# Single Asset Real Estate Cases: Implications and Strategies for Practitioners

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This Practice Note provides an overview of the Single Asset Real Estate (SARE) Chapter 11 case. This Note addresses the qualifications for classifying a debtor as a SARE, the specific Bankruptcy Code provisions applicable to SARE debtors, and the practical considerations and strategies for both SARE debtors and lenders.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) revised the definition of single asset real estate (SARE) and added provisions to the Bankruptcy Code that impacted how SARE cases are administered. Specifically, the revisions to the Bankruptcy Code:

- Expanded the definition of SARE to eliminate a $4 million debt cap.
- Instituted a strict time period for SARE debtors to file a plan of reorganization or begin making interest payments to the lender.
- Limited the duration of the automatic stay in favor of lenders.

A SARE debtor typically files a Chapter 11 case to avoid imminent foreclosure on its property because filing for bankruptcy gives the debtor the benefit of the automatic stay and the necessary breathing room to raise new capital, refinance debt, and offer a plan.

This Note provides an overview of a single asset real estate bankruptcy case, discussing the statutory implications for SARE debtors and strategies for SARE debtors and their secured lenders.

## DEFINITION OF A SINGLE ASSET REAL ESTATE DEBTOR

Single asset real estate is defined in the Bankruptcy Code as a single property or project that generates substantially all of the debtor's gross income (§ 101(51B), Bankruptcy Code). If the debtor's only business is operating the property and the property generates substantially all of the debtor's income, a SARE typically includes the following types of properties:

- Shopping centers.
- Office buildings.
- Industrial and warehouse buildings.
- Apartment complexes.

A SARE debtor does not include:

- Family farmers.
- Residential complexes with less than four units.
- Businesses that generate revenue independent from the operation of the property.

Because not every entity that owns real estate is a SARE debtor, determining whether the debtor qualifies as a SARE is a fact driven question. Counsel must carefully review the statute and the debtor's business to determine if the SARE provisions apply (see Determining Whether a Debtor is a SARE).

### DESIGNATING AS A SARE DEBTOR

The debtor must elect to be treated as a SARE by checking the appropriate box on the official Chapter 11 bankruptcy petition (Official Bankruptcy Form B 201).

If the debtor does not elect to declare itself as a SARE debtor on the petition, a secured creditor may file a motion with the bankruptcy court under section 101(51B) of the Bankruptcy Code to designate the debtor as a SARE debtor. This motion can be filed as a stand-alone motion or as alternative relief to a larger motion for relief from a stay or to dismiss the case. Because of specific timing restrictions on a SARE debtor to file a plan of reorganization or make interest payments to a lender, secured lenders should file this motion as soon as practicable after the petition date so that the clock can start running on a SARE debtor's time limits if the lender's motion is approved (see Statutory Standards for SARE Debtors).

## DETERMINING WHETHER A DEBTOR IS A SARE

The definition of SARE in the Bankruptcy Code governs a debtor's eligibility to qualify as a SARE Chapter 11 case. There are three elements to the definition that must all be met, and each are commonly litigated:

- The real property must constitute a single property or project.
- The real property must generate substantially all of the debtor's gross income.
- The debtor must not be involved in any substantial business other than the operation of the real property.

### SINGLE PROPERTY OR PROJECT

The first frequently litigated factor is whether the property owned by the debtor is a "single property or project, other than residential real property with fewer than 4 residential units" (§ 101(51B), Bankruptcy Code).

While determining whether a debtor operates a single property is generally straight forward, it is less clear whether the debtor's business is a single project. The generally accepted test for determining whether a property consisting of multiple parcels is a single project focuses on the debtor's intent or purpose (see *In re JJMM Int'l Corp.*, 467 B.R. 275 (Bankr. E.D. N.Y. 2012)). Courts focus on how the debtor treats its property and hold that the SARE provisions can apply to a debtor with multiple properties where the properties are linked together in some fashion in a common plan or scheme involving their use (see *In re McGreals*, 201 B.R. 736, 742 (Bankr. E.D. Pa. 1996)).

