

## Real Estate Lenders Rejoice: Ninth Circuit Holds that the Property Held by One Debtor in a Bankruptcy Case Involving a Consolidated Group of Real Estate Companies Qualified as a Single Asset Real Estate

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On January 27, 2012, the Ninth Circuit Court of Appeals held that a property level debtor was subject to the single asset real estate provisions of the Bankruptcy Code even though the debtor was one of fifty-three debtor subsidiaries in a bankruptcy case involving a consolidated group of real estate companies that had centralized management and a centralized cash management account. Meruelo Maddux Properties-760 S. Hill Street, LLC v. Bank of America, N.A. (In re Meruelo Maddux Properties, Inc.), No. 10-56128 (9th Cir. Jan. 27, 2011).

Under section 362(a) of the Bankruptcy Code, immediately upon the filing of its bankruptcy petition, a debtor receives the protection of the automatic stay, which, among other things, operates to prevent secured creditors from enforcing liens against the debtor's estate. 11 U.S.C. § 362(a). One way a creditor can obtain relief from the automatic stay is if the bankruptcy estate qualifies as "single asset real estate," commonly referred to as a "SARE." 11 U.S.C. § 362(d). If a debtor's property constitutes a SARE, the court will grant a creditor relief from the automatic stay unless, within the latest of (1) 90 days after the order for relief, (2) such longer period as the court determines during the initial 90-day period or (3) 30 days after the court determines that the debtor is subject to the SARE provisions, the debtor files a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time, or the debtor has commenced monthly payments equal to the interest at the then applicable non-default contract rate of interest on the value of the creditor's interest in the real estate. 11 U.S.C. § 362(d)(3).

The Bankruptcy Code defines a SARE as "real property constituting a single property or project, other than residential real property with fewer than [four] residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial businesses being conducted by a debtor other than the business of operating the real property and activities incidental." 11 U.S.C. § 101(51B). Congress included the SARE provisions in the Bankruptcy Code to prevent debtors from filing for bankruptcy protection with the sole purpose of delaying mortgage foreclosures until the value of their real estate appreciated. 93 S. Rep. No. 168, 103d Cong., 1st Sess. (1993).

In In re Meruelo Maddux Properties, Inc., Meruelo Maddux Properties-760 S. Hill Street LLC ("MMP Hill") owned a 92-unit apartment complex in Los Angeles commonly known as "Union Lofts." MMP Hill's parent had a centralized management team that operated the parent, MMP Hill and a network of fifty-two other subsidiaries on a consolidated basis with revenues from operation of the subsidiaries' properties swept daily into a single general operating account. In 2006, Bank of America loaned MMP Hill \$28.72 million to renovate Union Lofts, taking a security interest in the real estate. In 2009, MMP Hill, MMP Hill's parent and fifty-two other subsidiaries of the parent each filed voluntary chapter 11 petitions. The bankruptcy court ordered the cases to be jointly administered, but did not substantively consolidate the cases. Soon after the bankruptcy petition, Bank of America filed a motion seeking relief from the automatic stay on the basis that MMP Hill's property qualified as a SARE.

The United States Bankruptcy Court for the Central District of California held that, although MMP Hill appeared to have the characteristics of a SARE debtor, the SARE provisions of the Bankruptcy Code should not apply because MMP Hill was part of a “whole business enterprise.” In re Meruelo Maddux Properties, Inc., et al., Case No. 09-13356 (Bankr. C.D. Ca. May 21, 2009) (Docket No. 312). The district court reversed, holding that MMP Hill’s property constituted a SARE because it met the elements of the definition of a SARE under the Bankruptcy Code and that no “whole business enterprise” exception existed absent substantive consolidation. Bank of America, N.A. v. Meruelo Maddux Properties, Inc., et al., Case No. 09-5976 (C.D. Ca. Jun. 29, 2010) (Docket No. 33). MMP Hill appealed.

In deciding whether MMP Hill’s property constituted a SARE, the Ninth Circuit analyzed the plain language of the Bankruptcy Code’s definition of a SARE. The court determined that MMP Hill’s property satisfied the three elements of the definition of a SARE because it was (1) a single property that (2) generated all or substantially all of MMP Hill’s gross income and that (3) MMP Hill’s only business activities involved operating and collecting rents from Union Lofts.

With respect to the third element, MMP Hill had argued that the consolidated management team and cash management system of its parent and its sister subsidiaries permitted MMP Hill to claim income generated by the other entities, and that therefore its business went beyond operating and collecting rents from its property. The court rejected this argument, however, finding no evidence that MMP Hill received funds from its parent or the other subsidiaries that could qualify as income because MMP Hill had not exchanged labor or services with the other entities.

Further, the Ninth Circuit agreed with the district court that the plain language of the Bankruptcy Code provided no basis for a “whole business enterprise” exception to the definition of a SARE, and that absent a substantive consolidation order, the court must consider each debtor as a “separate and distinct entity from its parent corporation and sister subsidiaries.”

Finally, the court made short shrift of MMP Hill’s contention that the court should look to the substance rather than the form of the definition of a SARE because Congress had not intended to include entities involved in complex financial structures in the definition. The Ninth Circuit found that only in rare cases would it adopt a non-literal approach to a statute, and that this was not one of those cases.

Real estate lenders could benefit from the Ninth Circuit’s ruling, which makes clear that a single purpose real estate entity will not be able to avoid compliance with the SARE provisions of the Bankruptcy Code merely by virtue of being part of a larger corporate group. The ruling reaffirms the effectiveness of the SARE provisions, which provide real estate lenders with the ability to pursue remedies within a short time after the petition date or to receive monthly interest payments equal to the value of their interest in the real estate. This could give real estate lenders greater leverage in bankruptcies and out of court negotiations.