ORANGE COUNTY BUSINESS JOURNAL

GIBSON, DUNN & CRUTCHER LLP's LEGAL INSIGHTS

Single Asset Real Estate - Fast Track Bankruptcy Cases

■ By Teresa J. Farrell and Eric J. Fromme - Gibson Dunn's Orange County office

Does your business own real property? Are all of its revenues generated by the sale or lease of real property? Have you structured your business as a single purpose entity at your lender's request, on your tax advisor's recommendation, or to limit liabilities?

If you've answered yes to these questions, then your business may be a "single asset real estate" ("SARE") entity. Before 2005, only businesses with debt of $4 million or less had to be concerned about SARE status. Now, many more businesses must be aware of the fast-track rules that apply to SARE debtors in bankruptcy – and of the opportunistic buyers that target debtors who cannot avoid bankruptcy.

The Way It Was

In the late 1980s, when the real estate market collapsed, bankruptcy courts were flooded with a new kind of Chapter 11 case: debtors whose only asset was a single piece of real property and whose only significant creditor was a financial institution with a mortgage on that property. When these debtors filed their cases, the financial institutions that had lent them money were prevented from foreclosing while the debtors attempted to wedge themselves into the reorganization provisions of the Bankruptcy Code -- despite the reality that the typical SARE, with few employees, minimal operations, and no significant unsecured debt, was not a good candidate for reorganization under Chapter 11.

> *"the $4 million debt ceiling has been removed, qualifying many more debtors as SAREs"*

As a result, secured lenders faced expensive and unpredictable litigation in single asset real estate cases. To obtain relief from stay to foreclose, a creditor had to prove that the debtor had no equity in the property and that the property was not necessary to a reorganization. Even where property value demonstrably fell short of the debt, bankruptcy courts were reluctant to find that the debtor's only asset was not necessary to its reorganization. A lender denied relief from the stay was faced with two problems: (i) it would receive no post-filing interest because it was undersecured, and (ii) it could be "crammed down" in a Chapter 11 reorganization plan.

The Way It Is

Fueled by secured lenders' frustration, Congress imposed stringent deadlines on SARE debtors to either file a plan within 90 days or make the required payments to the secured lender under the loan documents. Until 2005, if a borrower's total secured debt exceeded $4 million, the "90-day Plan or Pay" deadline did not apply. Now, however, the $4 million debt ceiling has been removed, qualifying many more debtors as SAREs.

FARRELL

FROMME

Three requirements must be met for a debtor to be classified as a SARE: (i) it must own real property constituting a single property or project (other than four or fewer residential units), (ii) the real property must generate substantially all of the debtor's gross income, and (iii) the debtor may conduct no substantial business other than the business of operating the real property and activities incidental thereto. The heart of the analysis is whether the debtor's revenues are generated by the active efforts of employees, or by the sale or lease of the property itself. For example, a full-service hotel with income generated from a gift shop and restaurant, a golf course with income generated from retail operations and catering events, a timber company with substantial real estate holdings and logging operations, and a ski resort with retail operations were not SAREs. Conversely, a business that sold raw land, or developed houses and then sold them, or rented out apartments in an apartment building, generated revenues solely by selling or leasing real property were SAREs.

From the debtor's perspective, if there is an argument that it is not a SARE, then it should not designate itself as such. This puts the burden on the lender to seek SARE designation and to litigate the issue. A borrower that is clearly a SARE may avoid foreclosure by promptly filing a confirmable plan of reorganization, or by making the required payments but applying them to principal. It is well settled that an oversecured lender is entitled to post-filing interest, while an undersecured lender is not. The undersecured lender may object and seek to have the payments applied to accrued and unpaid interest before applied to principal. However, if the debtor is successful it can delay foreclosure and pay down its loan without accruing additional interest. Finally, the debtor may seek to extend the 90-day Plan or Pay deadline for "cause" if it can show that it genuinely needs more time, but it must present strong evidence of need and that the secured lender would not be prejudiced.

From the perspective of investors on the sidelines, an opportunity awaits to take control of real estate assets by aiding vulnerable and cash strapped SAREs facing the fast track deadlines or lenders looking to sell off loans secured by undervalued assets.