Courts have found multiple parcels of land constituting a single project when:

- The debtor owned several apartment buildings on adjacent parcels. The separate buildings constituted an apartment complex comprised of a single project because the debtor had a common plan or purpose for the property (see *In re Vargas Realty Enter. Inc.*, 2009 WL 2929258, at *4-5 (Bankr. S.D.N.Y. July 23, 2009)).
- Five adjacent undeveloped parcels were considered a single project even though the debtor planned to construct a hotel, golf courses, convention center, spa, and related services on the property, because the debtor planned to develop them as one large resort (see *In re Webb MTN, LLC*, 2008 WL 656271, at *1 (Bankr. E.D. Tenn. Mar. 6, 2008)).

### PROPERTY GENERATES SUBSTANTIALLY ALL DEBTOR'S GROSS INCOME

The requirement that the debtor's real estate must generate the substantial portion of its gross income is typically satisfied when the debtor's primary source of income is the sale, rental, or operation of real property. However, "a business would not be a SARE if a reasonable and prudent business person would expect to generate substantial revenues from the operation of activities separate and apart from the sale or lease of the underlying real estate" (*In re Scotia Pacific Co., LLC*, 508 F.3d 214, 222 (5th Cir. 2007)).

To make the determination, courts examine the relative income generated by the real property compared with the income generated by other operations related to the real property. Courts specifically look to the material nature of the business activities and whether the revenues the property owner receives are passive in nature, such as the simple collection of rents (see *In re Kara Homes, Inc.*, 363 B.R. 399 (Bankr. D.N.J. 2007)).

### OPERATING THE PROPERTY

If the debtor is operating a business that is generating income independent or ancillary to the ownership of the real estate, the other business, if significant, is not considered incidental to the business of operating the real property and therefore the debtor does not qualify as a SARE.

Of the three elements of the SARE definition, this one is most commonly litigated. Courts have analyzed whether certain businesses and operations qualify as a SARE and have determined that the following businesses do not qualify as SARE debtors when they are engaged in other substantial business:

- **Hotels.** A hotel is not a SARE debtor when it operates significant other businesses, including a restaurant, bar, and gift shop, and provides room cleaning services and phone services for its guests (see *Centofante v. CBJ Dev., Inc. (In re CBJ Dev., Inc.)*, 202 B.R. 467 (9th Cir. B.A.P. 1996); *In re Whispering Pines Estate, Inc.*, 341 B.R. 134 (Bankr. D. N.H. 2006)).
- **Golf courses.** A golf course is not a SARE debtor when it also offers golf cart rentals, a pool, and concessions (see *In re Larry Goodwin Golf, Inc. d/b/a Uwharrie Gold Club*, 219 B.R. 391 (Bankr. M.D.N.C. 1997)) or when it is connected to residential land developments and not simply operating the gold course (see *In re Prairie Hills Golf & Ski Club, Inc.*, 255 B.R. at 228 (Bankr. D. Neb. 2000)).
- **Marina.** A marina is not a SARE when, in addition to providing for the mooring of boats, the marina also stores, repairs, and winterizes boats, as well as sells gas concessions (see *In re Khemko, Inc.*, 181 B.R. 47 (Bankr. S.D. Ohio 1995)).
- **Timberland.** A timber company owning about 200,000 acres of timberland is not a SARE because it was engaged in the business of harvesting timber and conducted other substantial business aside from the operation of real estate (see *In re Scotia Pacific Co., LLC*, 508 F.3d at 224-225).

### MULTI-DEBTOR CASES INVOLVING A SARE DEBTOR

In multi-entity bankruptcy filings, it is common for one entity to own real estate for other operating entities. In that situation, some, but not all, of the debtors may qualify as a SARE.

Courts have held that section 101(51B) does not contain an exception to the single asset real estate definition whereby the court may look to the whole enterprise of the parent entity or affiliated debtors to determine SARE status (see *Meruelo Maddux Props.760 S. Hill St., LLC v. Bank of Am., N.A. (In re Meruelo Maddux Props., Inc.)*, 667 F.3d 1072 (9th Cir. 2012)). This means that one debtor entity may be deemed a SARE even though the other debtor entities do not qualify. For example, in a typical real estate structure that contains a parent company, subsidiaries, and affiliates with consolidated operations and shared operating accounts, if one of the subsidiaries qualifies as a SARE under the plain language of section 101(51B) of the Bankruptcy Code, the court must designate that entity a SARE and treat it that way during the bankruptcy case even if the other debtor entities are not SAREs.

Absent substantive consolidation, in multi-debtor cases the bankruptcy court will examine the following to determine whether each debtor qualifies as a SARE:

- The legal status of each debtor as a separate and distinct entity.
- The assets, income, and operations of each specific entity.

