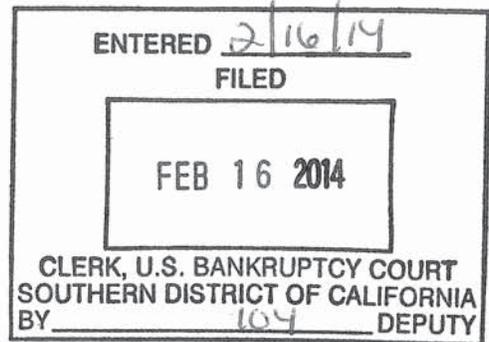


WRITTEN DECISION – FOR PUBLICATION



UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF CALIFORNIA

12	In re:)	Case No. 13-09784-CL11
13)	Chapter 11
14)	MEMORANDUM DECISION AND
15	SR REAL ESTATE HOLDINGS, LLC,)	ORDER DISMISSING DEBTOR'S
16)	CASE
17)	Judge: Christopher B. Latham
18	Debtor.)	
19)	
20)	

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**MEMORANDUM DECISION AND
ORDER DISMISSING CASE**

8 For the following reasons, the court finds that Debtor’s case was filed in bad faith and so
9 **dismisses it.**

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Background

20 The material facts in this case are not in dispute. In June 2000, Blackhawk Financial
21 Corporation (“Blackhawk”) lent Sargent Ranch, LLC (“Sargent”) \$15 million at a 15% non-default
22 interest rate. Adams Decl. ¶ 14, ECF No. 5; Debtor’s Req. for Judicial Notice, Ex. 3, ECF No. 86-4.
23 Sargent used these funds to purchase 6,400 acres of undeveloped real property near Gilroy, California
24 (the “Property”). Adams Decl. ¶ 14. It planned to develop the Property for a variety of residential,
25 industrial and commercial uses. Adams Decl. ¶ 12. And Sargent encumbered the Property with a first
26 deed of trust to secure the loan. Adams Decl. ¶ 14. Later, in November 2000, Blackhawk increased
27 the loan’s principal amount to \$25 million. Adams Decl. ¶ 14. Blackhawk also issued a second loan to
28 Sargent for another \$15 million, this time apparently at a 31% interest rate. Adams Decl. ¶ 15. A
second deed of trust on the Property secured this second loan. Adams Decl. ¶ 15. Blackhawk then
fractionalized¹ both loans and sold individual interests in them to various investors (the “First
Lienholders” and “Second Lienholders,” respectively). ¶¶ 14-15.

In October 2003, Blackhawk loaned Sargent an additional \$3 million. Adams Decl. ¶ 16. A
third deed of trust encumbered the Property and secured the Third Loan. Adams Decl. ¶ 16. And
Blackhawk again fractionalized and sold the loan to individual investors (the “Third Lienholders”).
Adams Decl. ¶ 16. Many of the individual interest holders were neighbors, friends and colleagues who
lived in northern California. Adams Decl. ¶ 17. Consequently, the holders did not enforce the note for
many years. Adams Decl. ¶ 17. But the Property remained undeveloped, and in late 2009 the First
Lienholders directed the Third Lienholders to foreclose on the Property. Adams Decl. ¶¶ 18-19. On

¹ Mr. Adams’s declaration states that Blackhawk “factionalized” the loans. Although this description is undoubtedly apt, the court finds it likely that Mr. Adams meant Blackhawk “fractionalized” the loans.

1 January 4, 2010, before the Third Lienholders could conduct a foreclosure sale, Sargent filed a
2 voluntary Chapter 11 petition in Case No. 10-00046-PB11 (the “First Case”).

3 4 **The First Bankruptcy**

5 The court found Sargent to be a single asset real estate (“SARE”) debtor under 11 U.S.C.
6 § 101(51B), subject to the hastened program described in 11 U.S.C. § 362(d)(3). First Case, ECF
7 No. 118. To aid in its reorganization, Sargent employed The Watley Group , LLC (“Watley”) as its
8 exclusive investment banker. Watley provided Sargent, *inter alia*, a new CEO and several Managing
9 Directors. First Case, ECF No. 104. But after nearly a year as debtor-in-possession, Sargent had not
10 obtained approval of its disclosure statement, let alone confirmed a plan. And on December 28, 2010
11 the court directed the United States Trustee to appoint a Chapter 11 Trustee in the case. First Case,
12 ECF No. 223. In describing the case, the Chapter 11 Trustee stated,

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14 [D]ue to the lack of management mechanisms for the loans[], there is a deadlock of
15 control among various interest holders in the first, second, and third trust deeds – some of
16 whom own significant interests in each of the levels of debt – resulting in disagreement
17 and distrust over the decisions with regard to the loans, and allegations of conflicts of
18 interest. In short, there is no single party with decision-making authority that could
19 authorize the employment of non-bankruptcy remedies for the benefit of the beneficiaries
20 of the deeds of trust.

