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Ch. 11 Prospects In The New SARE Landscape

Law360, New York (June 10, 2011) -- With the real estate market in shambles for the past few years, it comes as no surprise that companies in the business of developing and leasing real estate have increasingly been filing for Chapter 11 relief.

Very often, these companies own a single building or a single complex of buildings, and typically these properties carry mortgages with balances in excess of their value. Bankruptcy courts have long recognized that such "single asset real estate" (SARE) debtors[1] present particular problems that more traditional companies do not, because SARE debtors generally have only one source of income — rents (if they have any income at all) — and little or no equity. SARE cases are also often filed in reaction to the filing of a foreclosure action by a secured lender.

The current economic climate has been hard on SARE debtors, given the unavailability of new financing and the stagnant real estate market. As a result, bankruptcy courts are facing more SARE cases than ever before. Moreover, lenders whose efforts to foreclose have been frustrated by the filing of a Chapter 11 petition are often more aggressively opposing their borrowers' attempts to reorganize.

The proliferation of SARE cases has led to an apparent shift in the analysis conducted by bankruptcy courts in deciding whether to dismiss a SARE case as a "bad faith filing" under Section 1112(b) of the Bankruptcy Code. As set forth below, that shift is a good news/bad news situation for both secured lenders and SARE debtors.

Motion to Dismiss for "Bad Faith" under Section 1112(b)

SARE cases are often filed on the eve of foreclosure by a secured lender to avoid the loss of the debtor's sole material asset — its real property. One tool used by secured lenders in SARE cases for many years has been an immediate motion to dismiss the case as a "bad faith filing" under Section 1112(b) of the Bankruptcy Code.

Section 1112(b) allows for dismissal of a Chapter 11 case if the court finds "cause." See 11 U.S.C. § 1112(b). Bad faith is not among the nonexhaustive, enumerated "causes" for dismissal, but courts have nonetheless recognized it as constituting cause. See, e.g., In re General Growth Props. Inc., 409 B.R. 43, 55-56 (Bankr. S.D.N.Y. 2009).

Different circuits have evolved lists of various factors that, taken together, may indicate bad faith on the part of the debtor. Among these factors are:

- Debtor owns a single, encumbered asset.
- Few unsecured creditors with small claims compared to those of secured creditors.

- Few employees.
- Little cash-flow and no available income to fund reorganization and provide adequate protection.
- Allegations of wrongdoing by the debtor.
- Debtor is a "new debtor" formed on the eve of foreclosure.
- Debtor's real property is subject of a foreclosure action.
- Debtor's financial problems are really a two-party dispute with a secured creditor.
- Timing of filing shows intent to delay or frustrate secured creditor's efforts to enforce its rights.
- No realistic possibility of reorganization of the debtor's business. See In re SGL Carbon Corp., 200 F.3d 154, 165 (3d Cir. 1999); In re C-TC 9th Ave. P'ship, 113 F.3d 1304, 1311 (2d Cir. 1997); In re Phoenix Piccadilly, Ltd., 849 F.2d 1393, 1394-95 (11th Cir. 1988).

Traditionally, many courts were inclined to dismiss "eve of foreclosure" SARE cases because they were essentially two-party disputes filed solely as a means of frustrating the expectations of the secured lender. See, e.g., In re 801 South Wells Street Ltd. P'ship, 192 B.R. 718, 727 (Bankr. N.D. Ill. 1996); In re SB Props. Inc., 185 B.R. 206, 208 (Bankr. E.D. Pa. 1995).

Since the inception of the real estate and financial crises in 2008, the landscape has changed in SARE cases, both in publicly available decisions and unpublished rulings across the country. While giving lip service to all of the traditional bad faith factors, most courts ultimately look to the last factor — whether there is a realistic possibility of reorganization — to determine whether to dismiss a petition for bad faith under Section 1112(b).

And in many cases the court are conducting this analysis right out of the gate, where a lender has filed a Section 1112(b) motion very soon after the petition was filed. Overall, this landscape is a good news/bad news situation for both debtors and secured lenders.

Good News for Debtors

The good news for debtors in the changing SARE landscape is that by focusing almost exclusively on the debtor's reorganization prospects, the debtor's Chapter 11 case is unlikely to be dismissed solely because it was filed on the eve of foreclosure and is essentially a two-party dispute with the secured lender.

Indeed, one bankruptcy court, presiding over a case in which the authors represented the secured lender, remarked in response to a Section 1112(b) motion to dismiss that if he applied the bad faith factors from the case law strictly, he would "dismiss every [SARE] case on my docket." Accordingly, this court, like many other courts, focused on the debtor's reorganization prospects and ability to ultimately confirm a plan.

The practical effect of this analysis is that bankruptcy courts are treating "bad faith filing" motions just like motions to lift the automatic stay under Section 362(d)(2) of the Bankruptcy Code under which the court determines whether the debtor has established "a reasonable possibility of a successful reorganization within a reasonable time." United Sav. Ass'n v. Timbers of Inwood Forest, 484 U.S. 365, 376 (1988).

Indeed, notwithstanding many of the traditional "bad faith" factors, debtors have survived motions to dismiss where they have demonstrated that funds are available, or may be available in the future, to finance a reorganization.

For example, a Vermont bankruptcy court held that a SARE debtor filed its petition in good faith — despite the fact that the debtor filed the petition soon after an adverse ruling in a state-court foreclosure — because the debtor had adequate cash-flow to meet expenses. In re R & G Props., Inc., No. 08-10876, 2009 WL 1076703 (Bankr. D. Vt. April 16, 2009).