For more information on substantive consolidation, see Practice Note, Substantive Consolidation in Bankruptcy (*http://us.practicallaw.com/7-521-6812*).

## STATUTORY STANDARDS FOR SARE DEBTORS

Designating a Chapter 11 case as a SARE imposes heightened requirements on a debtor. A SARE debtor is placed on an expedited timeline to either:

- File a plan of reorganization that has a reasonable chance of being confirmed.
- Begin making monthly payments to the secured creditor at the loan's nondefault contract interest rate

(§ 362(d)(3), Bankruptcy Code.)

If a SARE debtor fails to satisfy either of these requirements, the bankruptcy court is likely to grant a secured creditor relief from the automatic stay to begin or continue a foreclosure of the real property.

### SECTION 362(D)(3): LIMITED AUTOMATIC STAY

Unlike in other Chapter 11 cases, a SARE debtor cannot rely on the automatic stay remaining in force throughout the life of the case. Instead, to maintain the automatic stay, section 362(d)(3) of the Bankruptcy Code requires a SARE debtor to either:

- File a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time.
- Begin making monthly interest payments to the lender at the original contract rate.

These actions must be made within the later of:

- 90 days from entry of the order for relief (or a later date as the court may determine for cause by order entered in that 90-day period).
- 30 days after the court determines a debtor is a SARE debtor.

Therefore, to avoid termination of the automatic stay a SARE debtor has two options:

- File a plan that can be supported by reasonable prospects and assumptions regarding feasibility (§ 1129(a)(11), Bankruptcy Code).
- Begin making monthly interest payments for the continuation of the automatic stay. Making monthly payments could prove challenging for debtors with partially built or low income producing real estate projects, forcing the debtor to file a plan.

If the debtor fails to satisfy either of these requirements, the secured creditor will likely be able to obtain relief from the automatic stay to foreclose on the property (see Practice Note, Automatic Stay: Lenders' Perspective: Relief From the Stay (*http://us.practicallaw.com/9-380-7953*)).

These rules do not preclude a secured creditor from seeking relief from stay on other grounds, such as a lack of adequate protection or other cause (see Motion for Relief from the Automatic Stay).

### EXPEDITED PERIOD TO FILE PLAN OR MAKE MONTHLY PAYMENTS

Generally, under section 1121(b) of the Bankruptcy Code, a debtor has the exclusive right to file a plan during the first 120 days of a bankruptcy case and may seek extensions of up to a maximum of 18 months on a showing of cause. However, for a SARE debtor, section 362(d)(3) of the Bankruptcy Code compresses the time period for filing a plan to a minimum of 90 days if the debtor has not begun monthly payments equal to the nondefault rate of interest on the secured claim.

Because of these requirements, a SARE debtor needs to properly plan for bankruptcy by either:

- Conserving its cash before the bankruptcy filing or obtaining financing so that it has adequate funds to make interest payments to the secured creditors. The interest payments are a form of adequate protection for secured creditors (§ 362(d)(1), Bankruptcy Code; see Practice Note, Protecting the Lender's Interest in Bankruptcy: The Remedy of Adequate Protection (*http://us.practicallaw.com/8-382-8989*)).
- Drafting and filing a plan of reorganization that has a reasonable chance of being confirmed and is not patently unconfirmable on its face (see Timing for Designating as a SARE).

## THE GOOD FAITH DOCTRINE

Like other Chapter 11 debtors, the SARE debtor must file its Chapter 11 case in good faith. Because real estate cases are often filed on the eve of a pending foreclosure sale, they have often been challenged on grounds that the case was filed in bad faith. A lack of good faith is a basis for a secured creditor to seek dismissal of the case or relief from the automatic stay.

While section 1112 of the Bankruptcy Code provides that a bankruptcy court, after notice and a hearing, may dismiss a Chapter 11 case for cause, dismissal of a Chapter 11 case on lack of good faith is not expressly covered in the list of nonexclusive grounds in the Bankruptcy Code. However, most jurisdictions accept that there is an implicit requirement that a SARE bankruptcy case be filed in good faith. There is a divide among the circuit courts concerning the determination of good faith and two distinct tests have emerged:

- Subjective Bad Faith (see Majority View: Subjective Bad Faith).
- Objective Bad Faith (see Minority View: Objective Bad Faith).