21 First Case, ECF No. 257.

22 On May 17, 2011, the court gave notice of its intent to convert the case to Chapter 7. First
23 Case, ECF Nos. 324 & 325. On June 20, it held a hearing. First Case, ECF No. 336. And on July 22,
24 it converted the case. First Case, ECF No. 338. In its conversion order, the court stated that “[t]he
25 case has been through Mr. Pierce as manager, then the Watley Group, and then a Chapter 11 trustee.
26 There does not appear to be a solution in the bankruptcy arena for this property and these parties.”
27 First Case, ECF No. 338. The United States Trustee then appointed a Chapter 7 Trustee, who
28 promptly abandoned the Property. First Case, ECF Nos. 338 & 345.

1 **The Instant Bankruptcy**

2 In early December 2011, the Third Lienholders conducted their foreclosure sale and
3 successfully took title to the Property. Adams Decl. ¶ 30. Shortly thereafter, they created SR Real
4 Estate Holdings, LLC (“Debtor”). Adams Second Decl. ¶ 26, ECF No. 84-1. And, eventually, they
5 transferred the Property to Debtor. Adams Second Decl. ¶ 27. On August 14, 2012, the notes’ servicer
6 – Sargent Ranch Servicing Corporation – recorded “Majority Action Affidavit #1” against the
7 Property. Adams Second Decl. ¶ 31; Debtor’s Req. for Judicial Notice, Ex. 1 at ECF No. 86-1.

8 The affidavit directed the servicer to pursue a global settlement to the various lienholders’
9 disputes. Adams Second Decl. ¶ 32. It provided the Property’s transfer to the First Lienholders, and a
10 payment waterfall from the Property’s proceeds. Adams Second Decl. ¶ 32. But a majority of the
11 First Lienholders then emerged in support of foreclosure on the first trust deed. Adams Decl. ¶ 32.
12 They scheduled a foreclosure sale for August 21, 2013. Adams Decl. ¶ 32. And on August 20, Debtor
13 filed a voluntary Chapter 11 petition in the above-captioned case. Debtor’s Petition, ECF No. 1.

14 Debtor’s manager – Mr. Norman I. Adams – provided a declaration to support its petition. This
15 declaration stated, “Debtor intends to promptly propose and seek confirmation of a viable plan of
16 reorganization [It] intends to proceed on the schedule required of single asset real estate debtors
17 if not even faster.” Adams Decl. ¶ 34. Debtor’s schedules valued the Property at \$15 million.
18 Debtor’s Schedule A, ECF No. 25. But no payments had been made to the First and Second
19 Lienholders for approximately thirteen years. As such, secured claims against the estate totaled an
20 astounding \$548 million: \$142 million for the First Lienholders, and \$406 million for the Second
21 Lienholders. Debtor’s Schedule D. Debtor scheduled both unsecured claims and personal property at
22 approximately the same amount: \$16,500. Debtor’s Schedules B & F.

23 On October 7, creditors DACA 2010L, L.P. and Sargent Ranch Management Company, LLC
24 (collectively, “DACA”) moved to dismiss Debtor’s case as a bad faith filing. ECF No. 57. The
25 motion alternatively sought: (1) an order finding Debtor to be a SARE debtor; and (2) relief from the
26 automatic stay. Creditors First Priority Lenders (“FPL”) joined DACA’s motion to dismiss. ECF
27 No. 93. And Debtor brought opposition. ECF No. 84. This opposition explicitly affirmed that Debtor
28 “does not contest that it is a SARE and consents to the Court making such a finding” ECF

1 No. 84. It also twice stated that Debtor would file its plan shortly, and within the SARE deadlines.
2 ECF No. 84. No other parties came forth to oppose the motion. And DACA and FPL replied. ECF
3 Nos. 100 & 101.

