

**AN INTRODUCTION TO SINGLE ASSET REAL ESTATE CASES**

**Sam Anderson, Esquire  
Jeremy Fischer, Esquire  
Bernstein, Shur, Sawyer & Nelson, P.A.**

As the mortgage crisis continues to deepen, more and more owners of commercial real estate are finding themselves in financial dire straits. Due to the economic downturn, commercial properties that at one time generated positive cash flow are now unable to generate revenues sufficient to service the debt on the property. Making matters worse, the overall depreciation in real estate values, coupled with ever tightening credit markets, has left property owners with an inability to refinance indebtedness in order to help alleviate these cash flow issues.

These problems are increasingly resulting in property owners defaulting on their obligations to their secured lenders and these lenders are often times quick to resort to foreclosing on the property at issue. It is when the foreclosure process begins that the property owner picks up the phone and seeks advice of counsel. In these circumstances, often times the only way of effectively stopping the sale may be to seek protection under the Bankruptcy Code.

This article provides a general overview of certain issues involving “single asset real estate” debtors as such term is defined by the Bankruptcy Code. Specifically, this article will focus first on the threshold issue of what constitutes a “single asset real estate” debtor and, second, on specific issues relating to relief from the automatic stay in the event the case is determined to be a single asset real estate case.

**I. WHAT IS A SINGLE ASSET REAL ESTATE DEBTOR?**

While the term “single asset real estate” (“SARE”) was only added to the Bankruptcy Code in 1994 as a specifically defined term,<sup>1</sup> it has long been a “well-known and often used colloquialism[] that essentially refer[s] to real estate entities . . . rather than businesses involving manufacturing, sales, or services.” In re Philmont Dev. Co., 181 B.R. 220, 223 (Bankr. E.D. Pa. 1995) (citing In re Mayer Pollock Steel Corp., 174 B.R. 414, 422-23 (Bankr. E.D. Pa. 1994)). The most common “single asset real estate” case before 1994 generally involved “an apartment building, office building, or ‘strip’ shopping center owned by an entity whose sole purpose was to operate that real estate with monies generated by the real estate.” Id.

Although the courts had been developing their own definition of what constituted a SARE case, in 1994, as noted, Congress decided to get involved. In the 1994 amendments to the Bankruptcy Code, Congress specifically defined “single asset real estate” in section 101(51B). The intent of Congress in specifically defining SARE cases “was to correct perceived abuses by debtors” in this type of case. William L. Norton, Jr., Norton Bankruptcy Law and Practice 3d, § 43:48 (3d ed. rev. 2009). In other words, “[t]he primary purpose of the amendments was to place single asset cases, a distinct species of bankruptcy cases on an expedited procedural track.” In re McGreals, 201 B.R. 736, 741 (Bankr. E.D. Pa. 1996).

Although SARE was originally codified in 1994, section 101(51B) currently defines SARE as follows:

The term ‘single asset real estate’ means real 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.

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<sup>1</sup> See Pub. L. 103-394, 108 Stat. 4111 et seq. (1994).

11 U.S.C. § 101(51B). The current definition was adopted through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), which incorporated two important changes from the 1994 definition. Ad Hoc Comm. of Timber Noteholders v. Pacific Lumber Co. (In re Scotia Pacific Co., LLC), 508 F.3d 214, 224 n. 8 (5<sup>th</sup> Cir. 2007). First, the clause “who is not a family farmer” was added to limit which types of debtors could be considered SARE debtors.<sup>2</sup> Second, BAPCPA eliminated the requirement that SARE debtors must have “aggregate, noncontingent, liquidated, secured debts of no more than \$4,000,000.”

Courts interpreting the codified definition, both pre-BAPCPA and post-BAPCPA, have consistently broken it down into elements and required that **all** elements be satisfied before a debtor may be deemed a SARE debtor. Scotia Pacific, 508 F.3d at 220 (post-BAPCPA case finding that “three requirements emerge from this definition which must all be met for a debtor to be considered a SARE debtor”); In re MTM Realty Trust, 2009 WL 612147, \*1 (Bankr. D. N.H. Mar. 9, 2009) (post-BAPCPA case finding that “all three elements in the statutory definition [must be] satisfied”); Philmont, 181 B.R. at 223 (pre-BAPCPA case finding four elements, one of which was that the debtor must have aggregate, noncontingent, liquidated, secured debts of no more than \$4,000,000 (a requirement, as noted, eliminated by the 2005 amendments to the definition)). The three elements are as follows:

- First, the debtor must have real property constituting a “single property or project” other than residential real property with fewer than four units.
- Second, the real property must generate “substantially all” of the gross income of the debtor.
- Third, the debtor must not conduct business on the real property other than “operating the real property and activities incidental thereto.”

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<sup>2</sup> The term “family farmer” is defined at 11 U.S.C. § 101(18).

Each of these requirements will be discussed in turn below. As will be discussed in relation to the section addressing relief from the automatic stay in SARE cases, the threshold determination of whether the case satisfies these three requirements can have important repercussions on the overall viability of the case.

**A. “Single Property or Project”**

The first element of the definition of a SARE debtor under section 101(51B) requires that the debtor owns “real estate constituting a **single property** or **project**, other than residential real property with fewer than 4 residential units[.]” 11 U.S.C. § 101(51B) (emphasis added). Courts have generally not struggled with determining whether a debtor’s real property assets constitute a “single property” – if the property is a single parcel, it is a “single property” for the purposes of the SARE definition in section 101(51B). *See, e.g., McGreals*, 201 B.R. at 741 (“Since there is no doubt in this case that more than a single parcel of real property is involved, the issue to be decided can be further narrowed to the question of whether the Properties, collectively, constitute a ‘single project’ . . .”); *In re Webb Mtn., LLC*, 2008 WL 656271, \*4 (Bankr. E.D. Tenn. Mar. 6, 2008) (five parcels of real estate not “single property”). Therefore, the general field of battle for determining whether the first element of the SARE definition is satisfied is the meaning of the term “single project.”

The Congressional intent for the meaning of “single project” is not clear either from the wording of the statute or its legislative history. *Philmont*, 181 B.R. at 223; *McGreals*, 201 B.R. at 741-42. Courts have therefore applied common rules of statutory construction, and examined the common meaning of the term, to determine the meaning of “single project.” First, courts have recognized that the drafters of section 101(51B) defined SARE to include two separate classifications in the disjunctive, single properties and single projects. Thus, the meaning of

“single project” necessarily encompasses multiple parcels of real property held by a debtor which are beyond the meaning of “single property.” In re Rear Still Hill Road, LLC, 2007 WL 2935483, \*4 (Bankr. D. Conn. Oct. 5, 2007) (internal citations omitted); McGreals, 201 B.R. at 742-43; Philmont, 181 B.R. at 224. Second, courts have interpreted the term “consistent with the commonly accepted meaning of the component words ‘common’ and ‘project.’” McGreals, 201 B.R. at 743 n. 7 (citing Perrin v. U.S., 444 U.S. 37, 42 (1979) (stating that it is a fundamental canon of statutory construction that the words chosen by Congress are to be interpreted according to their “ordinary, contemporary, and common meaning”)).

Based on these considerations, courts have generally defined a “single project” as multiple parcels of real estate purchased, developed, or sold pursuant to a “common plan or scheme,” linked together by “common usage” or in pursuit of a “common purpose.” McGreals, 201 B.R. at 742-43; Rear Still, 2007 WL 2935483 at \*5 (“properties must be linked together in some fashion in a common plan or scheme involving their use”) (quoting McGreals); In re Village Walk, LLC, 2008 WL 2477601, \* 3 (Bankr. D. Conn. May 29, 2008) (same) (quoting McGreals); Webb Mtn., 2008 WL 656271 at \*4 (debtor contemplated developing multiple parcels into single resort). Courts focus on these factors, rather than the location of the property. For instance, one court held that two contiguous parcels were not a “single project” because they were not linked by a common scheme or plan or by common usage. See McGreals, 201 B.R. at 743. Conversely, just because properties are non-contiguous does not mean that they are not part of a “single project” where they are linked by a common scheme or plan or by common usage. See id. at 743 n. 8.