### MAJORITY VIEW: SUBJECTIVE BAD FAITH

Most circuit level courts follow a test of subjective bad faith. This test is based on a variety of nonexhaustive factors evidencing a bad faith filing by a SARE debtor. These factors include whether:

- The debtor has only one asset (the property).
- The debtor has few unsecured creditors whose claims are small in relation to the claims of the secured creditors.
- The debtor has few (or no) employees.
- The property is the subject of a foreclosure action resulting from arrearages on the debt.
- The debtor's financial problems involve a dispute between the debtor and the secured creditors that can be resolved in the pending state court action.
- The timing of the debtor's filing evidences an intent to delay or frustrate the legitimate efforts of the debtor's secured creditors to enforce their rights.

(*Phoenix Piccadilly, Ltd. v. Life Ins. Co. of Va. (In re Phoenix Piccadilly, Ltd.)*, 849 F.2d 1393 (11th Cir. 1988).)

Subjective bad faith examines the debtor's internal motivation for filing the petition and requires a debtor's honest intention to reorganize its financial affairs in accordance with the policies underlying the Bankruptcy Code (see *In re Setzer*, 47 B.R. 340 (Bankr. E.D.N.Y. 1985)).

Any petition filed for an improper purpose inconsistent with those aims, or with the intent to gain an unfair advantage over creditors and other adverse parties, may be found to have been filed in subjective bad faith.

A SARE petition is generally filed in subjective bad faith when it is filed solely to cause hardship to creditors without any real ability or willingness to reorganize (or liquidate in an orderly manner) for the benefit of all parties in interest (see *Carolin Corp. v. Miller*, 886 F.2d 693, 702 (4th Cir. 1989)).

### MINORITY VIEW: OBJECTIVE BAD FAITH

In addition to the subjective bad faith test, other circuit courts, namely the US Courts of Appeal for the Second and Fourth Circuits, apply a two-step bad faith analysis that requires both:

- Objective futility of the reorganization process.
- Subjective bad faith in the filing of the petition or prosecution of the case.

To demonstrate objective bad faith, a party must show that the debtor's efforts to reorganize in Chapter 11 are objectively futile and there is no realistic possibility of reorganization (see *Carolin Corp. v. Miller*, 886 F.2d 693 (4th Cir. 1989)); *In re General Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009); *Kingston Square Assocs.*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997)). To meet the objective test for good faith, the SARE debtor must also have a potentially viable business to protect and reorganize.

Examples of factors that would satisfy the objective bad faith requirement include:

- The debtor's inability to obtain acceptance of the plan by an impaired class of creditors (§ 1129(a)(10), Bankruptcy Code).
- The debtor's proposed plan violates the absolute priority rule (§ 1129(b)(2)(B)(ii), Bankruptcy Code).

## STRATEGIES FOR SARE DEBTORS

The additional filing requirements and compressed deadlines may make it difficult for counsel and the debtor to successfully confirm a SARE Chapter 11 plan. Counsel and the SARE debtor must therefore properly prepare for the Chapter 11 filing to understand the benefits, burdens, and risks associated with filing a SARE Chapter 11 case. SARE debtors and their counsel should be aware of the:

- Dynamics between the parties.
- Relative strengths and weaknesses of each case.
- Stringent timelines.

### PRACTICAL CONSIDERATIONS FOR SARE DEBTORS

Despite the fact track deadline to file a plan or pay interest, filing a Chapter 11 case provides a SARE debtor with significant breathing space when it is faced with litigation or imminent foreclosure. The time in bankruptcy can allow a SARE debtor to:

- Sell the property in a section 363 sale (see Practice Note, Buying Assets in a Section 363 Bankruptcy Sale: Overview (*http://us.practicallaw.com/1-385-0115*)).
- Raise additional capital (see Practice Note, Loan-to-Own Strategies in Bankruptcy (*http://us.practicallaw.com/w-000-6314*)).
- Obtain new financing (see Practice Note, DIP Financing: Overview (*http://us.practicallaw.com/1-383-4700*)).