The court noted that the debtor could not be held responsible for the financial decisions of a receiver the state court had appointed to run the debtor's property, and that the debtor had filed a reorganization plan and disclosure statement and credibly testified regarding its plans to refinance its debt. See id. at *6-7.

In a South Carolina case, the bankruptcy court denied a motion to dismiss for bad faith, despite the presence of numerous traditional "bad faith" factors, where the debtor owned lots that it could potentially sell to fund its reorganization, even though the debtor had no income at present. In re Harmony Holdings LLC, 393 B.R. 409 (Bankr. D.S.C. 2008).

The court found that it could not dismiss where there was even "a slim possibility of reorganization." See id. at 420; see also In re Crown Village Farm LLC, 415 B.R. 86, 93 (Bankr. D. Del. 2009) (finding good faith where debtor's plan of liquidation might maximize value for creditors); In re Encap Golf Holdings LLC, No. 08:18581, 2008 WL 4200324, at *8 (Bankr. D.N.J. Sept. 4, 2008) (finding debtor's post-petition conduct in formulating plan indicated good faith).

Moreover, paradoxically, the addition of Section 362(d)(3) of the Bankruptcy Code — which requires stay relief in SARE cases if the debtor does not file a (potentially) feasible plan or make interest payments within 90 days of the petition, may also be leading courts to focus solely on a debtor's reorganization prospects. Debtors often point to Section 362(d)(3) and argue that they should have at least 90 days to propose a potentially feasible plan.

Good News for Secured Lenders

The new SARE landscape is not all good news for debtors and bad news for secured lenders. Courts' laser-beamed focus on whether the debtor has reasonable prospects for reorganization also has forced debtors to produce evidence that they have a feasible exit strategy, even at the outset of a case, or else face immediate dismissal under Section 1112(b).

Several decisions in which the courts have ruled on Section 1112(b) "bad faith" motions in SARE cases make clear that courts are cognizant of the realities of the current credit and real estate markets and are perhaps more comfortable declaring reorganization a nonstarter near the outset of the case than they would have been in the pre-2008 boom years.

Not surprisingly, the inability to obtain financing to fund a plan of reorganization has been a consistent theme in cases where bad faith was found.

In a recent case in Texas, an SARE debtor was found to have filed in bad faith where its proposed plan depended "entirely on a change in market conditions." See In re LJH Enterp., No. 10-34355-H3-11, 2011 WL 597034, at *3 (Bankr. S.D. Tex. Feb. 11, 2011).

The debtor had sought refinancing for eight months without success, and the court found that there was no possibility that the debtor would be able to refinance in the immediate future. The court noted in particular that the debtor's principal testified that the credit markets were not offering financing on

terms necessary for the debtor to refinance. See id. at *2.

Similarly, a Georgia bankruptcy court found bad faith where the debtor needed significant funding for its proposed plan and obtaining such financing was "speculative and unrealistic." Importantly, the debtor had already proved unable to refinance prepetition. In re Vallambrosa Holdings, LLC, 419 B.R. 81, 87 (Bankr. S.D. Ga. 2009); see also In re DCNC North Carolina I LLC, 407 B.R. 651, 660-61 (Bankr. E.D. Pa. 2009) (finding subjective good faith, but dismissing based on objective futility of reorganization).

The authors were also involved in a recent case in Illinois in which the debtor was found to have filed in bad faith where it was unable to demonstrate the availability of new financing and therefore could not propose a feasible plan. See In re Sam & Realty LLC, No. 10-52220 (Bankr. N.D. Ill. Feb. 28, 2011) (unpublished, oral ruling) (Goldgar, J.).

Tips to Succeed in the Current SARE Landscape

In light of the current SARE landscape, soon after a petition is filed, a secured lender should evaluate the debtor's finances and determine if there is sufficient basis for a Section 1112(b) motion on the grounds that reorganization would be futile. For most SARE debtors, many of the subjective bad faith factors will be present, such as few unsecured creditors, few or no employees, and petition filed on the eve of foreclosure.

Consequently, a motion to dismiss for bad faith will likely turn on whether there is any hope of reorganization. Motions that rely too heavily on the traditional "bad faith" factors without evidence of a futile reorganization may be unconvincing to many bankruptcy courts and could lead to the debtor receiving a "chance" to reorganize in a situation where it is unwarranted.

Secured lenders must be able to show that, in light of the current financial and real estate markets, any proposed reorganization is a visionary scheme with little chance of success. Indeed, the motion to dismiss should be treated as if it is a mini-Section 362(d)(2) motion even if brought under Section 1112(b). Among other things, secured lenders should be prepared to present evidence on the following issues:

- The debtor's cash flow and expenses currently and into the future.
- The debtor's prospects for obtaining refinancing or selling its assets.
- The range of reasonable cram-down interest rates and the debtor's inability to confirm a feasible plan under any rate within that range.

Debtor's counsel, on the other hand, should have at least a preliminary proposal for a Chapter 11 plan in mind on the petition date. Given that the court's focus is likely to be on whether any plan is feasible — a low bar in most cases — a prudent debtor will be able to present a preliminary proposal that has at least some hope of viability and alleviates the court's concerns regarding available financing and income.

Waiting until the eve of a hearing on a motion to dismiss to present a hastily prepared plan that does not evidence a reorganization that is "on track" — the practice of many SARE debtors — will likely convince the court that a successful reorganization is merely a pipe dream and that the debtor seeks only a tactical delay in the secured lender's inevitable foreclosure.

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[1] See 11 U.S.C. § 101(51B) (defining “single asset real estate”).