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Ninth Circuit Issues a Bankruptcy Opinion Favorable to Lenders to SPEs

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The Court of Appeals for the Ninth Circuit recently held that an entity that meets the definition of a "single real estate" debtor under the Bankruptcy Code may not escape the consequences of such designation simply because it is a subsidiary of a group of companies with integrated and intertwined relationships among them. The author of this article explains how the decision may provide powerful rights not only to lenders to such entities in general, but could significantly enhance the rights of creditors of real estate owning single purpose entities.

In its recent decision in *Meruelo Maddux Properties, Inc.*,[1] the Court of Appeals for the Ninth Circuit held that an entity that meets the definition of a "single real estate" debtor under the Bankruptcy Code may not escape the consequences of such designation simply because it is a subsidiary of a group of companies with integrated and intertwined relationships among them. The decision may provide powerful rights not only to lenders to such entities in general, but could significantly enhance the rights of creditors of real estate owning single purpose entities ("SPEs").

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THE MMPI CASE

Meruelo Maddux Properties, Inc. ("MMPI") is the parent company to more than 50 subsidiaries that filed Chapter 11 bankruptcy petitions in Los Angeles in March of 2009. MMPI and its subsidiaries own and develop real property in the Los Angeles area. Their business is operated on a consolidated basis, cash is swept into a general operating account that is also used to pay all of the entities' expenses and they prepare and file consolidated financial reports with the Securities and Exchange Commission as well as consolidated tax returns with the Internal Revenue Service.

The subsidiary in question, Meruelo Maddux Properties-760 S. Hill Street LLC ("MMP Hill"), owned an apartment complex. Bank of America loaned MMP Hill $28.72 million and took a lien in the real estate. The bankruptcy cases of MMPI and its subsidiaries, including MMP Hill, were jointly administered but not substantively consolidated. Shortly after the filing, the various debtor subsidiaries filed a motion seeking a declaration that the single asset real estate provisions ("SARE Provisions") of the Bankruptcy Code are inapplicable to them. Bank of America filed a cross-motion seeking the application of the SARE Provisions to MMP Hill.

The bankruptcy court granted the debtors' motion and denied Bank of America's motion finding that "MMP Hill appears to have the characteristics of a [single real estate] case" but declined to apply the SARE Provisions to them due to the consolidated, interrelated nature of the business operations of MMPI and its subsidiaries. Bank of America appealed and the district court reversed, holding that there is no "whole enterprise exception" to the SARE Provisions. The Court of Appeals for the Ninth Circuit affirmed the district court.

THE COURT OF APPEALS OPINION

The Bankruptcy Code defines "single asset real estate" to mean:

> 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 thereto.[2]

The Court of Appeals first recited the bankruptcy court's conclusions that MMP Hill appears to qualify under the SARE Provisions since (i) the apartment complex was a single property, (ii) it generated all or substantially all of the MMP Hill's income and (iii) MMP Hill's only business involved operating and collecting rents from the apartment complex. In light of these findings, the court held that in the absence of evidence that MMP Hill received funds from its affiliates for labor or services, or as profit, no showing was made that MMP Hill does not qualify under the SARE Provisions.

Next, the Court of Appeals was unequivocal in rejecting the bankruptcy court's refusal to apply the SARE Provisions since MMP Hill was part of a whole business enterprise:

> [W]e hold that the plain language of § 101(51B) gives no basis for a 'whole business enterprise' exception. 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 [the apartment complex] is single asset real estate.[3]

WHY DOES IT MATTER?

In a case subject to the SARE Provisions, the secured creditor is entitled to relief from the automatic stay unless, within the later of, 90 days after the bankruptcy petition date, or 30 days after the court holds that the SARE Provisions apply, the debtor either files a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time, or commences monthly payments in an amount equal to interest at the nondefault contract rate.[4]

The SARE Provisions, therefore, provide a debtor with a very short leash. The debtor must commence payments to the secured creditor, or file a confirmable plan, in each case fairly quickly after the bankruptcy filing date. In contrast, in a non-SARE Chapter 11 case, the secured creditor is not automatically entitled to payment, and it may or may not be entitled to adequate protection payments depending on the circumstances of the case. And in a non-SARE case, the debtor enjoys a fairly long exclusivity period with no statutory outside deadline for proposing and confirming a plan.

Critically, in light of recent decisions holding that in confirming plans, debtors must satisfy the cramdown test on a per-debtor basis, rather than per-plan basis,[5] it could be extremely hard for single purpose entities to establish a likelihood of success of confirming a plan when the plan is opposed to by their secured lenders. After all, the secured lenders are likely the only meaningful creditors in the case.

IMPLICATIONS

While the SARE Provisions do not apply to every entity that owns a single real estate property or project,[6] they would appear applicable to single purpose entities used in securitizations of commercial real estate assets. Typically, each such single purpose vehicle entity owns one commercial building, apartment complex, mall or a shopping center, has no or few employees, and generates little if any income from activities unrelated to the real estate it owns (and incidental activities). The Court of Appeals opinion does, however, open new frontiers in dealing with these entities.

First, the opinion seems to suggest that entities could be structured to avoid the SARE designation by noting the "absence of evidence that MMP Hill received funds from MMPI or its sister subsidiaries in exchange for labor or services, or as profit from MMP Hill investments, or that any money received from [its affiliate] entities otherwise qualified as income." Perhaps, these shortcomings can be addressed in structuring single purpose entities.[7]

More importantly, the Court of Appeals notes that "[a]bsent substantive consolidation order, we must accept MMP Hill's chosen legal status as a separate and distinct entity."[8] If seeking substantive consolidation is a likely remedy for the SARE designation, one can envision an increased level of substantive consolidation litigation involving real estate owning single purpose entities.

NOTES

[1] *In the Matter of Meruelo Maddux Properties, Inc.*, 667 F.3d 1072 (9th Cir. 2012).
[2] Bankruptcy Code, §101(51B).
[3] *Meruelo Maddux*, 667 F.3d at 1077.
[4] Bankruptcy Code, §362(d)(3).
[5] *In re JER/Jameson Mezz Borrower II, LLC*, No. 11-13338 (MFW), 2011 WL 6749058 (Bankr. D. Del. Dec. 22, 2011); *In re Tribune Co.*, No. 08-13141 (KJC), 2011 WL 5142420 (Bankr. D. Del. Oct. 31, 2011).
[6] *In re Scotia Dev., LLC,* 375 B.R. 764, 774-79 (Bankr. S.D. Tex. 2007), *aff'd,* 508 F.3d 214 (5th Cir. 2007) (timber operator is not a SARE debtor since its income was produced by commercial activities of its employees and non-real estate commercial activities); *In re CBJ Dev., Inc.,* 202 B.R. 467 (Bankr. 9th Cir. 1996) (hotel is not a SARE debtor since it generates revenues from catering, restaurants, services and merchandise).
[7] Or at least, that is where the battleground lines will be drawn in negotiations among the borrower and its lenders.
[8] *Meruelo Maddux*, *supra.*