SINGLE ASSET REAL ESTATE BANKRUPTCY & RECENT DEVELOPMENTS

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I. Overview

A. If a debtor's estate constitutes a single asset real estate (a "SARE"), the Bankruptcy Code contains certain restrictions designed to limit the length of the case and the economic imposition that may be placed on creditors whose claims are secured by the debtor's real property. This section was first added to the Bankruptcy Code in 1994 to prevent abuse of the automatic stay, while also giving the debtor an opportunity to create a workable plan of reorganization.

B. With the turn in the credit markets and the recent downturn in the real estate market, SARE debtors will be required to propose a confirmable plan within a short time frame or commence making payments equal to the non-default contract rate of interest on the loan or be subject to foreclosure proceeding by their secured creditors after they obtain relief from the automatic stay.

C. This outline discusses (i) the definition of SARE under the Bankruptcy Code and the various interpretations of such definition by courts; (ii) the requirements the Bankruptcy Code imposes upon a SARE debtor; (iii) the application of SARE in the context of the automatic stay; and (iv) recent developments under the case law.

II. Single Asset Real Estate

A. Bankruptcy Code Section 101(51B)

1. The Bankruptcy Code defines "single asset real estate" to mean:

> [R]eal property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.

11 U.S.C. § 101(51B).

a. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Amendments")

(i) Prior to the enactment of the 2005 Amendments, section 101(51B) only applied to debtors whose property value did not exceed $4 million.

(ii) The 2005 Amendments removed the $4 million cap making all SARE debtors subject to the requirements under sections 101(51B) and 362(d)(3) of the Bankruptcy Code.

2. To fall within the SARE definition, a chapter 11 debtor must satisfy three conditions:

a. <u>Single Property or "Single Project"</u>

(i) Multiple properties constitute a "single project" when a group of properties have a related connection or purpose in a common plan or scheme involving their use. *In re The McGreals*, 201 B.R. 736, 742 (Bankr. E.D. Pa. 1996); *see also In re Philmont Dev. Co.*, 181 B.R. 220, 224 (Bankr. E.D. Pa. 1995) (interpreting the term "single project" as broad enough to encompass a string of semi-detached houses).

(ii) To constitute a "single project," the debtor's properties do not have to be geographically proximate. Instead, Congress intended to capture real estate developments consisting of separate projects with each comprising more than one tract or parcel of land that may not be contiguous. *In re Club Golf Partners, L.P.*, No. 07-40096, 2007 WL 1176010, at *5 (E.D. Tex. Feb. 15, 2007) (holding that a debtor owning separate tracts of property collectively constituted a golf club owned real estate constituting a single property for purposes of section 101(51B) of the Bankruptcy Code, however, the debtor was not a SARE debtor because it generated substantial income from activities not related to the real estate (i.e. renting golf carts and selling merchandise)).

(iii) Courts have not ruled on whether the development of several different projects, at different times, and in geographically disparate locations, can constitute a SARE.

b. <u>Property/Single Project Generating Substantially All Revenue</u>

(i) The standard for making this determination is whether the debtor's activities are able to generate revenue separate and apart from the sale or lease of the underlying real estate. *Kara Homes, Inc. v. Nat'l City Bank* (*In re Kara Homes, Inc.*), 363 B.R. 399, 406 (Bankr. D.N.J. 2007) (holding that debtors that were in the business of acquiring land, constructing, and selling homes were SARE debtors).

(ii) Where revenues of the debtor are the product of active commercial endeavors, including the labor of the debtor's employees, and not passive investment income, a debtor will not be considered a SARE debtor. *In re Scotia Dev., LLC*, 375 B.R. 764, 774-79 (Bankr. S.D. Tex. 2007), *aff'd*, 508 F.3d 214 (5th Cir. 2007) (holding that timber operator was not a SARE debtor because (a) its revenues were the product of commercial endeavors of its employees, (b) its operations were spread out and did not constitute real estate, and (c) it operated substantial commercial business on its property).

