If It Looks Like a Duck, err, a SARE Debtor...

March 15, 2012 by Krystyna Blakeslee

Recently, the Ninth Circuit Court of Appeals brought smiles to the faces of many lenders (especially Bank of America, the appellee and secured lender) when it refused to combine the assets of related debtors without a substantive consolidation order and held that a single asset real estate debtor will be treated as a single asset real estate debtor.

Let's take a little detour – some background information may be necessary. In 1994, the Bankruptcy Code (§ 362(d)(3)) was amended to include provisions relating to the "single asset real estate" ("SARE") debtor. A SARE debtor (§ 101(51B)) is a debtor that owns a single property (commercial or residential with 4 or more units) which generates substantially all of the gross income of the debtor, is not a farmer and is not engaged in any other business (other than owning and operating that property). These provisions are fondly (at least in some circles) referred to as the "SARE Provisions." The SARE Provisions require a debtor to propose a confirmable plan or commence making payments equal to the contract rate of interest (as opposed to default interest) due on the loan within a short time frame (90 days after entry of an order for relief or 30 days after the court determines that the SARE Provisions apply). If a SARE debtor fails to comply, a creditor (well, any creditor whose claim is secured by the property) may obtain relief from the stay and commence foreclosure. The effect of the SARE Provisions has been to shorten the life of a case and the economic burden placed on creditors whose claims are secured by a SARE debtor's property.

Now, back to the Ninth Circuit. The Ninth Circuit case discussed here and alluded to above involved Meruelo Maddux Properties, Inc. ("MMPI"), the parent company of more than fifty subsidiaries, all of which filed for bankruptcy in 2009. MMPI's business was operated on a consolidated basis – cash was swept into a general operating account that was also used to pay the expenses of all of the entities (MMPI and all of its 50+ subs). MMPI and its subs filed consolidated financial reports with the SEC and filed consolidated tax returns with the IRS. The subsidiary at issue, Meruelo Maddux Properties – 760 S. Hill Street LLC ("MMP HILL"), owned a swanky 92-unit Los Angeles apartment complex commonly known as the Union Lofts.

The cases of MMPI and MMP Hill were jointly administered but not substantively consolidated. This is a distinction with an important difference having legal consequences for all parties involved. Substantive consolidation allows a Bankruptcy Court to pierce the corporate veil of related debtors and use the assets of one debtor to satisfy the debts of another (see footnote 1 of the decision). Joint administration is merely a procedural way of dealing with a case aimed at streamlining the process to make the case administration easier for all parties involved.

I digress…. The Bankruptcy Court found that the SARE Provisions would not apply to MMP Hill due to "the consolidated interrelated nature of the business operations of MMPI and its

subsidiaries" (even though MMP Hill was a separate and distinct entity and the cases of MMP Hill and its parent corporation and sister subsidiaries were not substantively consolidated). On appeal, the Ninth Circuit overturned the decision of the Bankruptcy Court (affirming the District Court), and held that since MMP Hill qualifies under the SARE Provisions, "absent a substantive consolidation order, we must accept MMP Hill's chosen legal status as a separate and distinct entity from its parent corporation and sister subsidiaries, and look only to its assets, income and operations in determining whether it is a single asset real estate debtor." In short, absent substantive consolidation, the Ninth Circuit Court of Appeals refused to ignore MMP Hill's existence as a separate legal and distinct entity from its parent and sister subs and found that what looks like a SARE debtor, acts like a SARE debtor and smells like a SARE debtor IS a SARE debtor.

This is great news (at least if you are in the Ninth Circuit)! This case has made it clear that when entities are treated separately and distinctly a court will not (should not is probably more accurate) disregard that status without a court order (which means without a hearing and findings of fact and time to object). The Ninth Circuit has confirmed the belief that the bankruptcy of an SPE's affiliates will not per se result in substantive consolidation. Importantly, the Ninth Circuit has confirmed that single asset real estate debtors will be treated as contemplated by the Bankruptcy Code (even the most debtor-friendly judge may find this difficult to get around). Lenders are given some comfort that if the debtor is a SARE debtor, one way or another (i.e., plan confirmation, payment of contract interest or relief from stay) the lender will be afforded some relief.

So what does this mean going forward? In addition to just giving lenders some extra comfort, it means that lenders should ensure that their borrowers are not receiving funds from their parents or sister subs in exchange for labor or services or as a profit from investments. Some extra reps to that affect are worthwhile.

The Bankruptcy Court's order telegraphed that substantive consolidation may be a way to circumvent the SARE provisions. If this is so, we may see more debtors trying to have their cases substantively consolidated. Their success, however, is doubtful, since debtors will have to set the stage (e.g., comingling funds, sharing labor and services… in other words, lots of things that will cause a default under most loan documents) for substantive consolidation way ahead of the bankruptcy petition date.

The Ninth Circuit's straightforward reading of the Bankruptcy Code is an affirmation of a common deal structure for commercial loans, but we will still keep an eye on the rest of the circuits to see how other courts come down on this issue. In the meantime, lenders may consider adding some extra reps and can continue with business as usual.

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