In Philmont, Philmont Development Company (“Philmont Development”) built a series of virtually identical semi-detached houses on Blakeslee Drive in Philadelphia, Pennsylvania

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with a single construction loan. Philmont, 181 B.R. at 221-22. Philmont Development then formed three limited partnerships, in which it was the general partner of each, and sold more than four houses (a.k.a. “more than four residential units”) to each of the limited partnerships. Id. Philmont Development and the limited partnerships later filed for bankruptcy and Philmont Development’s assets were comprised entirely of its partnership interests in the limited partnerships, and the limited partnerships’ assets were comprised entirely of the houses. Id. at 222. In the context of a motion for relief from stay, the court was asked to determine whether the debtors met the statutory definition of SARE debtors, and the sole issue for the court was whether the real estate assets were a “single project.” Id. at 223. In holding that the real estate assets of the debtors were a “single project,” the court gave special consideration to the fact that all the houses were constructed with a single construction loan, which gave rise to an inference that the properties had a common usage and were constructed as part of a common plan or scheme. Id. at 224.

In McGreals, the debtor separately acquired, pre-petition, two contiguous parcels of property. McGreals, 201 B.R. at 738-39. Parcel 1 was developed into a manufacturing facility and the debtor intended to develop Parcel 2 into a warehouse unrelated to the manufacturing facility, though such development never occurred and the second parcel remained raw land. Id. The debtor decided, pre-petition, to sell Parcel 2 and retained a commercial broker to market it. Id. at 739. Several months later, the debtor also decided to sell Parcel 1 and retained a separate real estate broker to market that parcel. Id. at 739-40. After the petition date, anticipating that secured creditors might seek relief from the automatic stay, the debtor petitioned the court for a determination that it did not meet the statutory definition of a SARE debtor. Id. at 740. As in Philmont, the only disputed issue was whether the properties constituted a “single project.” Id. at

741. The court first determined that “the mere fact of common ownership or even a common border will not suffice” to establish the debtor as a SARE debtor. Id. at 743. The court further held, based on testimony provided by the debtor, that no common scheme or plan existed for the properties because they were acquired and developed separately, and the debtor “had no plans to combine the Properties in any way.” Id.

Several fairly recent cases have found multiple parcels of real property to constitute a “single project” pursuant to section 101(51B) based on representations and filings made by the debtor to regulatory authorities. For instance, in Rear Still, two contiguous parcels were found to constitute a “single project” based a unified application made by the debtor to the municipal planning/zoning board to develop the properties into single family residences. Rear Still, 2007 WL 2935483 at \* 5. Similarly, in Webb Mtn, the debtor owned five contiguous parcels which it planned to develop into golf courses, a hotel, a spa, a contention center, single-family houses, and condominiums. Webb Mtn, 2008 WL 656271 at \*4. While the debtor argued that each parcel was intended for a separate use and thus not part of a common plan or scheme, the bankruptcy court disagreed, holding that the resort itself was a common plan or scheme. Id. at \*4-5. Significant to the court’s decision was a pre-petition concept plan submitted and approved by the county regional planning commission in which the debtor merged individual parcels into a single parcel for the purposes of the project. Id. at \*5.

From the above, it seems apparent that the intention of the debtor, as opposed to the physical characteristics of the properties at issue, may carry the greatest weight with the court in its assessment of whether the properties constitute a “project” for purposes of the SARE definition.

**B. “Substantially All of the Income of the Debtor”**

The second element of the definition of a SARE debtor under section 101(51B) requires that the debtor’s real estate “generate[] substantially all of the gross income of the debtor.” 11 U.S.C. § 101(51B). For the purposes of section 101(51B), courts have held that the term “gross income” carries the same meaning as under section 61 of the Internal Revenue Code<sup>3</sup> - “gross income means all income from whatever source derived.” In re Club Golf Partners, L.P., 2007 WL 1176010, \*5 (E.D. Tex. Feb. 15, 2007) (reasoning that Congress must have intended to use an already-defined term and thus adopting the definition from the Internal Revenue Code).

Courts have found various ways of determining a debtor’s gross income. The most common source of such information is the debtor’s own schedules and statement of financial affairs filed at the commencement of the bankruptcy case. For instance, in MTM, in determining that all of the debtor’s gross income was generated by its passive ownership of real property, the court recited the debtor’s declaration in the statement of financial affairs that its previous year’s gross income was \$127,717.00 and it was completely derived from “rental income.” MTM, 2009 WL 612147 at \*2. In another case, the court relied on testimony offered by the debtor’s chief restructuring officer at a previous hearing regarding an interim debtor in possession financing motion. Kara Homes, Inc. v. National City Bank (In re Kara Homes, Inc.), 363 B.R. 399, 404 (Bankr. D.N.J. 2007). The officer was asked how the debtor derived its income, and he answered, “[f]rom the sale of homes, primarily.” Id.

In determining whether a debtor derives “substantially all” of its income from real property, courts have focused on the source and nature of different streams of income received by the debtor. One court explained that “the statute uses the verb ‘generates,’ denoting that it is the property itself, not the fruit of workers’ labor and management services that is responsible for

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<sup>3</sup> 26 U.S.C. § 61(a).

substantially all of the gross income.” Club Golf Partners, 2007 WL 1176010 at \*5 (citing In re National/Northway Ltd. P’ship, 279 B.R. 17 (Bankr. D. Mass. 2002)). Therefore, if substantially all of the debtor’s revenue is “the product of the efforts of management and workers conducted on the land, bringing in the customers and selling services and goods to them,” such as at a golf course, the debtor does not satisfy the definition of a SARE debtor. Id.

In many cases, all of the debtor’s income is generated as a result of passive ownership of the real property at issue. See e.g. McGreals, 201 B.R. at 741; Philmont, 181 B.R. at 223; MTM, 2009 WL 612147 at \*2. In other cases, the debtor generates no income, and the question arises whether the second element may be satisfied under such circumstances. Nearly all cases that have considered the question have concluded that real property that generates no income **does** fall within the definition of SARE. In re Kinard, 2001 WL 1806039, \*5 (Bankr. D.S.C. 2001); In re Syed, 238 B.R. 133, 140 (Bankr. N.D. Ill. 1999); In re Pensignorkay, Inc., 204 B.R. 676, 682 (Bankr. E.D. Pa. 1997); In re Oceanside Mission Assocs., 192 B.R. 232, 236 (Bankr. S.D. Ca. 1996).

**C. “No Substantial Business” Activity Other Than Operating the Real Property and Activities Incidental Thereto**

The third element of the definition of a SARE debtor under section 101(51B) requires that “no substantial business activity is being conducted by a debtor [on the property] other than the business of operating the real property and activities incidental.” 11 U.S.C. § 101(51B). Case law interpreting this element has focused on the nature of the revenue production by the debtor on the real property. In Scotia Pacific, the Fifth Circuit endorsed a widely accepted analysis as follows:

[The definition should be interpreted] ‘according to an active-versus-passive criterion that inquires into the nature of revenue generation on and by the property, that is, whether the revenue is

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the product of entrepreneurial, active labor and effort – and thus is not single asset real estate – or is simply and passively received as investment income by the debtor as the property’s owner – and thus is single asset real estate. . . . Real property that, for the generation of revenues, requires active, day-to-day employment of workers and managers other than or additional to the principals of the debtor, and that would not generate substantial revenue without such labor and efforts, should not be regarded as single asset real estate.’

Scotia Pacific, 508 F.3d at 218 (quoting In re Scotia Dev., LLC, 375 B.R. 764, 777-78 (Bankr. S.D. Tex. 2007) (quoting Club Golf Partners, 2007 WL 1176010 at \*4)). Many other courts have also endorsed the active-versus-passive criterion described in Scotia Pacific. See In re Kara Homes, 363 B.R. at 405-06; In re Whispering Pines Estate, Inc., 341 B.R. 134 (Bankr. D.N.H. 2006); In re Prairie Hills Golf & Ski Club, Inc., 255 B.R. 228 (Bankr. D. Neb. 2000); Bank of America Commercial Fin. Corp. v. CGE Shattuck, LLC (In re CGE Shattuck, LLC), 1999 WL 33457789 (Bankr. D.N.H. 1999); In re Larry Goodwin Golf, Inc., 219 B.R. 391 (Bankr. M.D.N.C. 1997); Centofante v. CBJ Dev., Inc. (In re CBJ Dev., Inc.), 202 B.R. 467 (B.A.P. 9<sup>th</sup> Cir. 1996).