Before filing a SARE case, counsel should advise the debtor of the following considerations:

- **Costs of a Chapter 11 filing.** While a SARE Chapter 11 case typically has discreet issues and a shorter lifespan than a traditional Chapter 11, filing a SARE bankruptcy case should be carefully considered because of the high expenses associated with professional fees and formulating a restructuring strategy with counsel. Also, debtors should be aware that funds used to pay professionals in the case will reduce recoveries to creditors.
- **Negotiating with the lender early on.** Successful Chapter 11 cases are built on consensus. If possible, the debtor and its secured creditors should be discussing alternatives to filing. The parties can enter forbearance agreements to allow for negotiations rather than continued foreclosure or bankruptcy litigation (see Practice Note, Forbearance Agreements: Key Issues and Provisions (Commercial Real Estate Loans) (*http://us.practicallaw.com/2-567-2686*) and Standard Document, Forbearance Agreement (*http://us.practicallaw.com/1-524-1560*)). If a Chapter 11 filing cannot be avoided, the debtor and lender should negotiate a cash collateral order and agree on milestones for filing a plan or selling the property. A negotiated cash collateral order can often give the parties a roadmap and certainty of expectations (see Practice Note, Cash Collateral: Overview (*http://us.practicallaw.com/3-618-3450*)).
- **The ability to overcome plan confirmation issues.** If the SARE debtor cannot make monthly interest payments to its lender, the debtor's focus must be placed on confirming a plan of reorganization. The debtor will likely need experts to:
  - opine on the plan's feasibility; and
  - provide valuation evidence, including a qualified appraisal.

  Given the expedited timeline to file a plan, experts should be consulted early on in the case.
- **Tax benefits and implications.** Section 1146 of the Bankruptcy Code contains an exemption from stamp or similar taxes for an any asset transferred under a plan confirmed under section 1129 of the Bankruptcy Code (§ 1146(a), Bankruptcy Code). Although the circuit courts were divided about what constituted a sale "under a plan" for purposes of the tax exemption, the US Supreme Court resolved the split and adopted a bright line rule, holding that only transfers occurring after confirmation of a Chapter 11 plan are exempt from transfer taxes (see *Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33 (2008)). While this generally means that the tax exemption does not apply to section 363 sales, at least one court has ruled that section 363 sales approved pre-confirmation that close post-confirmation are exempt from transfer taxes if the transfer helps the implementation of the plan (see *In re New 118th, Inc.*, 398 B.R. 791, 797-98 (Bankr. S.D.N.Y. 2009)) (see Practice Note, Buying Assets Under a Chapter 11 Plan (*http://us.practicallaw.com/2-548-9145*)). A SARE debtor that chooses to sell its property through Chapter 11 must consider the tax implications of selling it in a separate section 363 sale or under a plan.

### TIMING FOR DESIGNATING AS A SARE

While section 362(d)(3) of the Bankruptcy Code expedites the plan process and drives the debtor to file a plan sooner than it would in a non-SARE case, the expedited timing requirements in section 363(d)

(3) are not triggered until either the:

- Debtor designates itself as a SARE on the petition or by motion.
- Secured creditor files a motion seeking a determination from the bankruptcy court that the debtor is a SARE entity.

Debtors in need of the extra time to file a plan or begin monthly payments should consider the time requirements and alter their strategies accordingly. Because many debtors will want as long as possible to file a plan or begin making monthly payments, a debtor may choose not to classify itself as a SARE debtor on its own and wait for the debtor's creditors or lenders to make a motion to designate.

Until there is a finding that the debtor is a SARE debtor, the time limits in section 362(d)(3) do not begin or expire (see *In re Abdulla*, 2009 WL 348365 (Bankr. D. Mass Feb. 6, 2009)). Therefore, if it is unclear to the debtor when completing the petition whether it meets the definition of SARE, it may be more appropriate for the debtor not to designate itself as a SARE. That will also offer more time for the debtor to benefit from the automatic stay while the SARE designation is later litigated with the secured creditor.

Lenders must be aware of a debtor's strategy to delay designation and protect their rights (see Strategies for Lenders).

### PAYING INTEREST OR FILING A PLAN

When preparing to file for Chapter 11, a SARE debtor should try to conserve cash. The cash preserved before filing can be used to make payments to the secured creditor at the loan's contract nondefault rate. Alternatively, if a debtor's property generates revenues or it obtained financing from a third party, it can use those funds to make interest payments to the secured lender.