(iii) For example, a country club or hotel would not be considered a SARE debtor because it generates revenues from catering, restaurants, services, and merchandise, not just operation of the property itself. *Centofante v. CBJ Dev., Inc.* (*In re CBJ Dev., Inc.*), 202 B.R. 467 (B.A.P. 9th Cir. 1996) (hotel); *In re Kkemko*, 181 B.R. 47 (Bankr. S.D. Ohio 1995) (marina is something more than the simple rental of moorings because is also stored, repaired, and winterized boats).

(iv) It should be noted that a debtor's property is still subject to the SARE requirements even when the property fails to generate any revenue. *In re Syed*, 238 B.R. 133, 140 (Bankr. N.D. Ill. 1999) (finding that property formerly used as rental property but that was vacant at the time of the debtor's bankruptcy constituted single asset real estate regardless of the fact that the developed land generated no income); *In re Pensignorkay, Inc.*, 204 B.R. 676, 682 (Bankr. E.D. Pa. 1997) (finding that an undeveloped 275 acre tract of land that did not generate income but that the debtor held for future development fell within the definition of SARE); *In re Oceanside Mission Associates*, 192 B.R. 232, 236 (Bankr. S.D. Cal. 1996) (examining the Congressional intent and concluding SARE includes undeveloped real property that generates no income).

c. No Business Other Than The Operation <u>Of The Real Property And Activities Incidental Thereto</u>

(i) Purchasing and developing land, planning and constructing homes, and marketing and selling homes are activities incidental to operation of the real estate. *In re Kara Homes, Inc.*, 363 B.R. 399, 406 (Bankr. D.N.J. 2007)

(a) The court held that the debtor could not expect to generate revenue from its activities but for the eventual sale of the real estate. *Id.*

(ii) However, a debtor's ownership interest in partnerships that held only real estate did not constitute a SARE. *In re Philmont Development Co.*, 181 B.R. 220-3 (Bankr. E.D. Pa. 1995).

(a) Here, the general partner debtor developed several virtually identical semi-detached homes financed by a single construction loan. The debtor subsequently sold the property to its wholly-owned partnerships. When the debtor filed for bankruptcy, its sole assets were the interests in the subsidiary partnerships and several parcels of undeveloped land. The court determined that, because the debtor's rental income was not its direct source of income and the purpose of the business was not the operation of the real property, the court refused to find that the debtor was a single asset real estate. *Id.*

(b) The court concluded, in part, that, because the general partner debtor held different types of assets, it was involved in more than just real estate (*i.e.*, it was managing the partnership for profit, which was, in the court's view, not the same as managing real estate for a profit). *Id.* at 223.

(iii) Other courts have also determined that owning assets that derive value from underlying real property disqualify a debtor from SARE treatment. *See, e.g.*, *In re Scotia Dev., LLC*, 375 B.R. 764, 774-79 (Bankr. S.D. Tex. 2007), *aff'd*, 508 F.3d 214 (5th Cir. 2007) (holding that a debtor's ownership of rights to harvest and sell timber that is not real estate disqualified it from SARE treatment).

(iv) Courts that have been presented with a debtor whose

sole asset is a leasehold interest in real property have not directly analyzed the issue, but simply accepted the fact that such entities could be treated as SARE debtors.

(a) As an example, in *Lincoln National Life Insurance Co. v. Bouy, Hall & Howard & Associates* (*In re Bouy, Hall & Howard & Associates*), No. 95-40676, 1995 WL 17006338 (Bankr. S.D. Ga. Dec. 4, 1995), the debtor owned a hotel located on property that the debtor leased from a third party. In an action where a creditor sought relief from the automatic stay pursuant to section 365(d)(3) of the Bankruptcy Code, the court did not analyze the issue of whether the debtor was properly categorized as a SARE, but noted that the debtor never disputed the point.

d. It does not appear that there are any cases analyzing whether holding a license to use property qualifies or disqualifies a debtor for SARE treatment.