4 On November 4, the court held a hearing. ECF No. 106. The hearing's minute order indicated
5 that the court took the matter under submission, but that DACA's counsel – William M. Rathbone,
6 Esq. – was to prepare and lodge an order designating this case a SARE case. ECF No. 106. Three
7 days later, Mr. Rathbone submitted his proposed order (the "SARE Order"). Although he did not
8 lodge it, Debtor's counsel approved it as to form.

9 Then, on January 9, 2014, the court transferred this case from Judge Peter W. Bowie to Judge
10 Christopher B. Latham. ECF No. 128. The next day, having reviewed the record, Judge Latham
11 signed Mr. Rathbone's proposed order. ECF No. 135. The court entered the order on January 13.
12 ECF No. 135. And on January 14, Debtor filed an emergency motion to vacate or stay the SARE
13 Order. ECF No. 136. Despite Debtor's prior statements about its intent to promptly prepare a plan, it
14 asserted that – because the court has potentially case dispositive motions under submission – the funds
15 Debtor expends preparing a confirmable plan may go to waste. ECF No. 136. It therefore argued that
16 entering the SARE Order caused it extreme prejudice. ECF No. 136. After examining the language
17 and intent of § 362(d)(3), however, the court disagreed with Debtor and denied the emergency motion.
18 ECF No. 145.

19 The court then held a status conference on this case, and Judge Latham heard renewed oral
20 argument on February 12. ECF No. 148. Before the hearing, the court issued a tentative ruling that
21 granted DACA's motion to dismiss. ECF No. 160. At the hearing's close, the court affirmed and
22 adopted its tentative ruling. But it indicated that it would enter a separate order dismissing Debtor's
23 case. The court accordingly **grants** DACA's motion and **dismisses** the case.

24 Discussion

25
26 Section 1112(b) allows the court broad discretion to convert or dismiss a case for cause. And
27 cause exists where a debtor lacks good faith in filing its case. *Matter of Little Creek Development Co.*,
28 779 F.2d 1068, 1072 (5th Cir. 1986). "The existence of good faith depends on an amalgam of factors

1 and not upon a specific fact. *Matter of Little Creek Development Co.*, 779 F.2d at 1072. The
2 bankruptcy court should examine the debtor’s financial status, motives, and the local economic
3 environment. *Id.*” *In re Arnold*, 806 F.2d 937, 939 (9th Cir. 1986).

4 If it is obvious that a debtor is attempting unreasonably to deter and harass creditors in
5 their bona fide efforts to realize upon their securities, good faith does not exist. But if it
6 is apparent that the purpose is not to delay or defeat creditors but rather to put an end to
7 long delays, administration expenses . . . to mortgage foreclosures, and to invoke the
8 operation of the [bankruptcy law] in the spirit indicated by Congress in legislation,
9 namely, to attempt to effect a speedy efficient reorganization, on a feasible basis . . . good
10 faith cannot be denied.

11 *Id.* (quoting *In re Thirtieth Place, Inc.*, 30 B.R. 503, 505 (B.A.P. 9th Cir. 1983)).

12 In addition,

13 Findings of lack of good faith in proceedings based on [§ 1112(b)] have been predicated
14 on certain recurring but non-exclusive patterns, and they are based on a conglomerate of
15 factors rather than on any single datum. Several, but not all, of the following conditions
16 usually exist. The debtor has one asset, such as a tract of undeveloped or developed real
17 property. The secured creditors’ liens encumber this tract. There are generally no
18 employees except for the principals, little or no cash flow, and no available sources of
19 income to sustain a plan of reorganization or to make adequate protection payments
20 Typically, there are only a few, if any, unsecured creditors whose claims are relatively
21 small. The property has usually been posted for foreclosure because of arrearages on the
22 debt and the debtor has been unsuccessful in defending actions against the foreclosure in
23 state court The “new debtor syndrome,” in which a one-asset entity has been
24 created or revitalized on the eve of foreclosure to isolate the insolvent property and its
25 creditors, exemplifies, although it does not uniquely categorize, bad faith cases.

26 *Matter of Little Creek Development Co.*, 779 F.2d at 1072-73.

27 Importantly, the court may find indicia of bad faith where “[t]he debtor is attempting to use the
28 provisions of Chapter 11 to create and organize a new business, not to reorganize or rehabilitate an
existing enterprise, or to preserve going concern values of a viable or existing business.” *In re ACI
Sunbow, LLC*, 206 B.R. 213, 222 (Bankr. S.D. Cal. 1997). Indeed,

Chapter 11 of the Bankruptcy Code has one purpose; the rehabilitation or reorganization
of entities entitled by statute to its relief A corporation that is created for the
purpose of filing a bankruptcy is an imposition on the state that charters the corporation
and on the Chapter 11 court that serves to rehabilitate and reorganize the corporate
debtor. Thus, [a] factual issue to be determined is whether the debtor was created for the
predominant purpose of filing in bankruptcy.