When a debtor cannot make interest payments because it does not have enough revenue or financing, it can achieve additional time in bankruptcy by filing a plan. The requirement that a SARE debtor file a plan that has a reasonable possibility of being confirmed or risk lifting the automatic stay in favor of the secured lender is a less stringent standard than in other contexts of the Bankruptcy Code (§ 1112(b)(2)(A), Bankruptcy Code). The SARE debtor does not need to demonstrate that its plan will **actually** be confirmed and is not required to present the same level of evidence that is required at a confirmation hearing. Rather, it must produce enough evidence at a hearing to lift the automatic stay that there is a reasonable possibility to confirm the plan in a reasonable period of time (see *In re Bonner Mall P'ship*, 2 F. 3d 899 (9th Cir. 1993); *In re Trigee Found., Inc.*, 2013 WL 1401889 (Bankr. D.D.C. Apr. 8, 2013)).

### SEPARATE CLASSIFICATION OF DEFICIENCY CLAIM

The Bankruptcy Code permits a secured claim to be bifurcated when the value of the property is insufficient to fully satisfy a secured claim and the creditor is undersecured. In those instances, the creditor receives a secured claim to the extent of the collateral's value and an unsecured deficiency claim equal to the amount by which the claim exceeds the collateral value (§ 506(a), Bankruptcy Code).

In a typical SARE case, the secured lender's deficiency claim is the largest unsecured claim and would dominate the class if all unsecured creditors were classified in a single class. This can present a problem for a SARE debtor to confirm a plan with an impaired consenting class when the secured lender may not agree on the terms of the plan. A possible solution is to separately classify a secured creditor's unsecured deficiency claim from the claims of other unsecured creditors. Courts, however, are split on whether this is permitted and the analysis is fact and case specific.

When assessing the permissibility of separately classifing a deficiency claim, courts examine whether the deficiency claim of the secured creditor is "substantially similar" to the claims of general unsecured creditors (§ 1122(a) of the Bankruptcy Code) (see Practice Note, Chapter 11 Plan Process: Overview: Classification and Treatment of Claims and Interests (*http://us.practicallaw.com/0-502-7396#a564052*)). A few courts that have permitted separate classification of a deficiency claim have considered the existence of a third-party source of payment, including a guarantor. In *In re Loop 76 LLC*, the court permitted separate classification of the deficiency claim because the secured creditor held a personal guaranty which the court found made the deficiency claim not "substantially similar" to other unsecured claims because the secured creditor had access to another source of recovery not available to other creditors (see Wells *Fargo Bank, N.A. v. Loop 76 LLC (In re Loop 76 LLC)*, 465 B.R. 525 (Bankr. 9th Cir. 2012)).

However, most courts have declined to permit separate classification of a deficiency claim, holding that the presence of a personal guarantee for an unsecured claim of a partially secured lender, alone, is insufficient to support separate classification of that claim under section 1122(a) of the Bankruptcy Code (see *Boston Post Rd. Ltd. P'ship v. Fed. Deposit Ins. Corp. (In re Boston Post Rd. Ltd. P'ship.)*, 21 F.3d 477 (2d Cir. 1994); *In re 18 RVC, LLC*, 485 B.R. 492, 492 (Bankr. E.D.N.Y. 2012); see Section 506(a) Secured Claim and Deficiency Claim).

## STRATEGIES FOR LENDERS

SARE debtors typically prefer to stay in Chapter 11 for as long as possible with the hope that they can reorganize if either:

- The local real estate market improves.
- Rents or other income derived from the property increase.

To mitigate a debtor's ability to prolong its Chapter 11 case, there are various strategies that a secured lender can use to protect the value of its collateral, including:

- Moving to designate the debtor as a SARE (see Motion to Designate as a SARE).
- Moving to lift the automatic stay (see Motion for Relief from the Automatic Stay).
- Leveraging its deficiency claim (see Section 506(a) Secured Claim and Deficiency Claim).
- Making a section 1111(b) election (see Section 1111(b) Election).

### MOTION TO DESIGNATE AS A SARE

A lender must be vigilant in protecting its secured interest and ensuring that the value of its collateral does not deteriorate. If a SARE debtor has not checked the appropriate box on the petition designating itself a SARE case, the secured lender should immediately make a motion for the court to determine that the debtor's case is a SARE. The timing for making a motion is critical because the clock on the debtor's time to file a plan or make interests payments does not begin until the debtor's case is deemed a SARE (see Timing for Designating as a SARE).

The lender's motion to designate the debtor a SARE should:

- Seek an order that the debtor is a SARE nunc pro tunc to the petition date to preserve the 90 day deadline.
- Provide appropriate evidentiary proof that the debtor qualifies as a SARE under the definition of the Bankruptcy Code (see Definition of a Single Asset Real Estate Debtor).