III. SARE & The Automatic Stay

A. Bankruptcy Code Section 362(d)(3)

1. A bankruptcy court shall grant relief from the automatic stay against a SARE,

> by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later-- (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or (B) the debtor has commenced monthly payments that-- (i) may, in the debtor's sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and (ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate.

11 U.S.C. § 362(d)(3).

2. Upon the commencement of a chapter 11 case, section 1121(b) of the Bankruptcy Code permits a debtor 120 days to file a plan of reorganization with the right to seek extensions up to 18 months upon a showing of cause.

   a. <u>Sections 362(d)(3) and 1121 of the Bankruptcy Code</u>

      (i) In the context of SARE, section 362(d)(3) of the Bankruptcy Code effectively shortens the time periods set forth under section 1121 of the Bankruptcy Code if the debtor has not commenced monthly payments equal to the non-default rate of interest on the secured claim of the creditor seeking stay relief.

      (ii) Under the foregoing circumstances, a SARE debtor must file a plan within the later of (A) 90 days after the commencement of the bankruptcy case (or such date determined by the court for cause by an order entered during the first 90 days of the case); or (B) 30 days after the court determines the debtor is subject to the SARE requirements. 11 U.S.C. § 362(d)(3).

3. Thus, upon request by a creditor whose claim is secured by an interest in such property, a bankruptcy court is required to lift the automatic stay pursuant to section 362(d)(3) unless a SARE debtor can satisfy one of the two following requirements:

   a. Filing Plan Having A Reasonable Possibility
<u>Of Being Confirmed Within Reasonable Time</u>

      (i) At least one court has likened the standard for finding that property is necessary for an "effective reorganization" under section 362(d)(2)(B) of the Bankruptcy Code, to a finding under section 362(d)(3)(A) that the debtor has filed a "plan of reorganization that has a reasonable possibility of being confirmed." *In re 68 W. 127 St., LLC*, 285 B.R. 838, 847-48 (Bankr. S.D.N.Y. 2002) (stating that the standards in under sections 362(d)(2)(B) and 362(d)(3)(A) are similar, if not identical). However, it should be noted that section 362(d)(3)(A) requires a plan actually filed.

(ii) In the section 362(d)(3) context, it is not necessary for the bankruptcy court to determine that a SARE debtor's plan shall be confirmed. *68 W. 127 St., LLC*, 285 B.R. at 848.

(a) Rather, a court should analyze the assumptions and projections proffered in support of the plan and if on their face they cannot satisfy the Bankruptcy Code's requirements then a debtor has not submitted a plan that is confirmable within a reasonable time. *Pegasus Agency v. Grammatikakis* (*In re Pegasus Agency, Inc.*), 101 F.3d 882, 886 (2nd Cir. 1996) (construing section 362(d)(2)(B)).

(iii) What is a reasonable time will depend on the facts of each case and the stage of the case when the motion for relief is considered. *In re Bldg. 62 Ltd. P'ship*, 132 B.R. at 221 (finding in the context of a motion pursuant to section 362(d)(2) that to establish the prospects for an effective reorganization at an early stage in the case is not as great as it would be in the later stages of the case).

(iv) Even when a plan confirmable on its face has been filed but after the creditor sought stay relief and two months after the 90 day period expired, a bankruptcy court lifted the automatic stay pursuant so section 363(d)(3) against a SARE debtor whose case had the characteristics of a bad faith filing. *In re 652 West 160th LLC*, 330 B.R. 455, 462 (Bankr. S.D.N.Y. 2005).

b. <u>Commencement of Payments</u>

(i) If a debtor fails to submit a plan having a reasonable possibility of being confirmed within a reasonable time, the debtor may instead commence making payments to its secured creditor.

(a) The payments must equal the non-default contract rate of interest of the loan.

(b) The payments are designed to limit the economic hardship imposed by the automatic stay that prevents the creditor from exercising its rights against the SARE.

(ii) Section 362(d)(3)(B)(i) permits a debtor to use cash collateral to make the payments notwithstanding section 363(c)(2)'s limitation on the use of such property.

