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The Time Has Come to Suspend the SARE Provisions

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The world has just experienced once-in-a-lifetime medical and economic conditions resulting from a worldwide COVID-19 pandemic — and we are not done yet. There is a time lag between a pandemic and its full impact on real estate markets. Although every American might soon be vaccinated and be able to go shopping and resume travel, the impact on real estate values will be felt for years to come. According to the Commercial Real Estate Development Association, commercial real estate development and operations contribute in excess of $1 trillion to U.S. gross-domestic product.[2] The Bankruptcy Code should be amended to enable the bankruptcy court to be a better venue for value preservation of real estate. Unfortunately, it currently is not. Suspension of restrictions on single-asset real estate (SARE) cases offer a clear solution to preserve real estate value while reinforcing the balance of socio-economic and equitable considerations.

Bankruptcy Court's Equitable Role

Bankruptcy laws embody a compromise between social and economic objectives. The nature of the compromise varies from time to time, as public values and economic conditions dictate. Bankruptcy law is implemented by using both legal and equitable procedures. The function of bankruptcy courts is to implement the social policy set forth in bankruptcy law: A recognition that reorganization is a good thing, and that there is more value in reorganization than in liquidation.[3] Currently, as written, the Code is not a vehicle for reorganization by SARE debtors, which suffered a broadside attack from the COVID-19 pandemic. It should be such a vehicle because too much of the U.S. economy's worth is tied up in real estate for it not to be.

Characterization of bankruptcy courts as courts of equity has been used to define the scope of the courts' jurisdiction and authority. The phrase "court of equity," which conjures up a variety of popular sentiments — fairness, justness, right-dealing, inclusion and flexibility — has been used to legitimize the social policy embedded in bankruptcy law. As a court of equity, a judge may justify expansion, restriction or modification of statutory law to achieve justice in a particular case. Finally, powers of a court of equity are often invoked by litigants who desire a result that seems fair to them, but that may be at variance with the law.[4]

There are times when the interpretation of certain Code provisions, as well as the court's discretionary rulings, might reflect the macroeconomic circumstances at the time. Good examples are compassionate rulings during the Great Recession that may have, on balance, strayed from strict adherence to the Code in approving expedited § 363 sales, but nevertheless preserved jobs during a period of high unemployment.

Economic Uncertainty

Shortly after the COVID-19 pandemic began in early 2020, bankruptcy courts, not knowing how long the shutdown caused by the pandemic would last, issued "mothball" orders in retail chapter 11 cases in the recognition that such debtors simply were unable to operate their businesses. Despite the general mandate of the Bankruptcy Code that post-petition rent be timely paid, rent due during the first 60 days of the case could be deferred pursuant to such orders. In other words, bankruptcy courts chose to give retail debtors a "break," given the extraordinary external circumstances foisted upon them. This was recognition by the courts of larger *macro*economic, systemic circumstances *beyond the debtor's control*. Further, the circumstances were also beyond the control of the debtor's secured creditor. Although the relief was vigorously opposed by landlords, bankruptcy courts looked beyond the facts of each case in determining a fair interpretation and application of the law. In other words, they took a macro view.

Look at the real estate market a year into the COVID-19 pandemic. As of November 2020, the delinquency rate for commercial mortgage-backed securities (CMBS) loans was approximately 20 percent for hotels and 14 percent for retail, according to a real estate consulting firm, Trepp.[5]

1 The views expressed herein are those of the authors and are not necessarily shared by others at Lowenstein Sandler LLP.

2 "Commercial Real Estate Development and Operations Support 8 Million Jobs, Contributes More than $1 Trillion to the Economy," NAIOP (Feb. 3, 2021), *available at* naiop.org/en/Research-and-Publications/News/NAIOP-News/2021/Commercial-Real-Estate-Development-and-Operations (unless otherwise specified, all links in this article were last visited on May 24, 2021).

3 Marcia S. Krieger, "'The Bankruptcy Court Is a Court of Equity': What Does That Mean?," 50 *S. C. L. Rev.* 276 (1999).

4 Id. at p. 297.

5 "CMBS Delinquency Rate Slips Modestly in November," Trepp (Dec. 2, 2020), *available at* info.trepp.com/hubfs/Trepp%20CMBS%20Delinquency%20Report%20November%202020.pdf.

