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BANKRUPTCY LAW

The Single Asset Real Estate Debtor

Bankruptcy Act's amendments in the single-asset context will likely be of limited import

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Today's volatile real estate market will likely engender increased bankruptcy filings by real estate owners, operators and investors, and will give rise to new examination by lenders of the availability of stay relief under 11 U.S.C. § 362(d)(3). Given the dramatic limitations included in 11 U.S.C. § 362(d)(3) on the otherwise protective shield of the automatic stay and safe harbor provided to Chapter 11 debtors, it is increasingly important to understand the narrow contours of the "single asset real estate" (SARE) debtor as defined in section 101(51B) of the Bankruptcy Code. The amendments effectuated through passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the Act) add to this litigation prone issue.

The concept of single asset real estate was first introduced through the 1994 Bankruptcy Reform Act, where it defined the type and nature of debtor which could not avail itself of the continued protection of the automatic stay unless, within 90 days

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of filing its Chapter 11 petition, it either filed a reasonably confirmable plan, or commenced interest payments on its secured debt or otherwise obtained an extension of the time parameters for cause by an Order of the Court. See 11 U.S.C. § 362(d)(3). The Congressional intent in enacting this limitation on the benefits of the automatic stay otherwise available to the Chapter 11 debtor was to expedite the bankruptcy process and prevent possible abuse in single asset real estate cases. The typical SARE debtor was a company that filed a Chapter 11 petition seeking to halt a secured creditors' foreclosure, although there might be no equity in the property and no realistic chance of filing a reorganization plan. *In re 83-84 116th Owners Corp.*, 214 B.R. 530, 535 (Bankr. E.D.N.Y. 1997).

Even before it was codified, the concept of the SARE debtor was used by courts to denote "bad faith filings" by entities "attempting to cling to ownership of real property in a depressed market." The lessons learned by the courts, investors, lenders and their attorneys led to codification of developing case law. The cyclical nature of real estate investing invariably leaves some debtors with buildings purchased at the top of the market, with tenants no longer able or willing to pay the

rents necessary to support the building's debt service and cost of operations, and with the rents having been pledged or assigned to the lender. Under these circumstances, the courts, with frequency, ruled that such a debtor has little ability to file a confirmable plan, and the delay to the lender with the loss of interest and adverse impact upon the banking community was prejudicial.

Under the 1994 Bankruptcy Reform Act, to qualify as a SARE: (1) the debtor's estate had to involve a single property or project; (2) such property had to generate substantially all of the debtor's gross income; (3) the debtor had to conduct no substantial business other than operation of the property; and (4) the debtor could not have noncontingent, liquidated secured debt in excess of \$4 million.

The definition generated two types of criticism. First, concern was expressed that the \$4 million limitation was too low and that there was no reason to treat small and large SARE debtors differently. Fueled by the persistent lobbying effort of secured creditors, this criticism resulted in the 2005 expansion of the definition of SARE by eliminating, rather than increasing, the monetary cap. This change in the statute, however, is merely quantitative and does not effect a qualitative change. If a debtor qualified as a SARE debtor before the enactment of the Act because of its nature, it will qualify after the Act.

In addressing the very nature of SARE

entities, the second criticism (as evidenced by decisional law and expressed through the legislative history of the amendment as set forth in the Act) was focused on clarifying that the focus of the limitation on the automatic stay was designed to exclude debtors operating active businesses.

Secured creditors' repeated attempts to expand the purview of § 101(51B), by trying to include various operating entities involved in the real estate business, have consistently been rejected by the courts. See, e.g., *In re Prairie Hills Golf & Ski Club, Inc.*, 255 B.R. 228 (Bankr. D. Neb. 2000) (in rejecting the creditor's argument that the debtor is a SARE entity, the court pointed out that the debtor was engaged in other significant income-producing activities, such as developing and selling residential lots and constructing roads). The Court finds that "Prairie Hills does not simply hold passive real estate investments." Specifically, relevant court decisions, including *In re Whispering Pines, Estate, Inc.*, 341 B.R. 134 (Bankr. D.N.H. 2006), underscore that the "no substantial business" and "operation" test of the "single asset debtor" definition will continue to limit a secured creditor's attempt to obtain § 362(d)(3) relief to instances where income is generated from merely holding the real estate.

