

26. *Continental Airlines*, 203 F.3d at 214.
27. *Dow Corning Corp.*, 280 F.3d at 658.
28. *Metromedia*, 416 F.3d at 143. See also *SEC v. Drexel Burnham Lambert Group, Inc.* (*In re Drexel Burnham Lambert Group, Inc.*), 960 F.2d 285, 293 (2d Cir. 1992); *MacArthur Co. v. Johns-Manville Corp.* (*In re Johns-Manville Corp.*), 837 F.2d 89, 93-94 (2d Cir.), cert. denied, 488 U.S. 868, 109 S. Ct. 176, 102 L. Ed. 145 (1988).
29. *Metromedia*, 416 F.3d at 142-43.
30. *Airadigm*, 519 F.3d at 657-58.
31. *Airadigm*, 519 F.3d at 657-58.
32. *Airadigm*, 519 F.3d at 657-58.
33. *Airadigm*, 519 F.3d at 657-58.
34. *Airadigm*, 519 F.3d at 657-58.
35. *Metromedia*, 416 F.3d at 142.
36. Not all bankruptcy courts permit the filing of a lengthy, detailed draft confirmation order. In such circumstances, counsel should seek a ruling on the record or the issuance of a memorandum decision that includes appropriate findings of fact and conclusions of law regarding the release provision in the plan of reorganization.

SARE: NEW RULES FOR THE CURRENT DOWNTURN

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and
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The recent real estate boom that carried value endlessly upwards obscured the commercial relevance of the 2005 Amendments to the Bankruptcy Code, including the new importance of “single asset real estate” (SARE). Now, the sub-prime mortgage crisis has dashed residential markets, as evidenced by the Chapter 11 filings in the past several months by major national home builders such as Neumann Homes, Levitt and Sons, Dunmore Homes, TOUSA Inc., and others. In addition, commercial real estate developers and development projects are coming under increasing pressure as credit tightens and sources of needed capital become more difficult to tap. It is now clear that the definition of “single asset real

estate,” and the special rules that apply to SARE cases, are of material relevance to a wide range of real estate players.

Why Should You Care?

When rules governing so-called “single asset real estate” cases were first added to the Bankruptcy Code in 1994, many large money players dismissed the provisions as irrelevant because they only applied in cases involving less than \$4 million of debt secured by the debtor’s single real estate asset. The 2005 Amendments eliminated the debt cap. As a result, single asset real estate provisions may now be pivotal to many large cases that revolve around real estate.

What is Single Asset Real Estate?

Bankruptcy Code section 101(51B) defines “single asset real estate” as “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.”

Every apartment building, shopping center, and office building that is the sole asset of a debtor, including a special purpose or single purpose vehicle, will be the subject of a SARE case if it satisfies all three of the statutory criteria, regardless of the amount of debt involved. Because large developers often create an SPV for each new venture, many of the housing projects that are in jeopardy as a result of the current credit crunch may become SARE debtors.

(i) “Single property or project”

This criterion requires SARE treatment of every debtor that owns either a single property, or multiple properties that are considered to be a single project because they are “operated under a common design or plan.”¹

(ii) Generates “substantially all of the gross income of a debtor”

This criterion excludes from SARE treatment debtors who own a single piece of real property but also have other income-generating operations

or assets.² This criterion does not necessarily exclude a debtor whose sole asset is undeveloped real property that generates no income.³

(iii) No "substantial business" "other than the business of operating the real property and activities incidental" thereto

This criterion exempts from SARE treatment a debtor that owns a single income generating real estate asset on which the debtor conducts business operations that go beyond the business of operating the real property, and has enabled various real estate-related enterprises to avoid application of the SARE provisions.⁴

Why SARE Matters

SARE debtors are subject to special constraints imposed by 11 U.S.C. § 362(d)(3) that potentially limit the debtor's strategic options in its efforts to reorganize. Most materially, within the later of 90 days after a SARE debtor's bankruptcy case commences and 30 days after the court finds the debtor is subject to the SARE provisions, the SARE debtor must either "file a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time;" or begin making monthly payments "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)... 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." If the debtor fails to either make the requisite payments or file a plan within the applicable time frame, the Bankruptcy Code provides that "the Court shall grant relief" from the automatic stay "such as by terminating, annulling, modifying, or conditioning such stay."⁵ A bankruptcy court may extend the "pay or plan" deadline upon a debtor's showing of "cause."

