

## SARE: A new world for many creditors

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When Congress added provisions governing SARE cases to the Code in 1994, most commercial real estate players ignored them; they only applied in cases involving less than \$4 million of secured debt. The 2005 amendments eliminated the cap, thereby making these provisions relevant and potentially pivotal in many real estate-based cases.

### Why SARE matters

SARE debtors are subject to special constraints that can substantially limit their ability to reorganize. A SARE debtor must, within the later of 90 days after the commencement of its case and 30 days after the court finds that the debtor has a SARE case, either "file a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time," or commence monthly payments "to each creditor whose claim is secured by such real estate ... 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." Failure to pay or file a plan within the allotted time frame requires the court to grant relief from the automatic stay "such as by terminating, annulling, modifying, or conditioning such stay."

A secured creditor seeking stay relief under the SARE provisions has a reduced burden of proof. The creditor simply must show that it holds a claim secured by the debtor's single real estate asset. The debtor then must "either pay the creditor in a timely manner or prove that the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time." A creditor that waits until at least 90 days after the petition date before seeking relief against a SARE debtor will not have to litigate ancillary issues, such as whether the debtor has equity in the property, or whether cause otherwise exists to grant relief.

Although relief is mandated, termination of the stay followed by foreclosure is not necessarily assured. Relief instead may take the form of a continuation of the stay conditioned on the debtor's accomplishing specified tasks that protect the creditor's interests. Additionally, a debtor may seek an extension of the "pay or plan" deadline for "cause." Given the SARE-imposed time constraints, debtors can be expected to oppose application of the SARE rules and seek extended compliance periods.

### What is 'single asset real estate'?

Bankruptcy Code Section 101(51B) defines "single asset real estate" as "real property constituting a single property or project, [other than 1-3 unit residential real property], which generates substantially all of the gross income of a [nonfamily farmer] debtor," on which the debtor conducts "no substantial business ... other than the business of operating the real property and activities incidental."

The special SARE rules likely will govern whenever the debtor's assets consist of a single real estate property or project. Because many developers are required to create a special purpose vehicle to own each property or project, the SARE rules likely will govern many developers' bankruptcy cases. ■

### Contesting applicability

To avoid SARE status, a single-asset debtor may attempt to acquire a second property before bankruptcy. In one case, a debtor's shareholder contributed a second real property asset just months before the bankruptcy filing. This gambit was unsuccessful when discovery revealed that the contribution was a sham, and the secured debt purportedly assumed by the debtor actually was assured of repayment through a letter of credit procured by the shareholder, not through the property. Similarly, related SARE debtors may seek to merge in an effort to undo SARE status, notwithstanding negative covenants in their loan documents. Likewise, related SARE debtors may seek to substantively consolidate postpetition to foil their individual SARE status.

A debtor may not avoid SARE treatment simply because its sole property generates no income. Instead, such property is considered to produce substantially all of the debtor's income, thus subjecting it to the SARE provisions. (See *In re Oceanside Mission Assocs.*, 28 BCD 703 (Bankr. S.D. Cal. 1996).)

A debtor also may try to diversify its business activities in anticipation of arguing that it engages in business operations in addition to owning and operating real estate, such that SARE treatment is precluded. (See, e.g., *In re Kkemko, Inc.*, 27 BCD 134 (Bankr. S.D. Ohio 1995) (marina generated additional revenues by servicing boats and operating concessions; not SARE debtor); *In re CBJ Dev., Inc.*, 202 B.R. 467 (9th Cir. 1996) (non-SARE hotel owner operated revenue-generating gift shop, bar, and restaurant on premises).) (See also, *In re Club*

*Golf Partners, L.P.*, 47 BCD 229 (E.D. Tex. April 20, 2007) (observing that SARE debtors engage only in "passive types of activities" such as collecting rent, and truly incidental activities like maintenance and marketing.) The ploy fails, however, if the debtor itself is not conducting the business activity. (See, e.g., *In re Euro-American Lodging Corp.*, 47 BCD 171 (Bankr. S.D.N.Y. 2007) (owner of hotel was within SARE where it engaged separate entity to operate hotel business, including contracting with employees and vendors).)

The diversification strategy is exemplified in *In re Kara Homes, Inc.*, 47 BCD 274 (Bankr. D.N.J. 2007). Kara owned many special purpose vehicles. Each SPV developed and sold homes in a discrete project, and Kara provided all requisite construction, maintenance, sales services and related personnel. Each SPV contended it was not subject to SARE based on its myriad other business activities, including purchasing land, and planning and building residential communities. The court held that the SARE rules applied because no one "could reasonably expect to generate income from the activities undertaken by the affiliated debtors if the eventual sale of the real estate were not possible."

#### Delay tactics

- **Extend time for "cause."** The debtor may seek an extension of the "pay or plan" deadline for "cause," which should "consist of something extraordinary in the circumstances, something that tips the equities of a case outside the balance that Congress envisioned and then reinforced by establishing the underlying requirement." *In re Heather Apts. L.P.*, 47 BCD 286 (Bankr. D. Minn. 2007) ("any proffer of cause ... must include a concrete substitute for the creditor's statutorily-fixed expectation. ..."). A likely sale could constitute cause. *Id.* ("At a minimum, it seems, there should be a binding purchase agreement ...; a binding lending commitment in favor of the prospective purchaser; and demonstrated substantial progress in satisfying the ministerial minutiae for closing.")

- **File a plan; amend later.** In some cases, a debtor may obtain an extension by filing a non-

confirmable plan within the 90-day period. The debtor in *In re The Terraces Subdivision, LLC*, Slip Copy 2007 WL 2220448 (Bankr. D. Alaska 2007), within the 90-day period, filed a motion to extend the deadline and then filed a facially feasible plan. The fully secured lender moved for relief from the stay arguing the plan could not be confirmed as filed. The

court found the debtor "had the capability of presenting a feasible and workable chapter 11 plan," and extended the stay for approximately three months to enable the debtor to amend and seek confirmation of its plan. *Id.* This "conditioning" of the stay satisfied the statute's mandate that relief be granted when a feasible plan is not timely filed.

- **Litigate value of creditor's interest.** A debtor also may seek to delay the "pay or plan" date by litigating the value of the lender's interest in the property. A lender may find it advantageous to bring its own valuation motion early in the case, since valuation

frequently requires a longer litigation track that accommodates discovery, including expert depositions, and an evidentiary hearing.

- **Trigger intercreditor strife.** The SARE provisions authorize a debtor, notwithstanding the absence of lender consent or a bankruptcy court order, to pay postpetition interest to secured parties "from rents or other income generated before, on, or after the date of the commencement of the case by or from the property." A debtor thus may make interest payments to a junior secured creditor without demonstrating adequate protection of the senior creditor's interest in rents, and may trigger intercreditor litigation over the proper use and application of cash collateral, particularly in circumstances involving an ambiguous intercreditor agreement.

The Code's SARE provisions compel the attention of all parties in cases that involve a single real estate asset or project. These provisions may expedite SARE cases, but their application also may have unintended consequences. The devaluation of real estate in areas with large numbers of foreclosures, for example, echoes the S&L failures of two decades ago.

Perhaps not such a new world after all. ■

#### About the authors

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