### MOTION FOR RELIEF FROM THE AUTOMATIC STAY

Some courts have held that secured creditors are precluded from seeking relief from the automatic stay against a SARE debtor until the expiration of the 90-day period in section 362(d)(3) of the Bankruptcy Code (see *In re Hope Plantation Grp.*, 393 B.R. 98, 102-103 (Bankr. D. S.C. 2007)).

Other courts have allowed secured creditors in SARE cases to make a motion before the 90-day period expires, relying on the independent grounds for relief from the stay under section 362(d)(1), including:

- A lack of adequate protection.
- The debtor does not have equity in the property.
- The property is not necessary to an effective reorganization.

(See *Duvar Apt., Inc. v. Fed. Deposit Ins. Co. (In re Duvar Apt., Inc.)*, 205 B.R. 196, 200 (9th Cir. BAP 1996).)

If possible, lenders should consider making a motion for relief from the automatic stay early on in the case and include as many grounds for relief as practicable. This puts the judge on notice of the lenders' concerns at the start of the case and can help frame the course of the bankruptcy.

For more information on the automatic stay, see Practice Note, Automatic Stay: Lenders' Perspective: Relief From the Stay (*http://us.practicallaw.com/9-380-7953#a323739*).

### SECTION 506(A) SECURED CLAIM AND DEFICIENCY CLAIM

Under section 506(a) of the Bankruptcy Code, a secured creditor's claim is secured only to the extent of the collateral's value. If the value of the collateral is insufficient to fully satisfy a secured claim, the creditor is undersecured and receives two claims:

- A secured claim up to the value of the property.
- An unsecured deficiency claim equal to the amount by which the claim exceeds the property value (§ 506(a), Bankruptcy Code).

The creditor can then vote separately on the plan in each class in which it holds a claim (Fed. R. Bankr. P. 3018(d)).

The secured lender must protect its ability to vote its deficiency claim and ensure that the bankruptcy court does not permit the debtor to separately classify the deficiency claim (see Separate Classification of Deficiency Claim). The unsecured deficiency claim is often large enough to dominate the general unsecured class and control the vote of the class. Because the debtor will typically need the general unsecured class of creditors to be its impaired accepting class under section 1129(a)(10) of the Bankruptcy Code, the secured creditor will obtain leverage in negotiations with the debtor by controlling the amount of the class.

### SECTION 1111(B) ELECTION

Sometimes the Bankruptcy Code allows an undersecured creditor to waive its unsecured deficiency claim and elect to treat the entire face value of its claim as fully secured (known as the "section 1111(b) election") (§ 1111(b)(2), Bankruptcy Code). In doing so, the creditor would continue to be secured only by the assets that gave it partial security, which could be any amount up to the full value of its claim (if the collateral appreciates).

An undersecured creditor that makes the section 1111(b)(2) election is therefore entitled to have its entire claim treated under a plan (even a cramdown plan) as secured. If this election is made, the plan then must provide that the electing creditor will:

- Be paid the full amount of its claim (the face amount of its debt, not the undersecured collateral value).
- Retain its lien until the full amount of the claim is paid.

An election to be treated as fully secured must be approved by at least two-thirds in amount and more than one-half in number of the claims. A section 1111(b) election, however, may not be made if the underlying property is of inconsequential value or if the holder of the claim has recourse against the debtor on its claim and such property is being sold or is going to be sold under a plan.

A secured creditor's decision to make an 1111(b)(2) election in a SARE case often depends on whether it believes the value of the property will increase with time. If a secured creditor believes the value of the property will increase, it may make the strategic decision to make an 1111(b)(2) election and give up the benefit of receiving an unsecured deficiency claim in exchange for receiving the benefit of a fully secured claim. While this allows the creditor to capture the increased value of its property, the secured creditor is no longer part of the unsecured class for distribution or voting purposes.

The section 1111(b) election also protects the secured creditor against a quick sale of its collateral. If the collateral appreciates in value after confirmation of the plan and the debtor sells it, the secured creditor's lien attaches to the sale proceeds and entitles it to payment up to the full value of its claim. Without the section 1111(b) election, the debtor could sell the collateral opportunistically and keep the proceeds.

For more information on the section 1111(b) election, see Practice Note, The Section 1111(b) Election (*http://us.practicallaw.com/7-609-5507*).