In MTM, following the active-versus-passive criterion, the court held that the debtor fit squarely within this third element of the SARE definition because its business activities on the real property were sufficiently passive in nature. MTM, 2009 WL 612147 at \* 3. The debtor “simply collects rent from the four tenants. . . [and] there are no substantial business operations other than functions intrinsic to owning the real estate.” Id. at 2. In making this determination, the court paid special attention to the fact, not only that the debtor’s revenue generating activities were passive in nature, but also that the debtor’s only expenses were “normal expenses associated with owning a commercial real estate building . . . [such as paying for] electricity . . .

phone services, insurance and taxes, trash removal, building improvements, landscaping, and its mortgage.” Id.

By contrast, following the same test, many courts have held that certain other business activities do not satisfy this third element. For instance, in In re Kkemko, Inc., the court held that a debtor who operated a marina was not a SARE debtor because it engaged in sufficiently active revenue generation outside merely managing or owning real property, including renting moorings, storing boats, providing showers and a pool to patrons, and selling concessions and gas. Kkemko, 181 B.R. 47, 51 (Bankr. S.D. Ohio 1995). Similarly, full service hotels offering a wide variety of diverse amenities to their patrons are engaged in active revenue generation incompatible with the SARE designation. See CBJ Dev., Inc., 202 B.R. at 473-74; Whispering Pines, 341 B.R. at 136. The operation of golf courses has also generated a significant body of case law in reference to the third element of section 101(51B), and virtually all courts that have considered the subject have found that the sale of memberships and fee-for-access passes, rental of golf carts and other equipment, and provision of merchandise, food, and beverages render golf courses outside the scope of the SARE definition. See Club Golf Partners, 2007 WL 1176010 at \*6; Prairie Hills, 255 B.R. at 230; CGE Shattuck, 1999 WL 33457789 at \*7; Larry Goodwin Golf, Inc., 219 B.R. at 393; Commerce Bank and Trust Co. v. Perry Hollow Golf Club, Inc. (In re Perry Hollow Mgmt. Co.), 2000 WL 33679447, \*2 (Bankr. D.N.H. 2000).

In its recent and thorough discussion of the issue in Scotia Pacific, the Fifth Circuit considered whether a timber company was a SARE debtor. Scotia Pacific, 508 F.3d at 214. The debtor was a company that owned over 200,000 acres of timberlands in Northern California. Id. at 216. In addition to ownership of the real property, the debtor harvested timber on its land, as well as on over 10,000 acres of timberland owned by others. Id. The court held that the

revenues received by the debtor were not passive in nature because the debtor was engaged in very active business activities well beyond merely operating the real property (and activities incidental thereto) – the debtor employed over sixty individuals to assist in its sophisticated operations which included planning, growing, maintaining, and harvesting timber as well as building and maintenance of roads on the property. *Id.* at 224-25. Further, the court articulated the position that SARE debtors are the exception and not the rule under the Bankruptcy Code, stating that, “[s]ection 101(51B) severely limits the class of debtors which qualify as SAREs, and we have no warrant to expand the definition.” *Id.* at 225.

From the above, it is clear that the SARE definition under the Bankruptcy Code is complex enough to have generated significant case law attempting to define its exact parameters. The bankruptcy petition itself asks debtors to notate on the petition whether the debtor’s case constitutes a SARE case by checking the box if appropriate. It is evident from the abundance of case law on the subject that considerable thought should go into the decision of whether or not to check the box.

## II. RELIEF FROM THE AUTOMATIC STAY IN SARE CASES

In the event a debtor meets the definition of SARE, the question becomes what additional burdens are placed on a SARE debtor? One such burden is that the debtor now has to deal with the relief from stay provisions specifically enacted to address SARE cases.<sup>4</sup> 11 U.S.C. § 362(d)(3). Section 362(d)(3) provides that relief from stay shall be granted:

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<sup>4</sup> This is not to say that the enactment of section 362(d)(3) means that the only basis on which a creditor can seek relief from stay against a SARE debtor is under section 362(d)(3). To the contrary, most courts that have considered the issue have held that section 362(d)(3) provides an additional basis for relief from stay in SARE cases, rather than preempting the bases provided in section 362(d)(1, 2, and 4). See *In re Star Trust*, 237 B.R. 827, 833 (Bankr. M.D. Fla. 1999) (citing *In re Victory Constr. Co., Inc.*, 9 B.R. 549, 551-60 (Bankr. C.D. Cal. 1981)); *In re State Street Houses, Inc.*, 356 B.R. 1345 (11<sup>th</sup> Cir. 2004).

For instance, creditors in SARE cases often seek relief from stay “for cause” under section 362(d)(1) premised on a debtor’s bankruptcy filing immediately before a scheduled foreclosure sale. Although some courts

- (3) with respect to a stay of an act against single asset real estate under subsection (a), 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 an 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**.[.]

Id. (emphasis added). From this definition, three important questions arise. First, what is meant by the requirement that the debtor file a plan that has “a reasonable possibility of being confirmed within a reasonable time?” Second, in the event a suitable plan cannot be filed within

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have concluded that “bad faith” is no longer a ground for dismissal of a SARE case because of the remedy provided by section 362(d)(3), other courts have held to the contrary. See Fields Station, LLC v. Capitol Food Corp. of Fields Corner (In re Capitol Food Corp. of Fields Corner), 490 F.3d 21, 24 (1<sup>st</sup> Cir. 2007) (issue of whether bad faith constitutes cause remains open in the First Circuit); In re Victoria Ltd. P’ship, 187 B.R. 54 (Bankr. D. Mass. 1995) (stating that bad faith does not constitute cause under section 362(d)(1)); Webb MTN, LLC v. Whaley (In re Webb MTN, LLC), 2008 WL 361402, \*4 (E.D. Tenn. Feb. 8, 2008); In re Harmony Holdings, LLC, 393 B.R. 409, 420-21 (Bankr. D.S.C. 2008); In re ENCAP Golf Holdings, LLC, 2008 WL 4200324, \*8 (Bankr. D.N.J. Sept. 4, 2008); In re R&G Properties, Inc., 2009 WL 1076703, \*4 (Bankr. D. Vt. Apr. 16, 2009); C-TC 9<sup>th</sup> Ave. P’ship v. Norton Co. (In re C-TC 9<sup>th</sup> Ave. P’ship), 113 F.3d 1304, 1311 (2d Cir. 1997); Laguna Assocs. Ltd. P’ship v. Aetna Cas. & Sur. Co. (In re Laguna Assocs. Ltd. P’ship), 30 F.3d 734, 738 (6<sup>th</sup> Cir. 1994); In re Cambridge Woodbridge Apartments, LLC, 292 B.R. 832 (Bankr. N.D. Ohio 2003).

the ninety (90) day timeframe set forth in the section 362(d)(3), what are the payment obligations imposed on the debtor under the “value of the creditor’s interest in real estate” standard? Third, what constitutes “cause” in relation to extending the deadlines imposed by section 362(d)(3)? Each of these questions will be answered in turn below.

**A. The Filing of the Plan Requirement**

The underlying Congressional purpose in enacting section 362(d)(3) was to “address perceived abuses in single asset real estate cases, in which debtors have attempted to delay mortgage foreclosures even when there is little chance that they can reorganize successfully.” 3 Collier on Bankruptcy ¶ 362.07(5)(b) (Alan N. Resnik & Henry J. Sommer eds. 15<sup>th</sup> ed. rev. 2008). Consistent with this legislative purpose, section 362(d)(3) requires SARE debtors to file a plan of reorganization that has a “reasonable possibility of being confirmed within a reasonable time” within ninety (90) days of the petition date or risk the court granting relief from the automatic stay to the debtor’s secured creditors. This statutory standard was borrowed from the United States Supreme Court’s decision in United Savings Ass’n of Texas v. Timbers of Inwood Forest Assoc., Ltd., 484 U.S. 365 (1988); see also In re Windwood Heights, Inc., 385 B.R. 832, 837 (Bankr. N.D.W.V. 2008). In Timbers of Inwood, the Supreme Court held that, in order to avoid stay relief under section **362(d)(2)** by showing that a property was “necessary to an effective reorganization,” a debtor had to demonstrate that there was “a reasonable possibility of a successful reorganization within a reasonable time.” In re Windwood Heights, Inc., 385 B.R. at 837 (quoting Timbers of Inwood, 484 U.S. at 376). Therefore, “the standard for interpreting § 362(d)(3)(A) is nearly identical to the standard for determining whether or not property is ‘necessary for an effective reorganization’ under § 362(d)(2)(B).” Id. at 837-38 (citing In re Deep River Warehouse, Inc., 2005 WL 1287987, \*12-13 (Bankr. M.D.N.C. Mar. 14, 2005)).