(iii) Creditor sought stay relief on the basis that debtor's payments ($19,250) were not equal to the non-default rate under the contract ($20,000) and the bankruptcy court denied the request because the debtor's payments were equal to the current rate of a similar loan. *In re Cambridge Woodbridge Apts., LLC*, 292 B.R. 832, 840 (Bankr. N.D. Ohio 2003).

(a) Congress has since amended the section 362(d)(3)(B)(ii) by requiring such payments be equal to the contract rate of interest.

(iv) Presumably, section 506(b) of the Bankruptcy Code would prohibit payments made pursuant to section 362(d)(3)(B)(ii) to be used to reduce a creditor's interest claim if the creditor is not oversecured. *See* 11 U.S.C. § 506(b) (stating that only oversecured creditors are entitled to receive postpetition interest).

4. Section 362(d)(1) and (2) and SARE

a. <u>Application of section 362(d)(1) and (2) to SARE debtors</u>

(i) When Congress amended the Bankruptcy Code in 1994 by adding section 362(d)(3), they did not intend for this provision to be the exclusive remedy for stay relief against a SARE debtor.

(ii) Section 362(d) of the Bankruptcy Code was drafted in the disjunctive indicating that each subsection is an independent alternative for relief without regard to SARE. *Duvar Apt., Inc. v. Fed. Dep. Ins. Corp.* (*In re Duvar Apt., Inc.*), 205 B.R. 196, 200 (B.A.P. 9th Cir. 1996).

(iii) A SARE debtor's bad faith filing may serve as "cause" for lifting the automatic stay pursuant to section 362(d)(1) of the Bankruptcy Code. *In re State Street Houses, Inc.*, 356 F.3d 1345, 1347 (11th Cir. 2004).

(iv) A bankruptcy court may grant relief under section 362(d)(2) against a SARE debtor that fails to show that it has equity in the property and that it is necessary for an effective reorganization. *In re Kaplan Breslaw Ash, LLC*,

264 B.R. 309, 332 (Bankr. S.D.N.Y. 2001).

IV. Recent Developments Under the Case Law

A. SARE & Leasehold Interests

1. Courts continue to apply the Bankruptcy Code's SARE definition and its requirements upon debtor holding a leasehold interest in property.

   a. As an example, in *800 S. Wells Commercial, LLC v. WRT Marc RC, LLC*, No. 07-C-4010, 2007 WL 2156678 (N.D. Ill. July 23, 2007), the debtor was a SARE entity with a long-term leasehold in certain real property. A creditor, the holder of a leasehold mortgage, moved to have the automatic stay lifted and foreclose on the property. Without any analysis, the bankruptcy court approved the motion, and the district court did not analyze or discuss the finding that the debtor was a SARE debtor.

B. Single Project

1. Separate parcels of real property may constitute a "single project" if their use have a common purpose.

   a. The fact that a debtor intends to develop one parcel of land before another is not sufficient to show that properties purchased at the same time and with the same funds are not a "single project" when the debtor's intends to develop both parcels of property for single family homes. *In re Rear Still Hill Road, LLC*, 2007 WL 2935483, *5 (Bankr. D. Conn. Oct. 5, 2007).

C. Active v. Passive Criterion

1. The active-versus-passive criterion inquires into the nature of revenue generation and asks whether the revenue is the product of entrepreneurial, active labor and effort as opposed to revenue received as investment income by the debtor as the property's owner.

   a. The Court of Appeals for the Fifth Circuit recently reconfirmed this rule in *In re Scotia Dev., LLC*, 508 F.3d 214 (5th Cir. 2007). The Fifth Circuit held that while the debtor derived substantial revenue from the timber grown on the land, that it was not possible without planning, managing, and implementing harvesting plans, conducting the sale of timber, replanting and managing future timber stands, and attending to harvesting requirements and environmental prescriptions of nine watersheds.

(i) The court held that each of these activities were not incidental to the operation of the real property but rather sophisticated operations taking place on the land.

(ii) Moreover, the courts suggested that the sale of timber alone might be enough to preclude application of the SARE definition because such act is not the sale of real property.

