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The Ninth Circuit Strengthens Secured Lenders' Rights in Single Asset Real Estate Bankruptcy Cases

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In *In re Meruelo Maddox Properties, Inc.*, -- F.3d ---, No. 10-56128 (9th Cir. Jan. 27, 2012), the United States Court of Appeals for the Ninth Circuit recently rejected the “whole enterprise” exception to the application of the single asset real estate provisions in the Bankruptcy Code. As a result, an entity that constitutes a “single asset real estate” debtor will be subject to the special provisions applicable to single asset real estate bankruptcies even if the entity is part of a larger, integrated corporate family that owns and develops multiple real estate projects. This is significant because it is very common for real estate developers to form separate corporate entities to own each separate real estate project with management and development of each project being conducted by yet another corporate entity. Under the *Meruelo* decision, each project-level entity will now be subject to Bankruptcy Code provisions applicable to single asset real estate cases. As a result, secured lenders will have increased leverage.

What is single asset real estate?

The Bankruptcy Code defines “single asset real estate” as property that meets the following three elements: (i) it is “real property constituting a single property or project, other than residential real property with fewer than 4 residential units;” (ii) it “generates substantially all of the gross income of a debtor who is not a family farmer;” and (iii) that “no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.” 11 U.S.C. § 101(51B).

Why is a single asset real estate designation important?

The Bankruptcy Code creates special rules for single asset bankruptcy cases that allow secured creditors to obtain relief from the automatic stay if the debtor fails to take certain actions.

Specifically, the single asset real estate provisions provide that the court “shall” grant relief from the automatic stay unless, by the later of 90 days from the order for relief (which, in a voluntary bankruptcy case, is the date the bankruptcy petition was filed) or 30 days after an order designating the case as a single asset real estate case, the debtor either (i) proposes a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable period of time or (ii) makes monthly payments of interest at the non-default contract rate. *See* 11 U.S.C. § 362(d)(3)(A) - (B)¹.

As a result, a single asset real estate debtor must propose a plan of reorganization in a relatively short amount of time² or, alternatively, must begin making monthly interest payments, which in many cases, it is not able to do. If the debtor fails to comply with either of these requirements, the secured lender will be entitled to relief from the automatic stay. This gives secured lenders greater leverage and

¹ The monthly interest payments are to be based upon the value of the collateral securing the loan rather than the amount outstanding under the loan. 11 U.S.C. § 362(d)(3)(B)(ii).

² In other cases, a chapter 11 debtor has an initial period of 120 days to file a reorganization plan, and this 120-day period can be extended for up to 18 months after the filing of the bankruptcy case. 11 U.S.C. § 1121(d)(2)(A).

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limits the ability of a distressed borrower to buy time and cause significant delay through a bankruptcy filing.

The Court's Decision

The *Meruelo* decision arose out of the bankruptcy cases of Meruelo Maddox Properties, Inc. ("MMPI") and several of its subsidiaries. MMPI owned and developed real estate in the Los Angeles area through its subsidiary companies. MMPI and its subsidiaries were managed together and utilized a centralized cash management system with consolidated operating accounts and daily account sweeps. MMPI and its subsidiaries filed consolidated financial reports with the SEC and consolidated tax returns with the IRS. The bankruptcy cases of MMPI and its subsidiaries were jointly administered but not substantively consolidated³.

The matter before the Court arose from a dispute between one MMPI subsidiary, Meruelo Maddox Properties-760 S. Hill Street LLC ("MMP Hill"), and its secured, project-level lender, Bank of America, N.A. ("Bank of America"). Bank of America advanced \$28.72 million to MMP Hill for renovations of a 92-unit apartment complex. MMPI filed a motion seeking a determination from the Bankruptcy Court that its subsidiaries, including MMP Hill, were not subject to the single asset real estate provisions of the Bankruptcy Code. Bank of America filed a cross motion seeking to apply the single asset real estate provisions to MMP Hill.

MMP Hill argued that the single asset real estate provisions should not apply for two reasons. First, it asserted that its consolidated operations with its parent and sister subsidiaries were such that it generated income from operations unrelated to the apartment complex. Second, MMP Hill argued that because of the complexity of the overall financial and organizational structure, the Court should look to the "whole enterprise" of the MMPI operations and not just MMP Hill's business. The Court disagreed.

With respect to MMP Hill's first argument, the Court determined that cash consolidation and shared operating accounts did not constitute "income" from other sources such that the single asset real estate definition would not apply. In rejecting MMP Hill's second argument, the Court noted that the plain language of 11 U.S.C. § 101(51B) did not provide for any exceptions to the single asset real estate definition. In fact, the Court found no basis anywhere in the Bankruptcy Code to apply a "whole enterprise" exception. The Court further noted that "[a]bsent 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 a single asset real estate."

The end result was a significant victory for real estate lenders because the business structure utilized by MMPI and its subsidiaries is very common for real estate developers. If the "whole enterprise" exception had been recognized, many debtors would have been able to avoid complying with the special rules for single asset real estate cases. It remains to be seen whether courts outside of the Ninth Circuit will follow suit and reject the application of the "whole enterprise" exception, but the Ninth Circuit's forceful rejection of the "whole enterprise" theory will be very influential even outside the Ninth Circuit and will make it very difficult for debtors in other circuits to rely on the theory.

³ As noted by the Court, "substantive consolidation is an uncodified, equitable doctrine allowing the bankruptcy court, for purposes of the bankruptcy, to combine the assets and liabilities of separate and distinct—but unrelated—legal entities into a single pool and treat them as though they belong to a single entity." (internal quotations omitted)

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