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Utah State Bar

Banking & Finance Committee Annual Meeting

Salt Lake City, Utah

April 13, 2010

SARE'S AND SPE'S IN BANKRUPTCY

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American Bankruptcy Institute

15TH Annual Rocky Mountain Bankruptcy Conference

**Denver, Colorado
January 21-22, 2010**

**SINGLE ASSET REAL ESTATE
BANKRUPTCIES**

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Single Asset Real Estate Bankruptcies

I. Background

In 1994, Congress amended Title 11 of the United States Code (the “Bankruptcy Code”) to provide particularized treatment for debtors within the gamut of “single asset real estate” (“SARE”) entities. The purpose of adding a provision for SARE was “to put additional responsibility on a single asset real estate debtor and prevent a perceived abuse of the bankruptcy process on the part of these ventures.” *In re 652 West 160th LLC*, 330 B.R. 455, 460 (Bankr. S.D. N.Y. 2005) (citing S.Rep. No. 168, 103d Cong., 1st Sess. (1993)). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) significantly expanded the scope of SARE cases by subsequently removing the four million dollar secured debt cap component of the definition of SARE. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-08, 119 Stat. 23 (2005).

To qualify as SARE under the Bankruptcy Code after enacting BAPCPA, a debtor must own only:

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.

11 U.S.C. § 101(51B). In other words, the debtor’s sole source of income is generated from the sale and divestment of a single real property asset.

The most common SARE case is a dispute between a debtor with a single piece of real estate as its only asset, and one creditor with a secured claim on the asset. On each voluntary petition, debtors may check a box under the nature of business indicating “Single Asset Real Estate as defined in 11 U.S.C. § 101(51B).” However, in many cases debtors do not indicate that the debtor is a SARE entity on the voluntary petition. In the event the debtor files for relief and leaves that box unchecked, a party in interest may raise the question of whether the debtor is a SARE entity, and the courts must determine the issue.

II. The Test for SARE

Applying the Section 101(51B) definition of SARE under BAPCPA, the U.S. Court of Appeals for the Fifth Circuit expounded the appropriate test to determine whether a debtor is a SARE entity. *See In re Scotia Pacific Co.*, 508 F.3d 214, 220 (5th Cir. 2007). The Fifth Circuit described a three pronged test requiring proof of the following elements: “(1) the debtor must have

real property constituting a single property or project (other than residential property with fewer than 4 residential units), (2) which generates substantially all of the gross income of a debtor, and (3) on which no substantial business is conducted other than the business of operating the real property and activities incidental thereto.” *Id.* (focusing primarily on the third prong of the analysis and discussing the debtor’s business and corporate structure). The court was clear that these are mandatory elements, rather than mere factors for consideration. *See id.*

A. Real Property Constituting a Single Property or Project

The first inquiry is whether the debtor’s real property is a single property or project. Clearly, where a debtor’s real property consists of a single parcel of real estate, other than residential property with fewer than four residential units, the first element is satisfied.

The practical problem of classifying a debtor’s real property as SARE arises where the debtor owns multiple parcels of land. To classify multiple parcels of land as SARE, the property must be “linked together in some fashion in a common plan or scheme involving their use.” *In re McGreals*, 201 B.R. 736, 742 (Bankr. E.D. Pa. 1996); *see also In re Webb Mtn. LLC*, 2008 WL 656271 (Bankr. E.D. Tenn. March 6, 2008) (applying the three pronged test from *In re Scotia Pacific Co.*, and determining the debtor’s five parcels constituted SARE because the debtor had not yet developed the parcels and was not conducting any active business on the property).

B. Real Property Generating Substantially All of the Gross Income of a Debtor

Generally, the second determination regarding gross income is derived from a straightforward comparison of the revenue generated from the sale of the debtor’s real property to the revenue generated from the operation of the real property. In cases where the debtor’s primary source of income is derived from the sale of the real property, the debtor will satisfy this second element of the SARE analysis. *See Kara Homes v. National City Bank (In re Kara Homes, Inc.)*, 363 B.R. 399, 404-05 (Bankr. D.N.J. 2007) (holding the debtor received “substantially all of their income through the sale of real property.”). *Compare In re CGE Shattuck LLC*, Ch. 11 Case No. 99-12287 JMD, 1999 WL 33457789, at *7 (Bankr. D.N.H. 1999) (stating the debtor is not a SARE entity where “a significant percentage of the debtor’s revenues are derived from golf pro shop operations and other non-real property sources.”). In practice, courts have a tendency blend their discussions of the second SARE element with the third SARE element.

C. Real Property on which No Substantial Business is Conducted Other Than the Operating of the Real Property and Activities Incidental Thereto.