D. Activities Incidental To Operation Of Real Property

1. Courts continue to exclude debtors from the SARE definition when their activities generate revenue separate and apart from the underlying real property.

a. For example, in *In re Club Golf Partners, L.P.*, No. 07-40096, 2007 WL 1176010 (E.D. Tex. Apr. 20, 2007), the debtor was a limited partnership that owned and operated a golf club that included an eighteen hole golf course, a driving range, tennis courts, club house, and a casual dining restaurant.

(i) In this case, the court held that the debtor was not a SARE because it also operated a variety of revenue-producing activities on it including the employment of third-party personnel that were integral to revenue production, selling memberships, charging fees or prices for access to the public golf course, use of a golf carts, use of the driving range, use of the tennis courts, sale of merchandise in its pro shop, sale of food and beverages (beer, wine, and nonalcoholic) in the restaurant in its clubhouse, and use of the clubhouse for special events.

b. However, in *In re Kara Homes, Inc.*, 363 B.R. 399, 406 (Bankr. D.N.J. 2007), the courts held that a debtor designing homes, arranging for construction, marketing, and selling such homes is subject to SARE because these activities are not separate and apart from owning and developing the real estate and that the income generated from these activities is tied to the sale of the real estate.

(i) The court distinguished between a builder that arranges for construction to benefit another's property and a builder that arranges construction on its own behalf, to benefit its own property. The court determined that the former would not qualify as a SARE debtor because its business is the arranging itself, while the latter *would* qualify as a SARE debtor because the arranging is incidental to the builder's

ownership of the property. *Kara Homes*, 363 B.R. at 406 n.5.

E. Plan Having Reasonable Possibility Of Being Confirmed

1. A plan that on its face violates the requirements under section 1129 of the Bankruptcy Code does not have a possibility of being confirmed.

a. In *In re The Terraces Subdivisions, LLC*, 2007 WL 2220448, *4 (Bankr. D. Alaska Aug. 2, 2007), the court refused to grant stay relief despite the fact the debtor's plan did not proposed to pay the secured creditor's claim in full.

(i) The court provided the debtor a reasonable time to revise the plan because the evidence showed there was sufficient value in the property to pay the creditor's claim in full and provide a distribution to creditors.

b. A debtor's plan that was premised on making payments to secured creditors based on a negative amortization was speculative and not likely to be confirmed. *In re Windwood Heights, Inc.*, 2008 WL 519410, **7-***8 (Bankr. N.D. W. Va. 2008).

(i) The court did not lift the automatic stay but instead provided the debtor with 30 days to propose a new plan based upon the substantial equity cushion in the property. *Id.* at *8.

F. Stay Relief

1. Motions for relief from automatic stay pursuant to section 362(d)(3) should not be filed before the debtor's 90-day period has expired.

a. *In Hope Plantation Group, LLC*, 2007 WL 3051533, *3 (Bankr. D.S.C. June 14, 2007), the bankruptcy denied a motion for stay relief without prejudice because the motion filed 73 days after the petition date.

(i) The court reasoned that there was no basis for relief at the time the motion was filed not to mention that the debtor filed a plan within the time period contemplated by the statute. *Id.*

(ii) The court also held that it is not necessary to consider stay relief pursuant to section 362(d)(3) on the 90th day if certain events are expected to take place within a reasonable

time that will aid in determining whether the debtor has proposed a plan that has a reasonable possibility of being confirmed. *Id.* at *4.

2. Section 362(d)(3) is applicable to judgment creditors in addition to consensual secured creditors.

   a. A debtor argued that a judgment creditor could not seek relief from the automatic stay because it was a judgment creditor. *In re Windwood Heights, Inc.*, 2008 WL 519410, *3 (Bankr. N.D. W. Va. 2008).

      (i) The court held that while a judgment creditor could not insist on payments pursuant to section 362(d)(3)(B)(i-ii) that did not preclude such creditor from seeking relief by showing the debtor had not proposed a plan that had a reasonable possibility of being confirmed. *Id.*