feasible, *i.e.*, that confirmation of the plan is not likely to be followed by liquidation, or the need for further financial reorganization by the debtor (unless proposed by the plan).

- Issues that may arise during the plan confirmation stage of a real estate bankruptcy case include:
  - Is the lender's deficiency claim (which is a general unsecured claim) classified with other unsecured creditors and, if so, will the lender's claim control the class?
  - If the lender's claim controls the class and it votes to reject the plan, the debtor will only be able to confirm the plan if another class of impaired creditors votes to accept the plan.
    - If there is no impaired class voting to accept the plan, the plan cannot be confirmed.
    - The debtor will also need to satisfy the cram down provisions relating to the non-accepting class.

E. Plan Confirmation Issues (Cont.)

- Determining the appropriate market rate of interest on the new debt instrument to be given to the lender.
- Determining whether there is a cushion in the lender’s collateral to justify paying it post-petition interest and attorney’s fees.
- Determining whether the debtor’s projections demonstrate that its new debt can be serviced, such that the plan is feasible.
- Valuing the collateral for purposes of secured creditor cram-down.
- Determining the collateral to be provided for the lender, and the priority of liens on said collateral.

F. The § 1111(b) Election

- At times, a non-recourse lender will be concerned that it will be crammed down because of severe market conditions and artificially low property values and a market rebound has not yet occurred.
  - In this situation, the lender may take the "§ 1111(b) election"
  - If such election is taken, the lender will receive a new debt instrument equal to the face amount it is owed, but the present value of the debt instrument will be equal only to the value of the collateral.
  - A lender may take this election if it expects the market to rebound, that the debtor will want to sell the property and that the full debt will be repaid long before the scheduled maturity date.
  - The secured creditor will retain its lien on the property securing its claim.
  - If the § 1111(b) election is not taken, a non-recourse debt will be treated as recourse debt for purposes of a borrower's Chapter 11 case.

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Single Asset Real Estate Cases Under the Bankruptcy Code

Presented by:

Jason B. Binford

Real Estate Bankruptcies: Single Asset Real Estate Rules and Lessons From General Growth

April 27, 2010

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The Purpose of SARE Provisions in the Code

- Added to the Bankruptcy Code in 1994
- Attempts to address situation where a debtor files bankruptcy solely to avoid – or delay – foreclosure
- Protects interests of secured creditors

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Protects Secured Parties By:

- Shortening the case by lifting the stay; or
- Requiring a plan to be filed quickly; or
- Requiring adequate protection payments to the secured party

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Definition of SARE

(51B) The term "single asset real estate" means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.

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Definition of SARE Pre-BAPCPA

(51B) "single asset real estate" means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto having aggregate noncontingent, liquidated secured debts in an amount no more than $4,000,0000.

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Definition of SARE

Three Prong Test:

1. Is the real property a single property or a project?
2. Does the real property generate substantially all of a debtor's gross income?
3. Is the debtor conducting substantial business other than operating the real property?

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Definition of SARE

- Single Project Versus Multiple Projects
- *In re Vargas Realty Enterprises, Inc.*, 2009 WL 2929258 (Bankr. S.D.N.Y. July 23, 2009)

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Definition of SARE

- Generating Substantially All of the Debtor's Gross Income

- Debtor deriving significant income from non-real estate sources ≠ SARE
- Undeveloped property generating no income can still establish this prong

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Definition of SARE

- Substantial Business Other Than Operating Real Property

- *Ad Hoc Group of Timber Noteholders v. Pacific Lumber Co. (In re Scotia Pac. Co.)*, 508 F.3d 214 (5th Cir. 2007)
  - 200,000 acres of private timberland ≠ SARE because of "sophisticated operations" and generation of income other than activities involving the sale or lease of the land

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Definition of SARE

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- *In re Kkemko,* Inc., 181 B.R. 47 (Bankr. S.D. Ohio 1995)
  - Marina ≠ SARE because the marina did more than just rent moorings

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- *In re Prairie Hills Golf & Ski,* Inc., 255 B.R. 228 (Bankr. D. Neb. 2000)
  - Golf and ski club ≠ SARE
- *In re CBJ Development*, 202 B.R. 467 (B.A.P. 9th Cir. 1996)
  - Hotel ≠ SARE

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Definition of SARE

- Substantial Business Other Than Operating Real Property
- *In re Kara Homes,* Inc., 363 B.R. 399 (D.N.J. 2007)
  - Residential land developer is a SARE
  - The debtor's activities were incidental to selling homes and condominiums
  - A reasonable person would not expect the debtor to generate revenues apart from the sale of the homes

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Section 362(d)(3)

With respect to a stay of an act against single asset real state under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that it 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later –

(A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

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Section 362(d)(3)

(B) the debtor has commenced monthly payments that –

(i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an umatured statutory lien); and

(ii) are in an amount equal to interest at the then applicable **nondefault contract rate of interest** on the value of the creditor's interest in the real estate; or . . . .

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Section 362(d)(3)

1. <u>Reasonable Possibility of Being Confirmed Within a Reasonable Time</u>

In re Saddlebrook Subdivision, LLC, 2008 WL 5146541 (E.D.N.C. Dec, 8, 2008).

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Section 362(d)(3)

2. <u>Monthly Payments</u>

In re Heather Apartments, L.P., 366 B.R. 45 (D. Minn. 2007).

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Section 362(d)

The Court shall grant relief from stay:

1. For cause, including lack of adequate protection of an interest in property of such party in interest;

2. with respect to a stay of an act against property under subsection (a) of this section if –

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization

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Section 362(d)(3)

Provides lenders in SARE cases with additional options with respect to the automatic stay and adequate protection.

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Questions

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