A Bloomberg analysis explained that the pandemic has upset real estate fundamentals by changing how we lead our lives.[6] COVID-19 has reshaped where people live, work and shop. The remote-work experiment thrusted on employers will become a permanent trend, but at some point, employees will return to the office in numbers that match the past. As for when that might happen, it could take *five years*, according to a new forecast from Cushman & Wakefield.[7] Global office vacancies might not return to their pre-pandemic peak levels until 2025.[8]

COVID-19 and Property Values

The pandemic has also taken a big bite out of property values. According to a recent *New York Times* article, commercial real estate values are projected to decline by 7.2 percent nationally from pre-COVID-19 levels.[9] The hardest hit categories are the office and retail sectors, with values declining by 12.6 percent for offices and 16.5 percent for retail.[10] A recent Bloomberg article showed New York retail, hotel and office building values declining by 21.1, 22.4 and 15.6 percent, respectively.[11] CB Richard Ellis (CBRE) predicts that there will be 20 percent less retail space nationally by 2025.[12] Wendy Silverstein, a former executive at Vornado Real Estate Trust, has stated that in 2020, property owners just put "bandages"[13] on their problems, and that these stopgap measures are now coming to a conclusion. Lenders have granted struggling borrowers months of forbearance, but that is set to change soon. Now the issue will be whether to put more money into the property, surrender the property, or something else — such as file for bankruptcy.

Silverstein has also stated that there has been substantial collateral damage that will be hanging around for a while.[14] The ripples in the pond are getting wider and wider. When real estate prices decline, wealth also declines, and individuals and businesses are less likely to borrow and spend. So there is reason to worry. According to Bloomberg, $430 billion in commercial and multifamily real estate debt matures in 2021 alone.[15] The rebound to pre-COVID-19 levels could take until 2022, and more than $2 trillion of commercial loan debt matures through 2025.[16] The problem is *not* going away anytime soon.

SARE Cases

Under the Bankruptcy Code, the definition of single asset real estate (SARE) includes the following types of properties: (1) shopping centers; (2) office buildings; (3) industrial and warehouse buildings; and (4) apartment complexes.[17] It is shopping centers and office buildings that have been hit the hardest by the COVID-19 pandemic, as they have suffered the most devaluation and will take the longest to recover. To maintain the automatic stay, § 362(d)(3) of the Bankruptcy Code requires a SARE debtor to do one of the following:

- File a reorganization plan that has a reasonable possibility of being confirmed within a reasonable time; or
- Begin making monthly interest payments to the lender at the original contract rate, which 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), or
  - 30 days after the court determines whether a debtor is a SARE debtor.[18]

We are about to see billions (maybe trillions) of dollars of real estate go through several years of restructuring. For SAREs, bankruptcy today is *not* an option, but it should be.

The SARE debtor could not promulgate a confirmable reorganization plan that gives the lender a large deficiency claim, because the lender would then hold a blocking position on votes. The interest payments must be made from *rents generated from the property*. Further, the interest payments at the *nondefault contract rate* must be on the *value of the lender's interest* in the real estate. The debtor could not make interest payments on the actual reduced value of the lender's interest due to rents having declined.

So, access to the bankruptcy court by SARE debtors simply does not make sense. Providing only 90 days to re-tenant or to return to market normalcy is unreasonable. Being unable to subsidize the property from non-rent sources makes no sense.

In addition, SARE's definition does not give any discretion to bankruptcy courts to distinguish between (1) a mall that is "dead" because the surrounding neighborhood has undergone a demographic change or socioeconomic decline, is redundant, has been superseded by something bigger and better, or has failed due to a lack of capital improvement by its owners; (2) an undeveloped landfill; (3) a state-of-the-art "green" office building with modern ventilation and air-filtration systems; (4) an office building where updating is too expensive to make the property competitive in an already overbuilt market; or (5) a mall that suddenly hemorrhaged as a result of the loss of retail tenants due to the unanticipated pandemic, but nevertheless is in a high-traffic, desirable demographic area and is poised for a comeback.