The standard for determining whether a SARE debtor’s proposed plan has a reasonable possibility of being confirmed is much lower than the standard for actual confirmation pursuant to section 1129. Id. at 838; see also In re LDN Corp., 191 B.R. 320, 325 (Bankr. E.D. Va. 1996); In re Kent Terminal Corp., 166 B.R. 555, 560 (Bankr. S.D.N.Y. 1994); In re National/Northway Ltd. P’ship, 279 B.R. 17, 24 (Bankr. D. Mass. 2002); In re Harmony Holdings, LLC, 393 B.R. 409, 421 (Bankr. D.S.C. 2008). In Windwood Heights, the court described the standard as follows:

Importantly, adjudicating a relief from stay motion under § 362(d)(3)(A) is not to be a mini confirmation hearing. At a confirmation hearing, a debtor must prove its entitlement to confirm a plan under 11 U.S.C. § 1129 by a preponderance of the evidence, and concerning the plan feasibility requirement of § 1129(a)(11) in particular, the debtor must demonstrate that the confirmation of the plan is not ‘likely’ to be filed by liquidation or the need for further financial reorganization. By comparison, the showing required by a debtor under § 362(d)(3)(A) is only that the plan have a reasonable possibility of being confirmed, which is a lesser showing than that required at confirmation. . . .

Windwood Heights, 385 B.R. at 838 (internal citations omitted). Stated another way, “[t]he terms reasonable possibility within a reasonable time are rather vague and hopeful terms that require a far lower standard of proof than will be required of the Debtor [at the confirmation hearing].” Id. at 838.

In proving the “reasonable possibility” of plan confirmation, courts have generally held that the debtor must, at minimum, show the following:

- The debtor is proceeding to propose a plan of reorganization;
- The proposed or contemplated plan has a realistic chance of being confirmed; and
- The proposed or contemplated plan is not patently unconfirmable.

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National/Northway, 279 B.R. at 24; see also Windwood Heights, 385 B.R. at 838; Harmony Holdings, 393 B.R. at 421. The court's inquiry into the reasonable possibility of plan confirmation, therefore, is not merely on the **actual** plan filed at the time of the stay relief motion, but also on the viability of reasonable amendments and modifications to such a plan. Windwood Heights, 385 B.R. at 838; Harmony Holdings, 393 B.R. at 421-22. In other words, as stated by the court in Windwood, "[t]he Court is not aware of any requirement, and will not impose one, that the Plan filed at the time the stay motion is pending is the only bench mark for determining whether or not stay relief is appropriate; rather all that is required is that an effective reorganization be in prospect and attainable within a reasonable period of time." Windwood Heights, 385 B.R. at 838.

For instance, in Windwood Heights, the central element of the debtor's pending plan was the deferral of all payments to the secured creditor for a period of up to eight years while the debtor attempted to obtain third party sales, refinancing, or recapitalization to complete its housing project. Windwood Heights, 385 B.R. at 839. The debtor proposed adequately protecting the secured creditor's interest by "negative amortization," or allowing the debtor's substantial equity cushion in the property to diminish over that period. Id. The secured creditor objected that the negative amortization feature of the plan was not fair and equitable pursuant to section 1129(b)(2), and thus the plan was patently unconfirmable. Id. The court, while agreeing that the pending plan's eight year deferral period was patently unconfirmable under section 1129, denied the creditor's motion for relief from stay under section 362(d)(3). Id. at 841. The court held that, "[g]iven the substantial equity cushion in this case, it is not out of the realm of possibility that the court could approve a negative amortization plan of reorganization provided

that . . . the Debtor outlines a more accelerated timetable for allowing MSI to realize the value of its secured position . . . . [E]ight years is simply unacceptable.” Id.

Similarly, in Harmony Holdings, a creditor moved for relief from stay under section 362(d)(3), alleging that the confirmability of the debtor’s plan was in doubt because it did not address all issues relating to all creditors. Harmony Holdings, 393 B.R. at 421. The court denied the creditor’s motion, holding that “receiving relief from stay pursuant to section 362(d)(3) requires more than a showing that confirmation of a proposed plan is questionable.” Id. The court noted that “while there may be minor issues that need to be addressed and ironed out with certain creditors, all creditors except Movants indicate that the plan as proposed, with minor adjustments, has the ability to be confirmed.” Id.

From the above, in order to satisfy this requirement, the plan filed need not be the final version of the plan in the case. As reflected in the case law, a SARE debtor will not be held to the section 1129 confirmation standards and the court should allow for adjustments to the plan to make it “confirmable” enough to satisfy this standard.

**B. The Interest Payment Requirement**

In the event that a SARE debtor cannot, within ninety (90) days of the petition date, propose a plan with a reasonable possibility of confirmation within a reasonable time, the debtor can avoid relief from stay if it commences certain monthly payments to secured creditors pursuant to section 362(d)(3)(B). Specifically, the payments must be “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)(B)(ii). Despite the prohibitions on use of cash collateral imposed by section 363(c)(2), the debtor may make these payments with funds

generated from rents or other income generated by or from the real estate securing the creditor's claim. 11 U.S.C. § 362(d)(3)(B)(i).

In certain instances arising in the bankruptcy context, the applicable interest rate applied is the current fair market rate. For purposes of section 362(d)(3)(B), however, this rate does not apply. Rather, the statute requires only that the debtor make payments at the non-default rate applicable to the debtor by its contract with the secured creditor. Stuart M. Saft, Commercial Real Estate Workouts § 16.3 (3d ed. rev. 2008).

The interest payments required by section 362(d)(3)(B) are not necessarily made on the full, unpaid principal balance of the debtor's indebtedness to the secured creditor. Rather, section 362(d)(3)(B) requires the debtor only to make interest payments "on the value of the creditor's interest in the real estate." 11 U.S.C. § 362(d)(3)(B)(ii). As one court explained:

[T]he payments required by that paragraph are not in the amount of interest (at the contractual nondefault rate) owing under the agreement between the parties: that is, nondefault interest on the principal balance. Rather, it is in the amount of nondefault interest on the value of the creditor's interest in the real estate.

In re Abdulla, 2009 WL 348365, \*3 n. 2 (Bankr. D. Mass. Feb. 6, 2009). There is limited case law addressing exactly how to determine the value of the creditor's interest in the real estate. Considering that section 506(a) of the Bankruptcy Code uses almost identical language for purposes of claim bifurcation, it seems like section 362(d)(3)(B)(ii) may implicate many of the same valuation issues raised by section 506. This certainly leaves room for negotiations between debtors and creditors concerning the amount of the interest payment required to be made under section 362(d)(3).

C. **What Constitutes “Cause”**

In the event that a SARE debtor cannot, within ninety (90) days of the petition date, either propose a plan with a reasonable possibility of confirmation within a reasonable time pursuant to section 362(d)(3)(A) **or** commence monthly interest payments to secured creditors pursuant to section 362(d)(3)(B), the debtor may request that the court extend the ninety (90) day period “for cause.” 11 U.S.C. § 362(d)(3). Any such order extending this period must be **entered** within the original ninety day period. *Id.*

What exactly constitutes “cause” in the context of section 362(d)(3) was not indicated by Congress in its enactment of this section. *In re Heather Apartments Ltd. P’ship*, 366 B.R. 45, 47 (Bankr. D. Minn. 2007). Courts, therefore, are left to interpret the term’s meaning on a case by case basis. In its thorough analysis of the meaning of “cause” in SARE context, the court in *Heather Apartments* wrote that:

[I]n the context of bankruptcy, in the absence of an express definition or prescription, the courts should measure the existence of cause for excusing compliance, by referring to the purpose of the underlying statutory requirement. Cause then would consist of something extraordinary in the circumstances, something that tips the equities of a case outside the balance that Congress envisioned and then reinforced by establishing the underlying requirement. If the requirement on its face protects a specific constituency, the cause should incorporate a viable alternative to address that constituency’s specified entitlement. Where the structure of a particular requirement of the Code markedly reflects such an intent (or an intent to hamper the general latitude that another constituency would enjoy under the Code’s more free-ranging provisions), the party seeking a departure must directly respond to the legislative intent. In this light, for the establishment of cause, it is not sufficient to rely solely on the more global goals of bankruptcy relief, even if those might otherwise be served by excusing compliance with the requirement.