1 *Id.* at 221 (quoting *In re Thirtieth Place, Inc.*, 30 B.R. at 505).

2 In *In re ACI Sunbow, LLC*, two liens encumbered 707 acres of undeveloped real property. *Id.*
3 at 215. The junior of the two lienholders decided to sell its note and second trust deed. *Id.* Several
4 individuals formed ACI Sunbow, LLC (“Sunbow”) to bid on this note. *Id.* And Sunbow successfully
5 purchased it for approximately 1% of its face value. *Id.* Meanwhile, the note on the first trust deed
6 matured unpaid, and the first lienholder recorded a notice of default and election to sell the property.
7 *Id.* at 216. Before the foreclosure sale could occur, Sunbow filed a voluntary Chapter 11 petition. *Id.*

8 The court conducted an extensive analysis of the “lack of good faith” standard supporting cause
9 for stay relief or dismissal. It found that,

10
11 There was no business or going concern which [Sunbow] took over or seeks to preserve,
12 just a dormant real estate development project heavily in debt and default. [Sunbow]
13 seeks to use the provisions of Chapter 11 to create a new business for itself, and to
14 embark on a new speculative real estate venture, while denying [the first lienholder] its
15 right after ten years to look to its collateral to satisfy the debt owed to it. . . . Further, the
16 Court finds and concludes that under the circumstances of this case, the debtor’s filing
17 was a bad faith filing regardless of whether the debtor might be able to reorganize
18 [through a Chapter 11 plan] . . . an issue on which the Court expresses no opinion at this
19 juncture. The facts of this case meet most of the factors listed in *Little Creek* But
20 even with all [these] factors which favor a finding of bad faith, the subjective bad faith of
21 the debtor in attempting to use the bankruptcy process not to reorganize or rehabilitate a
22 struggling entity, but rather to organize a speculative real estate venture at the risk of the
23 secured creditor warrants [finding cause for stay relief or dismissal].

19 *Id.* at 225.

20 The facts at bar are complex and present a close case for determining Debtor’s bad faith. Like
21 *ACI Sunbow*, this case meets most of the *Little Creek* factors. Debtor essentially has one asset: the
22 Property. There is no dispute that the Property is over-encumbered and generates little cash flow.
23 There is no indication that Debtor has any employees other than its principals. It has few unsecured
24 creditors. The amount of its facially secured debt eclipses the sum total of its unsecured debt. Debtor
25 filed its bankruptcy on the eve of the First Lienholders’ foreclosure sale. And, although Debtor argues
26 that it has a willing and able investor to sustain a plan of reorganization or make adequate protection
27 payments, Debtor has demonstrated reluctance in expending any such funds to either propose a plan or
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1 make payments to lienholders. Indeed, at the court's February 12 hearing, movant's counsel
2 represented that Debtor failed to pay post-petition taxes, instead leaving it to lienholders to do so.

3 Moreover, like Sunbow, Debtor has no business or going concern to preserve. The Property is
4 mostly undeveloped. Any feasible plan of reorganization must necessarily create a new business that
5 develops the Property. And this, despite Debtor's arguments, is at the expense of the first lienholders;
6 lienholders whose corresponding notes – like the notes in *ACI Sunbow* – are in default. Debtor's
7 bankruptcy has kept lienholders, who are actively trying to foreclose, from using their collateral to
8 satisfy their debt. Even if Debtor could present a successful plan that provides surviving lienholders
9 everything they're entitled to in bankruptcy, it will still deprive them of their right to sell the Property
10 and credit bid to obtain its possession. If Debtor's plan fails, the First Lienholders will have suffered
11 considerable delay. And to what end? So that a third party can – through the rights of the former
12 Third Lienholders – engage in a speculative real estate adventure?

13 Debtor argues that *ACI Sunbow* and *Little Creek* do not support a bad faith finding because
14 Debtor: (1) has a commitment from an investor to provide sufficient cash to fund a plan; (2) is
15 comprised of the former Third Lienholders; (3) has unsecured creditors in excess of \$500 million due
16 to its vast undersecured debt; (4) intends to use its bankruptcy to consummate a deal that benefits the
17 undersecured lienholders and closely resembles the agreement they had nearly reached prepetition; and
18 (5) was not formed on the eve of bankruptcy. Again, the court recognizes that the facts here do not
19 precisely mirror those in the relevant and persuasive authorities. But under the totality of the
20 circumstances, these factual distinctions do not defeat a finding of bad faith.