#### When Lenders Should Think About Making the Election

The primary reasons a creditor makes a section 1111(b) election are:

- The court has undervalued the collateral or the collateral is likely to appreciate in value (see Practice Note, The Section 1111(b) Election: Collateral Undervalued or Likely to Appreciate (*http://us.practicallaw.com/7-609-5507#a690614*)).
- The creditor wants to receive better treatment for its claim under the plan or wants to block confirmation of the plan (see Practice Note, The Section 1111(b) Election: Plan Confirmation and Cramdown (*http://us.practicallaw.com/7-609-5507#a427626*)).
- Unsecured claims receive few or no distributions under the plan (see Practice Note, The Section 1111(b) Election: Unfavorable Plan Treatment of Unsecured Claims (*http://us.practicallaw.com/7-609-5507#a951011*)).

- The creditor wants to retain the collateral (see Practice Note, The Section 1111(b) Election: Surrender of Collateral (*http://us.practicallaw.com/7-609-5507#a380856*)).
- To avoid valuation difficulties (see Practice Note, The Section 1111(b) Election: Valuation Difficulties (*http://us.practicallaw.com/7-609-5507#a974536*)).

Ultimately the creditor must evaluate whether the present value of the payments received on its secured claim, together with the present value of the payments it is entitled to under the plan on its unsecured claim, is greater than the potential payments it may receive if the entire claim is treated as secured. If not, then the creditor should strongly consider making the election.

### Time of Election

A creditor can make a section 1111(b) election any time before the end of the disclosure statement hearing or within a later time fixed by the court (Fed. R. Bankr. P. 3014). This gives the creditor at least 28 days to explore its options under the debtor's plan before it makes the election (Fed. R. Bankr. P. 3017(a)). If material factual issues, such as valuation of the collateral or the cramdown interest rate, are not determined until the plan confirmation hearing, the parties should consider requesting that the court set a later deadline for the election or allow an election to be withdrawn under specified conditions before the disclosure statement hearing.

The creditor may be uncertain whether to make the election until it knows what treatment the debtor is proposing for its secured claim and for the class of unsecured claims. Therefore, some courts have required that the debtor explain the consequences of the election in the disclosure statement and propose an alternative plan if the creditor makes the election. Alternatively, the parties can resolve this issue through informal negotiation.

### Exceptions to Making an 1111(b) Election

The section 1111(b) election cannot be made under either of the following circumstances:

- The creditor's lien is of "inconsequential value" (for example, a low priority junior lien that is primarily unsecured) (§ 1111(b)(1)(B)(i), Bankruptcy Code). The Bankruptcy Code does not define inconsequential value. Most courts have held that if there is some collateral value, the creditor can make the election (see *In re Baxley*, 72 B.R. 195, 198 (Bankr. D. S.C. 1986)). Junior lienholders that are completely unsecured are deemed to have inconsequential value (see *In re 500 Fifth Ave. Assocs.*, 148 B.R. 1010, 1016 (Bankr. S.D.N.Y. 1993)).
- The class has recourse against the debtor and the collateral was sold in a section 363 sale or will be sold under the plan (see Practice Notes, Buying Assets in a Section 363 Bankruptcy Sale: Overview (*http://us.practicallaw.com/1-385-0115*) and Buying Assets Under a Chapter 11 Plan (*http://us.practicallaw.com/2-548-9145*)) (§ 1111(b)(1)(B)(ii), Bankruptcy Code). This is because in either case the creditor can retain the benefit of its bargain by credit bidding for its collateral, and therefore requires no special protection (see Practice Note, Credit Bidding in Section 363 Bankruptcy Sales (*http://us.practicallaw.com/7-500-4339*)). However, some courts have held that a creditor has the right to make the election where the collateral is to be sold under a plan that:
  - provides for a sale that does not give the creditor the right to credit bid (see *Tampa Bay Assocs., Ltd. v. DRW Worthington, Ltd. (In re Tampa Bay Assocs., Ltd.)*, 864 F.2d 47, 50 (5th Cir. 1989));
  - provides for a sale that is indefinite and not substantially contemporaneous with plan confirmation (see *In re Matrix Dev. Corp.*, 2009 WL 2169717, at *8 (Bankr. D. Or. July 16, 2009); and
  - is not a liquidating plan (see *In re H & M Parmerly Farms*, 127 B.R. 639, 643 (Bankr. D.S.D. 1989)).