As a general rule, debtors operating hotels, resorts, golf courses or marinas are not SARE entities. *See Centofante v. CBJ Dev. Inc. (In re CBJ Dev. Inc.)*, 202 B.R. 467, 473 (B.A.P. 9th Cir. 1996) (holding that hotels are not SARE entities because the hotel “gift shop, restaurant, bar and the bus tours launched from the [h]otel parking lot are all business other than the business of operating the property.”); *In re Whispering Pines Estate, Inc.*, 341 B.R. 134 (Bankr. D.N.H. 2006) (determining operating a hotel is sufficiently active to constitute a business other than the business

of operating the real property); *In re Prairie Hills Golf & Ski Club*, 255 B.R. 228 (Bankr. D. Neb. 2000) (explaining a debtor is not a SARE entity where the debtor builds and sells residences, constructs roads to residences, golf and ski areas, removes snow from golf and ski areas, sells liquor in the clubhouse, and leases golf and ski areas to third parties); *In re Larry Goodwin Golf, Inc.*, 219 B.R. 391 (Bankr. M.D.N.C. 1997) (holding operation of a golf course, golf cart rentals, pool, concessions and undeveloped property for sale constitute substantial business, rather than retaining the real property solely for income); *In re Kkemko Inc.*, 181 B.R. 47 (Bankr. S.D. Ohio 1995) (holding that a marina is not SARE because the marina sold both concessions and gas, and stored, repaired and winterized boats); *In re Vail Plaza Dev., LLC*, Ch. 11 Case No. 08-26920 HRT (Bankr. D. Colo. June 5, 2009) (concluding the debtor was not a SARE entity because of the debtor's involvement in the hotel operations and ongoing sale of parking spaces in a separate development); *In re Club Golf Ptnrs. LP*, Ch. 11 Case No. 07-40096 BTR, 2007 WL 1176010 (Bankr. E.D. Tex. 2007) (holding the debtor's golf course was not SARE because the debtor sold memberships and merchandise in its pro shop, charged fees to use the golf course, golf carts, the driving range, the tennis courts and the clubhouse for special events, and sold food and beverages in the clubhouse restaurant); *In re CGE Shattuck LLC*, 1999 WL 33457789 (determining that real property is not SARE when a substantial percentage of revenues are derived from a golf pro shop and golf related services). In summary, these types constitute substantial business outside the scope simply operating real property, and are considered activities that are not "incidental" from operating the real property.

Notably, one exception to the general rule is when a debtor owns SARE with only a passive investment in an operating resort or hotel. *See Kara Homes*, 363 B.R. 399. *Kara Homes* primarily involved an uncompleted real estate development project, and the court went to great lengths to distinguish cases involving real estate development from cases involving operating debtors with multiple revenue streams. *See id.* at 405-06. Moreover, the court cited with approval the "palpably clear" analysis that debtors operating marinas, golf resorts, ski resorts, and hotels cannot be included in the definition of SARE. *See id.*; *see also In re Scotia Pacific Co.*, 508 F.3d at 221-23. Thus, only if the debtor has no active role in the management of the operating resort or hotel can the debtor qualify as a SARE entity.

III. The Application of 11 U.S.C. § 362(d)(3) to SARE

Where all SARE statutory elements are satisfied, SARE cases receive an expedited reorganization through the automatic stay provisions of Section 362(d)(3) of the Bankruptcy Code. "SARE debtors are carved out and subjected to stringent requirements in § 362(d)(3) which expedite the time for SARE debtors to file a plan of reorganization or commence making monthly payments, failing which the automatic stay is promptly lifted." *In re Scotia Pacific Co.*, 508 F.3d at 225. The legislative intention of Section 362(d)(3) "was to terminate the stay when the debtor neither proposes a viable plan nor makes payments to the secured party." 3 Collier on Bankruptcy ¶ 362.07[5] (15th ed.2005) (citing *NationsBank, N.A. v. LDN Corp. (In re LDN Corp.)*, 191 B.R. 320, 326-27 (Bankr. E.D. Va.1996)). Therefore, this statute allows a single creditor to impose an acceleration of the relief from stay process, unless the debtor fulfills certain requirements.

Specifically, 11 U.S.C. § 362(d)(3) provides in part:

(d) On request of a party in interest and after notice and a hearing, *the court shall grant relief from the stay* provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay -

(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 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 non default contract rate of interest on the value of the creditor's interest in the real estate.

11 U.S.C. § 362(d)(3)(A)-(B) (emphasis added). Relief from stay under Section 362(d)(3) is only available to a creditor with a lien on SARE, as defined in 11 U.S.C. § 101(51B).

In Chapter 11 cases, 11 U.S.C. § 362(d)(3) must be read in conjunction with 11 U.S.C. § 1121. Section 1121(b) provides an initial exclusivity period for the debtor to file a plan, stating "only the debtor may file a plan until after 120 days after the date of the order for relief in this chapter." In contrast, Chapter 11 SARE cases applying 11 U.S.C. § 362(d)(3) entitle secured creditors to relief from stay within ninety days after the date of the order for relief. Thus, the debtor in a SARE case becomes subject to a fast-tracked ninety day deadline to file a plan, rather than the one hundred and twenty days provided in Section 1121(b).