21 That Debtor has a potential investor to fund a plan does not mitigate the fact that there is no
22 going concern value to be captured. The Property is undeveloped; it has no present, special
23 configuration that provides something beyond its liquidation value. Rather, this is one in a history of
24 many attempts to develop the Property for profitable use. That the former Third Lienholders are at the
25 helm makes no difference. Indeed, the order converting the first bankruptcy case noted that three
26 different managers could not find a solution for this Property and these parties in the bankruptcy arena.
27 Thus, without speaking to the merits of Debtor's plan, to characterize any eventual reorganization as
28 something other than a speculative real estate venture would be wholly unpersuasive.

1 That lienholders are vastly undersecured, and that Debtor intends to replicate a prepetition deal
2 which benefits these undersecured creditors, is also unpersuasive. First, the court notes that none of
3 these undersecured creditors stepped forward to object to the motion to dismiss. Further, the *de facto*
4 formation of a previously failed bargain serves no legitimate bankruptcy purpose. Although, in certain
5 circumstances, a debtor may structure a plan in a way that forces the other side to accept terms it
6 rejected prepetition, this is not the objective of Chapter 11. The court is mindful of the fractured,
7 combative history underlying the trust deeds. And it understands the allegations of sharp tactics on the
8 part of certain lienholders. Yet the fractionalized interests presumably agreed to a voting structure that
9 allowed such tactics.² And, moreover, two wrongs do not make a right; a creditor’s sharp tactics
10 outside of bankruptcy does not undo a debtor’s bad faith filing.

11 Finally, that Debtor was not formed on the eve of bankruptcy does speak against a finding of
12 “new debtor syndrome.” The court is not here relying on “new debtor syndrome” to support its finding
13 of bad faith. But it notes that, although the former Third Lienholders formed Debtor approximately
14 twenty months before the petition date, the structure and amount of the liens – and their underlying
15 interests – made it eminently foreseeable that Debtor would have to file bankruptcy. Debtor’s
16 principals knew that the fractionalized interests in the trust deeds were locked in a divisive struggle to
17 determine whether to foreclose on the Property. Its principals thus knew that foreclosure was a
18 possibility. And they knew that the only way to stall such foreclosure would be through a bankruptcy
19 petition. Although the Third Lienholders may not have formed Debtor for the sole purpose of filing
20 this bankruptcy, they surely formed it with the probability of such bankruptcy in mind.

21 22 **Conclusion**

23 At the hearing, Debtor argued that this ruling is a dangerous expansion of the “bad faith”
24 standard for dismissal under *Little Creek* and *In re Arnold*. But the court disagrees. It again
25 emphasizes the peculiar facts surrounding this case: (1) a SARE debtor with an asset encumbered at
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27 ² If the lienholders wished to preserve some sort of communal intent to act only for the benefit of the whole
28 group – rather than the benefit of each trust deed – they should have appointed a trustee with fiduciary duties to
execute this intent. Instead, they have apparently allowed majority rule to govern their trust deeds.

1 least six times over; (2) nearly \$550 million in secured debt from two deeds of trust accruing interest at
2 15% and 31% over the past thirteen years; (3) fractionalized and interrelated interests in those trust
3 deeds locked in a power struggle over how to proceed with the Property; and (4) a compelling history
4 of multiple bankruptcy filings with multiple managers' unsuccessful attempts to bring the Property to
5 profitable use. In the totality of the circumstances, these facts indicate that Debtor brought this power
6 struggle into the bankruptcy arena to cause delay and hinder the First Lienholders in their bona fide
7 efforts to realize upon their collateral. Debtor therefore filed its petition in bad faith. Like *ACI*
8 *Sunbow*, the court makes this finding regardless of whether Debtor might be able to reorganize through
9 a Chapter 11 plan – an issue on which the court expresses no opinion. It thus **grants** DACA's motion
10 and **dismisses** Debtor's bankruptcy case under 11 U.S.C. § 1112(b).

11 IT IS SO ORDERED.

12
13 Dated: February 16, 2014



CHRISTOPHER B. LATHAM, JUDGE
United States Bankruptcy Court