A good example of the latter is the Palisades Center Mall in West Nyack, N.Y., which saw its value drop from

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6 Noah Buhayar, John Gittlesohn & Jackie Gu, "Commercial Real Estate's Pandemic Pain Is Only Just Beginning," Bloomberg (Dec. 22, 2020), *available at* bloomberg.com/graphics/2020-commercial-real-estate.
7 "Global Office Impact Study and Recovery Timing Report," Cushman & Wakefield (Sept. 22, 2020), *available at* cushmanwakefield.com/en/insights/covid-19/global-office-impact-study-and-recovery-timing-report.
8 *Id.*
9 Alan Rappeport, "Empty Office Buildings Squeeze City Budgets as Property Values Fall," *New York Times* (March 3, 2021), *available at* nytimes.com/2021/03/03/business/pandemic-city-budgets.html.
10 *Id.*
11 Martin Z. Braun, "NYC Property Values Decline 5% as Offices and Hotels Stand Empty," Bloomberg (Jan. 15, 2021), *available at* bloomberg.com/news/articles/2021-01-15/nyc-property-values-decline-5-as-offices-and-hotels-stand-empty.
12 "2021 U.S. Real Estate Market Outlook," CBRE, *available at* cbre.us/research-and-reports/US-Real-Estate-Market-Outlook-2021 (as of March 18, 2021).
13 *See* Buhayar, Gittlesohn & Gu, *supra* n.6.
14 *Id.*
15 *Id.*
16 *Id.*
17 *See* 11 U.S.C. § 101(51B).
18 *See* 11 U.S.C. § 362(d)(3).

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$881 million to $425 million as a result of the loss of such tenants as JC Penney, Lord & Taylor and other retailers during the retail apocalypse of 2019-20.[19] The mall is relatively new, still retains Target, Macy's, BJ's Wholesale Club and Home Depot, and is located on one of the busiest roads in the state, connecting some of the densest communities. These factors do not count in the SARE equation when the bankruptcy court evaluates the value of the lender's interest.

The rationale behind a bankruptcy court mothballing a retailer's chapter 11 case and deferring rent was that even if the court permitted the debtor's secured lender to foreclose and take possession of its collateral, there would have been nothing better the lender could do with the assets. A liquidator could not have run a going-out-of-business sale. In other words, a "macro" circumstance crippled everyone alike, including the secured lender. It is the same with a mortgagee seeking to foreclose on SAREs that have suffered from a macroeconomic or systemic devastation. The foreclosing mortgagee will simply not be able to create any higher demand from prospective tenants than from the SARE debtor, especially where macroeconomic or systemic circumstances have distorted market conditions.

The bankruptcy court is capable of distinguishing whether value or tenancy is depressed because of (1) macroeconomic or systemic circumstances; or (2) a lack of capital investment, mismanagement or changes in local market conditions. In the case of the former, the debtor should be given more time than § 362(d)(3) currently permits, so market distortion may be corrected and conditions normalized.

If the bankruptcy court grants stay relief to the mortgagee to enable it to monetize its collateral, it is simply enabling the current mortgagee's transferee to capture the inordinate appreciation, which may follow eventually from an inordinate systemic devaluation. In other words, cash out at the very bottom, flush the equityholders, and capture all of the upside on the way up from the return to *normal market conditions*.

We are about to see billions (maybe trillions) of dollars of real estate go through several years of restructuring. For SAREs, bankruptcy today is *not* an option, but it should be. However, 90 days may be far too short for the bankruptcy court or anyone else to figure out a strategic plan for a property. The word "may" is being used here in order to be cautious about generalizing. Not all properties fall into the category of "[i]f it weren't for the ripple effect of the pandemic, we wouldn't be here."

With stay relief now (or 90 days from now), the lender will be able to do nothing other than dump its collateral at a deep discount at the bottom of the market. The equity owner will be suffering from long-term market conditions beyond its control. If the goal of seeking relief from the automatic stay is to permit the lender to liquidate its collateral, then it should sell its claim. The financial markets are sufficiently liquid for that purpose. As the authors heard a lender once say many years ago, "What is the business of a bank today? It is not to make and manage loans. It is to originate loans [and sell them]."

The bankruptcy court has the ability and discretion to ensure that there is no abuse of lenders by debtors, while at the same time giving debtors a reasonable period within which to reorganize. In addition, the bankruptcy court has the expertise to distinguish between debtors who are victims of macroeconomic effects and those seeking chapter 11 relief due to mismanagement, obsolescence and excessive leverage. abi

19 Sasha Jones, "Palisades Center Worth Half What It Was in 2016: Appraisers," *The Real Deal* (Dec. 21, 2020), *available at* therealdeal.com/tristate/2020/12/21/palisades-center-worth-half-what-it-was-in-2016-appraisers.

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