To resolve this conflicting time period for SARE entities to file a plan, debtors may Subsections (A) and (B) to Section 362(d)(3) of the Bankruptcy Code allow debtors to prevent the creditor from imposing the expedited relief from stay. To shield itself from this automatic stay provision, the debtor "must either file a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time or make monthly payments in an amount equal to interest

at current fair market rate on the value of [the property] within 90 days after the entry of the order for relief.” *In re Cambridge Woodbridge Apartments, LLC*, 292 B.R. 832, 839 (Bankr. N.D. Ohio 2003). The statute provides a safe harbor for debtors in Section 362(d)(3)(A) for those debtors that file a Chapter 11 plan that has a reasonable possibility of being confirmed within a reasonable time. *See In re 652 West 160th LLC*, 330 B.R. at 462.

Alternatively, even if this exception is inapplicable, Section 362(d)(3)(B) “excepts from the requirement of commencement of interest payments secured creditors whose debt is secured by a judgment lien or an unmatured statutory lien.” *See In re 652 West 160th LLC*, 330 B.R. at 462 (citing *In re Syed*, 238 B.R. 133, 139 (Bankr. N.D. Ill.1999)). For example, the U.S. Bankruptcy Court for the Northern District of Ohio held that a mortgagee could not utilize Section § 362(d)(3) to obtain relief from the automatic stay to exercise its rights in an 180-unit apartment complex that was the debtor’s sole asset, where the debtor had been making adequate monthly protection payments to the mortgagee since filing for Chapter 11 relief. *See In re Cambridge Woodbridge*, 292 B.R. at 839-40.

BANKRUPTCY “PROOF” ENTITIES GO “POOF” IN BANKRUPTCY – SPECIAL
PURPOSE ENTITIES ARE NOT SO SPECIAL ANYMORE

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I. THE PURPOSE OF SPECIAL PURPOSE ENTITIES

- A. Isolation of collateral from the claims of other creditors
- B. Easier, quicker and less expensive financing
- C. Better vehicle for securitization
- D. Prevent entity from filing bankruptcy
- E. Easier, quicker access to collateral for the lender

II. THE NATURE AND ELEMENTS OF AN SPE

- A. Limited purposes and limited business
- B. Sole ownership of collateral
- C. Restrictions on governance and decision-making
- D. Independent Director(s)
- E. Restrictions on amendments to organizational documents
- F. Non-consolidation opinions of counsel

III. USE OF THE SPE IN REAL ESTATE DEVELOPMENT AND FINANCING

- A. Ownership of separate real estate assets
- B. Unique Lender or group of Lenders
- C. Separate cash flow

D. Common ownership of related SPEs by parent entity – pyramid or tiered ownership structures

IV. PRACTICAL REALITIES

- A. Common management of related SPEs by parent’s managers
- B. Centralized, albeit separate, recordkeeping
- C. Commingled cash and inter-entity debits and credits
- D. Consolidated tax returns
- E. Consolidated financial statements
- F. Knowledge of lenders

V. WHEN THE ENTERPRISE IS IN FINANCIAL DISTRESS

- A. Some SPEs in the enterprise are solvent, while others are not
- B. Some SPEs have positive cash flow, while others have negative cash flow or no cash flow
- C. Commingled cash becomes impossible to trace from one SPE to another
- D. Common management expenses are allocated to all SPEs and their parent entities in some equitable or rational manner – cash flow; asset value; amount of debt; equally
 - 1. Insurance under blanket policies
 - 2. Common recordkeeping and accounting expenses
 - 3. Common tax preparation expenses
 - 4. Leasing, selling and security services
 - 5. Common professional expenses

VI. THE BANKRUPTCY SENERIO

- A. Parent replaces independent director with a “friendly” director who votes to cause the SPE to file Ch 11, or simply files Bankruptcy for the SPE in disregard of corporate governance documents
- B. Parent, all intermediate tier entities and all SPE file Ch 11 are in one bankruptcy venue
- C. First Day Motions

1. Joint Administration
2. Retention of common professionals
3. Retention of existing cash management systems and consolidated bank accounts
4. Use of Cash Collateral from all entities to support post-petition operating and administrative expenses of the “enterprise” of entities, including payment of salaries to common management team members
5. Payment of pre-petition wages of employees, including management
6. No substantive consolidation

D. Expected “Day 2” Motions and activities to follow shortly after the case is filed, and usually within the first 90 days

1. Extension of the period under § 362(d)(3) for filing a plan or commencing payments to lenders
2. Non-payment of pre-petition and/or post-petition real estate tax liabilities outside of a plan
3. Consolidated plan of reorganization for all entities

VII. THE LENDER’S ARGUMENTS

A. Motion to Dismiss Separate SPEs

1. Bad Faith Filing
2. Lack of proper authorization or authority

B. Relief from Stay

1. No equity in insolvent SPEs
2. No prospects for a successful reorganization of insolvent SPEs

C. No adequate protection from use of excess cash flow from solvent SPEs

D. No relief without Substantive Consolidation

VIII. THE DEVELOPER-DEBTOR’S ARGUMENTS

A. Lender had knowledge of the common enterprise at the time of the loan and has waived arguments of “separateness” by acquiescence