Id. at 47-48. The court then went on to examine the unique purposes Congress sought to serve by its enactment of section 362(d)(3), as opposed to the more general purposes served by the rest of the Bankruptcy Code:

[The] history and the statute's own structure suggest that Congress was concerned about the relative unfairness of lengthy delay in Chapter 11 cases involving single-asset real estate projects, that one of its goals aims to expedite the proposal of meritorious plans of reorganization in such cases, and that, where the case does not early kick forward toward confirmation, a debtor must compensate its mortgagee for the time-value of the mortgagee's debt investment, by the payment of interest at the original contractual rate.

Id. at 49-50 (internal citations omitted). Applying these unique purposes, the court determined that "any proffer of cause for excusing a debtor's compliance must include a concrete substitute for the creditor's statutorily-fixed expectation of payment." Id. at 50.

In Heather Apartments, the debtor's central argument for an extension of the ninety (90) day deadline imposed by section 362(d)(3) was that there existed a possibility of a sale of the real estate that would pay the secured creditor's claim in full, as well as provide a dividend to unsecured creditors and possibly a payoff to equity holders. Id. The court, however, rejected the debtor's request for an extension based on the mere possibility of a sale, because a mere possibility did not amount to a "concrete substitute" for payment of interest and because the debtor bore a "heavy burden of production as to the likelihood that a sale will close promptly, and that there would be enough proceeds to serve the needs honored by the statute." Id.

In demonstrating how heavy a burden would have to be carried by a debtor seeking to extend the ninety (90) day period in section 362(d)(3), the court in Heather Apartments explained that it would have been possible for the debtor to satisfy the high standard. The court explained that a prospective sale of the debtor's assets might carry the heavy burden if the

following conditions, at minimum, were met prior to the filing of the motion to extend the deadline for cause:

- A binding purchase agreement was executed between the debtor and the prospective purchaser;
- A binding lending commitment letter was obtained by the prospective purchaser; and
- The debtor and the prospective purchaser demonstrated “substantial progress in satisfying the ministerial minutiae for closing.”

Id. “Only then,” wrote the court, “could a court feel assured that the protected mortgagee would receive a substantial equivalent of its expectancy under § 362(d)(3), so as to merit holding it off from foreclosing after the first 90 days of the case.” Id. Although the case law concerning what constitutes “cause” specifically in relation to Section 363(d)(3) is sparse, in the event Heather Apartments becomes the guiding light on the subject, debtors will be held to a high standard in justifying “cause” for an extension of time to file a plan or to start monthly interest payments in order to avoid relief from stay under section 362(d)(3).

### III. CONCLUSION

As the economy continues to stumble, the rate of bankruptcy filings is likely to increase. Many of these cases will involve debtors with substantial real estate holdings. In counseling these debtors, it is important to fully assess at the outset whether the case is a single asset real estate case. From the above, it is clear that making these determinations may not be as easy as it might seem. Courts have spent countless hours trying to define the exact parameters of what fits the definition of single asset real estate first codified in 1994 and, although these cases provide some clarity, they certainly leave questions unanswered. Time needs to be taken to evaluate the facts and circumstances of each case in order to obtain an understanding of whether the case may

be a single asset real estate case and, thereby, trigger the additional burdens placed on this type of case by various provisions of the Bankruptcy Code.

**Single Asset Real Estate Bankruptcies: Single Purpose Entity Bankruptcy Issues**

**By: Jeffrey L. Jonas, Esquire  
Erin Gannon Apstein, Esquire  
Brown Rudnick LLP**

**I. Introduction**

In recent years, commercial mortgage lenders have required that a borrower be a special-purpose entity ("SPE") with an independent director in order to isolate the income producing asset, i.e., the property and cash flow from the property, from the risks of bankruptcy of the borrower SPE itself or an affiliate of the borrower SPE. As discussed below, whether or not a borrower SPE's assets will be considered part of its parent's or affiliate's bankruptcy estate (versus remaining solely in the borrower SPE and available to satisfy only the borrower SPE's creditors' claims) will depend on the facts and circumstances surrounding the bankruptcy filings and the court's analysis and application of substantive consolidation, true sale and fraudulent transfer law and the core asset doctrine.

**II. Role of Independent Director and Standard of Fiduciary Duty**

Although required by a lender, an independent director is not under the control or direction of a lender and has the same fiduciary duty as all other directors to the entity and its shareholders. Generally, SPEs are required to obtain the consent of an independent director in order to authorize a bankruptcy filing. Lenders often believe the independent directors, unlike equity holders/insiders, will be less willing to authorize a bankruptcy filing, especially if the SPE is in the "zone of insolvency". However, an independent director may authorize a bankruptcy filing if its in the best interest of the entity and its shareholders even if such action is adverse to the the lender.

A director generally owes a fiduciary duty only to its corporation and its shareholders (and not its creditors). See Kingston Square, 214 B.R. at 721; In re Doctors Hospital, 360 B.R. at 428. When an entity is insolvent, however, the independent director may also owe a fiduciary duty to the creditors of such entity. Kingston Square, 214 B.R. at 735; see also In re Cumberland Farms, Inc., 249 B.R. 341, 349-51 (Bankr. D. Mass. 2000) (noting that directors must act "with absolute fidelity and must place their duties to the corporation above every other financial or business obligation"). This principal -- that directors owe a fiduciary duty to a corporation's creditors when the corporation is in the "zone" or "vicinity" of insolvency<sup>1</sup> -- was first recognized by the Court of Chancery of Delaware in Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp. 1991 WL 277613 at 32 (Del. Ch., 1991). In this case, the court held that the duty owed by directors of an insolvent corporation is to the "enterprise," which includes creditors. Id. at 34 (noting that where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers). This case has been widely interpreted as supporting the notion that directors of a corporation approaching insolvency owe fiduciary duties to creditors. See Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del.Ch.2004); Trenwick America Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del.Ch.2006); Big Lots Stores, Inc. v. Bain Capital Fund VI, LLC, 922 A.2d 1169 (Del.Ch.2006).

Recently, however, in a case of first impression, the Delaware Supreme Court directly addressed the substantive question of whether a creditor of a corporation that is operating within the zone of insolvency can bring a direct action against its directors for an alleged breach of fiduciary duty. North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 at 99 (2007). In Gheewalla, the court affirmed the dismissal of a complaint alleging that because a corporation was either insolvent or operating in the zone of insolvency, its directors owed fiduciary duties directly to the plaintiff as a creditor. Id. at 100-01. In doing so, the court held that a creditor may not assert a direct claim for breach of fiduciary duty against the directors of insolvent corporations or corporations operating "in the zone of insolvency". Id. The court reasoned that creditors are protected by their "negotiated agreements, security instruments, the implied covenant of good faith and fair dealing, fraudulent conveyance law, and

bankruptcy law,” and therefore do not need the additional protection provided by fiduciary duty law. *Id.* at 100. The court noted, however, that creditors do have standing to maintain derivative claims against its directors on behalf of the corporation for breaches of fiduciary duties, but that to transform those claims into direct actions would “create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation.” *Id.* at 101.

The *Gheewalla* case creates some uncertainty in fiduciary duty case law because it implies that directors of insolvent corporations or corporations operating in the zone of insolvency may continue to have a fiduciary duty to the corporation and its shareholders (versus to its creditors). However, it is clear that the directors of solvent entities have a fiduciary duty to act in the best interest of the entity and its shareholders. Assuming that the SPEs in question are solvent, if the bankruptcy filings were in the best interest of the SPEs and their shareholders, the independent directors would be required to vote in favor of the filings despite the fact that such filings could be adverse to the secured lenders.