The judicial approach manifests itself in *In re Kkemko*, where the debtor owned and operated a marina, which, in addition to mooring boats (together with storage, repair and winterization), also operated a fuel dock, pool, concession stand and shower facility. These businesses supported the determination that the debtor was not a "single asset debtor" for purposes of automatic stay relief. 181 B.R. 47, 51 (Bankr. S.D. Ohio 1995). Likewise, in *Centofante v. CBJ Development, Inc.*, 202 B.R. 467 (9th BAP 1996), the court declined to grant automatic stay relief to a secured creditor where the debtor owned a hotel, operated a bar, restaurant and gift shop on the premises, and employed a "substantial number of people" who maintained rooms, laundered sheets and offered phone services. In holding that the debtor was "sufficiently active in nature to constitute a business other than the mere operation of the property," the court held

that the hotel was not a single-asset real estate because it had significant other business. Similarly, in *Prairie Hills Golf & Ski Club*, the court refused to extend the single-asset real estate debtor designation to a debtor engaged in "significant income producing activities," such as the development and leasing of golf and ski areas, and the selling of liquor in the clubhouse.

Furthermore, *In re Whispering Pines, Estate, Inc.*, a post-Act decision, the court again confronted the question of whether a hotel qualifies as a SARE debtor where it did not conduct significant activities other than rental of its hotel rooms. In answering this question in the negative, the court found that the debtor's operation of the hotel including room and towel-cleaning services, provisions for continental breakfast, a swimming pool, and Internet and telephone services, rendered it sufficiently active to avoid classification as a single asset debtor. The *Whispering Pines* decision, which is strikingly similar to the facts in *Centofante*, underscores the courts' narrow approach to the question of those activities which will constitute "mere operation of the property."

These decisions are consistent with the legislative history underlying § 101(51B), which reveals Congress's intent "to reach the single-asset apartment type cases which involve primarily tax-shelter investment . . . not the operating shopping center and hotel cases where attempts at reorganization should be permitted" Report of the Committee on the Judiciary, United States Senate (to accompany S 2266), S. Rep. No. 989, 95th Cong., 2d Session (1978), U.S.C.C.A.N. 1978, pp. 5787, 5839.

Importantly, in 1994, Congress formed a National Bankruptcy Review Commission which, inter alia, prepared a "Single Asset Proposals" as part of its 1997 report, which served as a platform for the 2005 changes. See Report of the National Bankruptcy Review Commission at 661-706 (Oct. 20, 1997). In addition to eliminating the \$4 million ceiling, the report proposed that the definition of SARE be more carefully worded "to exclude cases in which the real property is used by a debtor in an active business." The proposal reinforces the proposition that the scope of SARE is limited to real estate investors, who typical-

ly generate rental income and provide activities merely incidental to the operation of the property, such as cleaning and snow removal.

Moreover, the exclusion of active businesses from the scope of § 362(d)(3) is a logical extension of the public policy underlying Chapter 11, favoring reorganization, and concomitant preservation of jobs and going-concern values. *In re Chateaugay Corp.*, 201 B.R. 48, 72 (Bankr. S.D.N.Y. 1996). In addition, despite the fact that the Act does not contain the specific wording changes proposed by the Commission, the report recommending passage of the Act expressly states that the essence of the SARE concept remains limited to a passive real estate holding with a single or few secured creditors. Report of the Committee on the Judiciary, United States Senate (to accompany S 256), S. Rep. No. 109-31, 109th Cong., 1st Sess. (2005) *140, 2005 U.S.C.C.A.N. 88 **199. The Committee further described a SARE as an entity with few employees and few, if any, unsecured creditors, whose primary purpose is to stay the impending foreclosure proceeding.

Consequently, while the Act has effected significant changes to bankruptcy law and practice, its amendments in the single-asset context will likely be of limited import. While the economic downturn in the real estate market will spawn new real estate cases which will, in turn, give rise to secured creditors' attempts to obtain automatic stay relief, the provisions of § 101(51B) should not expand the secured creditors' reach beyond passive investment real estate holdings with few employees and a limited number of unsecured creditors. The reason lies in the courts' narrow interpretation of the "operation" language of 105(51B), which will continue to limit the types of entities and the nature of activities that will be deemed "single asset real estate" debtors. The elimination of the \$4 million cap on secured debt is unlikely to substantially alter the framework utilized by the courts when adjudicating automatic stay relief applications under § 362(d)(3), or significantly increase the entities that fall within the definition of single-asset real estate debtors under § 101(51B). ■