In some circumstances, however, it may be possible for a SPE to obtain the benefits of a bankruptcy filing without obtaining the independent director's consent. In *Kingston Square*, a secured creditor instituted foreclosure proceedings against eleven debtor special purpose entities, each of which held real estate and was controlled by a common principal. *In re Kingston Square Assoc's*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997); *See also*, Ellis, Robert Dean, *Securitization Vehicles, Fiduciary Duties, and Bondholder's Rights*, 24 J. CORP. L. 295, at 323 (1999) (discussing *Kingston Square's* role in establishing bankruptcy remoteness as a means to attack securitization transactions). The special purpose entities' independent director, who had been appointed by the secured creditor, was largely inactive in the company's operations and refused to approve a bankruptcy filing against the creditor's wishes. *Kingston Square*, 214 B.R. 713 at 721. In order to protect the interests of unsecured creditors and limited partners who would likely be wiped out in foreclosure proceedings, the debtors' principal solicited creditors of the special purpose entities to file involuntary bankruptcy petitions. *Id.* at 739. A group comprised of trade creditors and professionals hired by the debtors agreed to undertake the filing. *Id.* at 726. The lender sought to dismiss the bankruptcy petitions as collusive and bad faith attempts to circumvent the independent director requirements. *Id.* at 715. The court used a two part test from *In re Winn*, to determine whether the involuntary filing had been collusive. *See In re Winn*, 49 B.R. 237, 239 (Bankr. M.D. Fla. 1985). The *Winn* test asks whether (i) there has been a concerted effort between the debtor and the petitioning creditors to institute the involuntary filing and (ii) whether the parties fraudulently invoked the jurisdiction of the court to accomplish an illegitimate purpose. *Id.* at 239. In applying the test, the court found that the debtor and petitioning creditors had orchestrated the filing of bankruptcy of the special purpose entities but that their behavior did not rise to the level of collusion because (i) the debtors were eligible for relief and (ii) no court order restricted their access to such relief. The court supported this finding by implying that the independent director had breached its fiduciary duty to the special purpose entities by failing to approve the filings for bankruptcy protection. As a result, the court did not dismiss the bankruptcy filings. *Id.* at 739.

In summary, the existence of an independent director(s), in and of itself, will not “protect” an SPE's secured lender(s) against the SPE filing for bankruptcy (or being involuntarily put into bankruptcy).

### III. Substantive Consolidation

#### 1. Bankruptcy Code Contains No Express Provisions Permitting Substantive Consolidation

Substantive consolidation is an equitable remedy whereby the assets and liabilities of separate legal entities are consolidated and administered by the bankruptcy court as though held and incurred by a single entity. Although the Bankruptcy Code contains no express provision providing for substantive consolidation, bankruptcy courts have ordered substantive consolidation in appropriate circumstances in furtherance of their general equitable powers. *See* 11 U.S.C. § 105; *Meyer v. Hammes*, 187 B.R. 281, 284 n.2 (S.D. Ind. 1995); *In re Creditors Serv. Corp.*, 195 B.R. 680, 688 (Bankr. S.D. Ohio 1996). Because there are no express provisions to provide guidance for substantive consolidation, this equitable remedy is judge-made law. Precedents are of little value and substantive consolidation analysis is made on a case by case basis. *In re Crown Machine & Welding*, 100 B.R. 25, 27-28 (Bankr. D. Mont. 1989).

2. Burden of Proof on Party Seeking Substantive Consolidation

As courts generally do not favor disregarding the separate existence of corporations, a presumption exists against substantive consolidation and the party seeking it has the burden of establishing the need for it. See, e.g., In re Auto-Train Corp., 53 B.R. 990 (Bankr. D.C. 1985), aff'd, 810 F.2d 270, 276 (D.C. Cir. 1987); In re Steury, 94 B.R. 553, 554 (Bankr. N.D. Ind. 1988). Moreover, in light of the “possibility of unfair treatment to creditors who have dealt solely with the company having a surplus as opposed to those who have dealt with related entities with deficiencies,” courts are usually reluctant to grant a request for substantive consolidation. In re Hemingway Transp., Inc., 954 F.2d 1, 12 (1st Cir. 1992); In re Augie/Restivo Baking Co., Ltd., 860 F.2d 515, 518 (2d Cir. 1988); Talcott v. Wharton, 517 F.2d 997, 1001 (2d Cir. 1975), cert. denied, 424 U.S. 913 (1976); Creditors Serv., 195 B.R. at 689-690; Steury, 94 B.R. at 559; see Chemical Bank New York Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966); R<sup>2</sup> Investments v. World Access, Inc., 301 B.R. 217, 272 (Bankr. N.D. Ill. 2003). In In re Owens Corning, 419 F.3d 195, 211 (3d Cir. 2005), cert. denied, 126 S. Ct. 1910 (2007), the Third Circuit described substantive consolidation as an “extreme” remedy and “one of last resort” which should be used on “rare” occasions after considering and rejecting other remedies because such a remedy may affect profoundly creditors’ rights and recoveries.

3. Substantive Consolidation Factors

Courts apply various multi-faceted tests to determine whether substantive consolidation is justified. see, e.g., In re Vecco Const. Indus., Inc., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980). For example, courts in the Second Circuit generally look at the following “Augie/Restivo Factors” to determine whether substantive consolidation is appropriate: (i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identities in extending credit; or (ii) whether the affairs of the entities are so entangled that consolidation will benefit all creditors. Augie/Restivo, 860 F.2d at 518. Other courts have looked to substantially the same factors but framed the test as whether there was a substantial identity between the entities being consolidated and whether consolidation is necessary to avoid some harm or realize some benefit for creditors of such entities. Hemingway Transp., 954 F.2d at 112; Auto-Train, 810 F.2d at 276; Eastgroup Prop., 935 F.2d at 248-250.

Moreover, some decisions focus on whether all creditors would benefit by consolidation without undue prejudice to any particular group. E.g., FDIC v. Colonial Realty Corp., FDIC v. Colonial Realty Co., 966 F.2d 57, 61 (2d Cir. 1992); Hemingway Transp., 954 F.2d at 112. In Bonham, the Ninth Circuit adopted the Augie/Restivo factors, but the court also held that the burden rested on the creditors seeking consolidation to overcome the presumption that they did not rely on the separate credit of the two entities sought to be consolidated. Bonham, 229 F.3d at 767. In determining whether substantive consolidation is appropriate, the Bonham court focused on the harm to the entity with respect to which consolidation is being sought as opposed to harm to creditors.

The Third Circuit framed its test as follows:

In our Court what must be proven (absent consent) concerning the entities for whom substantive consolidation is sought is that (i) prepetition they disregarded separateness so significantly their creditors relied on the breakdown of entity borders and treated them as one legal entity or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors. Owens Corning, 419 F.3d at 211.

With regard to the pre-bankruptcy interrelationship between the entities which potentially may be consolidated, many federal courts have articulated a list of factors to be applied in substantive consolidation cases. See, e.g., Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940) (listing ten factors). The court in Vecco, 4 B.R. at 410, reformulated the Fish list into the following criteria for determining whether substantive consolidation is appropriate:

- the degree of difficulty in segregating and ascertaining individual assets and liabilities;

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- the presence or absence of consolidated financial statements;
- the profitability of consolidation at a single physical location;
- the commingling of assets and business functions;
- the unity of interests and ownership between the various corporate entities;
- the existence of parent and intercorporate guarantees on loans; and
- the transfer of assets without observance of corporate formalities.

Accord In re Murray Indus., 119 B.R. 820, 830 (Bankr. M.D. Fla. 1990); In re Mortgage Inv. Co., 111 B.R. 604, 610 (Bankr. W.D. Tex. 1990); Holywell Corp. v. Bank of New York, 59 B.R. 340, 347 (Bankr. S.D. Fla. 1986).

It should be stressed, however, that the factors set forth in Vecco, along with additional factors formulated in other cases, are merely “examples of information that may be useful to courts charged with deciding whether there is a substantial identity between the entities to be consolidated and whether consolidation is necessary to avoid some harm or realize some benefit.” Eastgroup Prop., 935 F.2d at 250. Therefore, although a “proponent of consolidation may want to frame his argument using the seven factors outlined in In re Vecco Const. Indus., Inc.,” the existence or absence of any number of those factors is not necessarily determinative. Eastgroup Prop., 935 F.2d at 249-50; see Creditors Serv., 195 B.R. at 690 (“[t]he factors merely provide a framework to assist the Court’s inquiry whether harm will result in the absence of consolidation”) (citation omitted). Moreover, the seven Vecco factors are not dispositive. “Rather, they should be evaluated within the larger context of balancing the prejudice resulting from the proposed order of consolidation with the prejudice movant alleges it suffers from debtor’s separateness.” In re DRW Prop. Co., 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985) (citing In re Donut Queen, 41 B.R. 706, 709-10 (Bankr. E.D.N.Y. 1984)).

Furthermore, some courts have stressed certain factors emphasizing commingling assets, transacting transfers without respecting corporate formalities and poor record keeping because these make it more difficult to segregate out the individual assets and liabilities. See, e.g., Eastgroup, 935 F.2d at 249; R<sup>2</sup> Investments, 301 B.R. at 276. These courts have noted that elements such as common ownership, a parent/subsidiary relationship, common directors and officers, inter-affiliate transfers, incorporation caused by the parent, the existence of inter-corporate claims, and consolidated financial statements or tax returns are typical of most affiliated corporations and the existence of the elements above are not sufficient for consolidation. R<sup>2</sup> Investments, 301 B.R. at 276.

Certain courts have also ordered substantive consolidation where there was a practical impossibility of reconstructing the financial records of the debtors so as to segregate assets and liabilities or where the segregation efforts would have been unduly expensive or difficult. See, e.g., Chemical Bank, 369 F.2d at 847; Creditors Serv., 195 B.R. at 690. Other courts have considered whether substantive consolidation would increase the likelihood of the debtor’s reorganization or the recovery for all creditors of each entity, due to potential savings of cost and time in not having to determine duplicate claims and questions of liabilities among debtors. See, e.g., Murray Indus., 119 B.R. at 830; Talcott, 517 F.2d at 1001; In re Drexel Burnham Lambert Group, 138 B.R. 723, 766 (Bankr. S.D.N.Y. 1992). However, notwithstanding such additional tests, under the case law, the other tests cited above (including lack of prejudice to other creditors by consolidation) must still be met to justify substantive consolidation.

4. SPE Substantive Consolidation Cases

In In re Central European Industrial Development Company LLC<sup>1</sup>, the first case to directly consider the substantive consolidation of a SPE, the court declined to apply substantive consolidation. 288 B.R. 572 (Bank ND Cal 2003). In this case, a debtor SPE had only one creditor and could not confirm a plan without the vote of that creditor, as it was impaired under the plan. Id. at 575. To remedy this issue, the debtor sought substantive consolidation with related debtors' entities, so that there would no longer be only a single creditor to vote on the plan. Id. The debtor argued that since the creditor had insisted on a SPE corporate structure for their lending transactions, and as it dealt with the debtors as a single economic unit, substantive consolidation is exactly what it bargained for. Id. at 576. The court rejected this argument, noting that the parties had agreed on the structure and that the lender plainly relied on the separateness of the entities. Id. The court also rejected debtors' attempts to portray SPE arrangements as an evil in need of curing by substantive consolidation, noting that the debtors did not cite any law that would be violated by such a corporate structure. Id.

The court again declined to apply substantive consolidation to a special purpose entity in In re Doctors Hospital of Hyde Park, Inc. 360 B.R. 787 (Bank ND Ill. 2007). In this case, the trustee moved for consolidation, arguing that lenders treated Doctors Hospital as the borrower of a securitized loan, and not its special purpose entity, and that Doctors Hospital had the ability to control the affairs of the special purpose entity. Id. at 844. Doctors Hospital and the special purpose entity were both owned entirely by the same principal, and the special purpose entity kept no corporate records, had no officers or employees, filed no tax returns and had no assets other than the loan in dispute. Id. The trustee argued that the special purpose entity was simply an instrumentality of Doctors Hospital and, as such, should be consolidated. Id. The court found that certain parties' views that Doctors Hospital was the borrower did not change the fact that the special purpose entity was the true borrower. Id. at 848. While the special purpose entity may have only been the "documented borrower," it is precisely this role that the parties relied on. Id. The special purpose entity, the court stated, was created for the special purpose of serving as a bankruptcy-remote entity, and not as a cover for fraud or to work an injustice. Id.

**IV. True Sale**

1. True Sale Protects SPE Assets from Automatic Stay and Restricts Debtor's Use of Such Assets as Estate Property in a Bankruptcy

A "true sale" consists of the absolute transfer of assets. Committee on Bankr. and Corporate Reorganization of the Ass'n of the Bar of the City of New York, Structured Financing Techniques, 50 Bus. Law. 527, 541-42 (1995) (explaining that a true sale is designed to "remov[e] the assets transferred from the transferor's estate under Section 541 of the Bankruptcy Code). In order for assets to be adequately protected as "bankruptcy remote," the originator of a SPE must transfer the assets in a "true sale". Otherwise, a court could find that the transfer of assets to the SPE was, in essence, a secured loan by the buyer, or an assignment of assets that operated as a pledge, and that the assets remain a part of the originator's bankruptcy estate. Lupica, Lois R, Asset Securitizations: The Unsecured Creditor's Perspective, 76 Tex. L. Rev. at 660 (February, 1998). This would subject the disposition of assets by the SPE to the automatic stay in the originator's bankruptcy and enable the debtor to use the SPE's assets as estate property. Id.

2. True Sale Factors

According to existing case law, courts will examine "all the facts and circumstances surrounding the transactions at issue" to determine whether a transaction should be characterized as a sale or contribution, on the one hand, or a pledge, on the other hand. In re Golden Plan, 829 F.2d 705, 709 (9th Cir. 1986). Courts will also examine the intent of the parties as well as whether the "legal rights and

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<sup>1</sup> It should be noted that unlike many other substantive consolidation cases, in In re Central European involved entities that were entirely under common ownership, with each sharing partial ownership of the other with a nondebtor.

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economic consequences of the agreement bear a greater similarity” to a financing transaction or to a sale or contribution. In re Evergreen Valley Resort, Inc., 23 B.R. 659 (Bankr. D. Me. 1982) (citing Major’s Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 544 (3d Cir. 1979)). One court has stated that “[w]here the intention of the parties is clearly and unambiguously set forth in the agreement, effect must be given to the parties’ intent as revealed in the language used without regard to extrinsic evidence.” In re Bevell, Bresler & Schulman Asset Management Corp., 67 B.R. 557, 586-88 (D.N.J. 1986), aff’d, 805 F.2d 120 (3d Cir. 1986). Another court has reasoned that “[i]t is incumbent upon the party challenging the assignment to show by clear and convincing proof that only a security interest was intended.” In re Candy Lane Corp., 38 B.R. 571, 577 (Bankr. S.D.N.Y. 1984) (citing In re 716 Third Ave. Holding Corp., 340 F.2d 42, 44 (2d Cir. 1964), cert. denied sub. nom. A.G.V. Assoc., Inc. v. Cross, 381 U.S. 913 (1965)). However, most courts look beyond the text of the relevant agreements to determine the true nature of the transaction. In re Joseph Kanner Hat Co., 482 F.2d 937, 940 (2d Cir. 1973).

To make a true sale determination, courts look to whether the structure and economic consequences of the transaction are consistent with a contribution and absolute conveyance characterization. See Bevell, 67 B.R. at 596-598; Candy Lane, 38 B.R. at 576-77; In re O.P.M. Leasing Serv., Inc., 23 B.R. 104, 116 (Bankr. S.D.N.Y. 1982); Major’s Furniture, 602 F.2d at 545; In re Armando Gerstel, Inc., 65 B.R. 602, 605 (S.D. Fla. 1986). Two factors which courts have considered are: (1) whether the transferee assumed the normal risks of loss and benefits of gain inherent in the ownership of the property conveyed, Major’s Furniture, 602 F.2d at 545. See Endico Potatoes, 67 F.3d at 1068-69; In re Woodson Co., 813 F.2d 266, 270-72 (9th Cir. 1987), and (2) whether the credit risk of the underlying obligors’ payments on the assets shifted from the transferor to the transferee. See, e.g., Endico Potatoes, 67 F.3d at 1068-69; In re Woodson Co., 813 F.2d at 271-72; Golden Plan, 829 F.2d at 709-10; McVay v. Western Plains Corp., 823 F.2d 1395, 1399 (10th Cir. 1987).

Perhaps the most significant factor looked to by courts as to the shifting risk of loss is whether the transferee has full recourse to the transferor in the event the required payment on the assets are not made. Where such recourse is present, courts have held that the risk of loss has not shifted from the transferor to the transferee. E.g., Endico Potatoes; Woodson; Major’s Furniture; In re Executive Growth Inv., 40 B.R. 417 (Bankr. C.D. Cal. 1984); In re Cornet Capital Co., 142 B.R. 78, 80-81 (Bankr. S.D.N.Y. 1992). Even where recourse is limited, however, if such recourse is material, courts have found the risk of loss to have shifted. E.g., In re S.O.A.W. Enter., 32 B.R. 279 (Bankr. W.D. Tex. 1983); In re Hurricane Elkhorn Corp II, 19 B.R. 609 (Bankr. W.D. Ky. 1982), aff’d in part and rev’d in part, 32 B.R. 737 (W.D. Ky. 1983), aff’d, 763 F.2d 188 (6th Cir. 1985).

Other factors considered by the court include:

- whether the risk of gain or loss due to market changes is shifted from the transferor to the transferee. See, e.g., In re Bellanca Aircraft Corp., 56 B.R. 339, 374-76 (Bankr. D. Minn. 1985), aff’d on this ground & rev’d on others, 850 F.2d 1275 (8th Cir. 1988);
- how the interest rate received by the transferee was determined. Woodson, 813 F.2d at 271-72 (finding that the transfer of mortgage notes was a secured borrowing because the transferee’s interest rate was based on the rate on which the transferor could borrow funds);
- whether the transferee’s rights may be extinguished by repayment of a debt by the transferor or by the transferee’s failure to pay any remaining balance of the purchase price or perform any other obligation to the transferor. Evergreen, 23 B.R. at 662; Joseph Kanner, 482 F.2d at 937; Rand v. Goldblatt, 347 Mass. 566 (1964);
- whether the transferee must account to the transferor for any recoveries in excess of the purchase price. Evergreen, 23 B.R. at 661;
- whether the transaction uses the form and language of an absolute sale; and

- whether the transferor or an affiliate of the transferor has the right to receive the transferred payments.

Some courts have indicated that if the transferor services the transferred payments or if the transfer is not recorded, and then the transfer is more likely to be characterized as a secured borrowing. E.g., In re Mid Atlantic Fund, 60 B.R. 604, 608 (Bankr. S.D.N.Y. 1986); In re Alda Commercial Corp., 327 F. Supp. 1315 (S.D.N.Y. 1971). However, other courts have rejected this view. E.g., Woodson, 813 F.2d at 272 (fact that transferor services mortgage loans is consistent with absolute sale).

## V. Other Issues For Consideration

### 1. Fraudulent Transfer

Section 548 of the Bankruptcy Code enumerates the standard for a fraudulent transfer. 11 U.S.C. § 548(a). Pursuant to Section 548, a trustee or the debtor in possession may bring a fraudulent transfer claim. Id. A transfer will be deemed fraudulent if the debtor/transferor: (i) transferred the assets with an actual intent to hinder, delay or defraud creditors; or (ii) received less than a reasonably equivalent value for the transfer and one of the following: (a) the debtor/transferor was insolvent at the time of the transfer or the transfer rendered the debtor/transferor insolvent, (b) the transfer left the debtor/transferor with an unreasonably small capital, (c) the transfer resulted in the debtor/transferor incurring debts that would be beyond the debtor's ability to pay, or (d) debtor/transferor made the transfer to or for the benefit of an insider. Id.; see Peter J. Lahny IV, Asset Securitization: A Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation, 9 Am. Bankr. Inst. L. Rev. 815. In addition, the transfer must have been made or incurred within two years of the date of the filing. 11 U.S.C. § 548(a)(1), although a fraudulent transfer claim may be brought in the bankruptcy court under state fraudulent transfer law, which may extend the statute of limitations period.

### 2. Core Asset Doctrine

The core asset doctrine has been applied by the courts in Chapter 11 proceedings where certain assets held by a special purpose entity are so necessary to the originator/debtor's successful reorganization that they should be drawn back into the debtor's estate. This doctrine was applied in a securitization context in the 1991 Days Inn bankruptcy case. See Borod, Ronald S., et. al., Reflections in plague time: prospectives on sub-prime crisis, The Americas Restructuring and Insolvency Guide 2008/2009. Days Inn was the sponsor to a securitization of the Days Inn trademark and franchise assets. Id. When Days Inn declared bankruptcy, the debtors caused the special purpose entity that issued the securities backed by the trademark and franchise assets to file as well, and prevailed upon the bankruptcy court to issue a preliminary ruling that it would substantively consolidate the assets of the special purpose entity with the assets of the bankrupt parent. Id. This ruling was based on a core assets analysis, under which the trademark and franchise agreements were considered core assets of the bankrupt debtor and therefore necessary for its successful reorganization in bankruptcy. Id. However, this ruling was subsequently withdrawn. Id.

In the LTV Steel bankruptcy case, the court applied a similar analysis. In re LTV Steel Co. Inc., 274 B.R. 278 (Bankr. N.D. Ohio 2001). The debtors filed an emergency motion requesting the interim use of cash collateral used in prior securitizations and claimed that those securitizations were not true sales, but disguised financings. Id. The court, on an interim basis, allowed the debtors to use for their own benefit the inventory and receivables (and the related cash proceeds) that had been transferred to certain special purpose entities, because such use was reasonable and the interests of the lenders in the securitization transaction were adequately protected notwithstanding the interim use. Id. The court found that it had proper jurisdiction to enter the interim order because the debtors had "at least some equitable interest in the inventory and receivables, and ... this interest is property of [their] estate." Id. Although the court did not apply the "core asset doctrine" in granting the interim order, the court clearly considered the working capital assets of the sponsor to be fundamental to the reorganization of the

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debtor, because without access to such assets, the debtor would have been unable to obtain debtor in possession financing or remain in operation following a filing.<sup>2</sup> See Borod, Ronald S., et. al., Reflections in plaque time: prospectives on sub-prime crisis, *The Americas Restructuring and Insolvency Guide 2008/2009*.

### VI. Further Issues for Consideration

In In re Lehman Brothers Inc., Case No. 08-13555, (Bankr. S.D.N.Y, Sept. 15, 2008), an unprecedented case, the court approved the debtors' motion to sell the debtors' brokerage business to Barclay's Capital Inc. pursuant to Section 363(f) of the Bankruptcy Code. See Stephen Lubben, The Sale of the Century and its Impact on Asset Securitization: Lehman Brothers, 27 Am. Bankr. Inst. J. 1 (2009). The brokerage business was housed in a special purpose entity owned by the debtor.<sup>3</sup> Id. at 59. Despite the fact that the brokerage assets were held in a special purpose entity and that the special purpose entity was not in bankruptcy, the court approved the sale because (i) there were no other viable alternatives for the disposition of the assets and (ii) the consequences that the failure to approve the sale would have on the global economy were perceived to be disastrous. Id. at 60; See remarks of Judge Peck, Sale Mot. Hr'g Tr. at 171, Sept. 19, 2008 ("in unrebutted testimony [the debtors] indicated through proffer that the markets, in effect, would tank [if the sale was not approved]"). In approving the sale, the court essentially expanded the debtors' estate by including the brokerage assets held by the special purpose entity without determining if the brokerage assets held by the special purpose entity were actually property of the estate. Lubben at 60. Although the court approved the sale without determining if the brokerage assets were part of the estate, the court protected certain secured parties by allowing all validly perfected interests in such assets to attach, with priority, to any proceeds of the sale. In re Lehman Brothers Inc., Case No. 08-13555, Order Authorizing and Approving the Sale of Purchased Assets Free and Clear of Liens and Other Interests at ¶24 (Bankr. S.D.N.Y, Sept. 19, 2008). It is important to note that the Lehman court explicitly stated that this case should not be viewed as precedent for other bankruptcy cases. See Emily Chasan, Judge Approves Lehman, Barclays Pact, Reuters, Sep 20, 2008.

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<sup>2</sup> This case ultimately was settled so the court did not make a final ruling on whether the pre-petition transfers were "true sales".

<sup>3</sup> It is unclear whether the brokerage assets were held by the debtors and the special purpose entity or only the special purpose entity.