Nothing precludes a party in a SARE debtor's case from seeking stay relief under the other subsections of section 362(d). However, a secured creditor in a SARE case enjoys a reduced burden under section 362(d)(3). Upon a showing that the creditor holds a claim secured by the debtor's single asset real estate, "the burden is on the debtor to either pay the creditor in a timely manner or prove that the debtor has filed a plan of reorga-

nization that has a reasonable possibility of being confirmed within a reasonable time." Simply by waiting at least 90 days after the petition date before seeking relief against a SARE debtor, a secured creditor can seek stay relief, but avoid the costs and risks of litigating ancillary issues, such as whether the debtor has equity in the property, or whether cause otherwise exists to grant relief.⁶ Of course, secured creditors also can seek alternative avenues of relief, such as dismissal of the bankruptcy case for bad faith, which also may be bolstered by the debtor's SARE status.⁷

Secured creditors should not expect their course through Chapter 11 with a SARE debtor to be entirely free of obstacles. Debtors can be expected to raise every colorable argument against application of the SARE rules, and to urge delay if they are found to own single-asset real estate. They also may delay enforcement of SARE remedies by initiating complex valuation proceedings and instigating intercreditor battles.

Contesting Applicability

Debtors may engage in a variety of activities to avoid SARE status in bankruptcy. A debtor that owns a single property or project may attempt to acquire a second one before bankruptcy. A pro-SARE creditor should scrutinize every such acquisition, to be sure it constitutes a bona fide transaction and not simply a ruse designed to avoid application of the SARE rules. For example, in a case where the debtor's shareholder contributed a second real property asset just months before the bankruptcy filing, the debtor purportedly assumed debt encumbering that asset, so that it had two properties and two secured creditors. Discovery revealed that the contribution was a sham, and the new secured debt actually was assured of repayment through a letter of credit procured by the shareholder, not through the property. Although, in the foregoing case, the sham transaction was meant to create an impaired class that would vote in favor of a plan that crammed down the lender on the primary asset, this type of ploy also may be attempted in an effort to defeat SARE treatment. Similarly, multiple SARE debtors may elect to merge into a single entity, or into their parent, thereby stepping out of the statutory SARE definition, even though doing so probably

will result in the violation of negative covenants in their loan documents. In addition, if they do not merge prepetition, they, or their creditors, may seek to break out of the SARE rules postpetition through substantive consolidation of the entities and their assets and liabilities.

A debtor also may attempt to diversify its business activities in anticipation of bankruptcy, in order to support an argument that it engages in business operations in addition to owning and operating real estate. For example, a debtor marina was exempt from SARE treatment where, in addition to generating rental income from mooring boats, it also generated revenues by storing, repairing, and winterizing boats; providing showers and a pool; and selling gas and concessions.⁸ A debtor-owner of a full service hotel similarly was exempt from SARE treatment because, in addition to collecting rack rates, it generated revenues by operating a gift shop, a bar, and a restaurant in the hotel.⁹ Such ancillary enterprises may provide a shield from SARE treatment even where they do not generate significant additional revenues.¹⁰

All such activities bear scrutiny. In the first instance, many may violate single purpose representations or covenants made by the debtor in financial or organizational documents. Alternatively, the debtor may not actually be the entity conducting the business activity upon which it seeks to rely to avoid SARE status. A debtor may own the office building, but not actually operate the spa, commissary, or other services that are available to tenants in the building. The debtor may own the golf course, but not really operate the business. A third party may have contracted for the right to run the pro shop or lease the carts.¹¹

The debtor in *In re Kara Homes, Inc.*¹² attempted, unsuccessfully, to take advantage of the diversified business operations strategy. Like many of the residential real estate developers now in or heading toward bankruptcy, Kara Homes owned multiple affiliated, single-asset entities, each of which owned, developed, and sold homes in a discrete housing project. Kara Homes provided all of the construction, maintenance, and sales services required for each affiliate's project, as well as all necessary personal services. When Kara and its affiliates filed their respective Chapter 11 peti-

tions, each affiliate checked the box indicating that it was filing a single-asset real estate case.¹³ Concurrently, however, each challenged its status as a SARE debtor by filing a complaint seeking a declaratory judgment that the affiliated entities were not SARE debtors, and alternatively moving for an order extending the deadline to pay interest or file a confirmable plan from 30 days to 60 days after the date of the SARE determination.¹⁴

The Kara SARE exemption argument relied on the contention that each affiliate engaged in substantial business activities including purchasing land, planning and building residential communities, and conducting myriad activities related to the projects located on its real estate.¹⁵ The court disagreed that these "other activities" constituted unrelated business activities sufficient to exempt the debtors from SARE status because no one "could reasonably expect to generate income from the activities undertaken by the affiliated debtors if the eventual sale of the real estate were not possible."¹⁶

A reluctant SARE debtor may attempt to buy time by forgetting to check the petition box admitting that it is filing a SARE case. Because the right to relief under section 362(d)(3) does not arise until the later of 90 days after the filing and 30 days after the date the court determines whether a debtor satisfies the SARE criteria, a lender should act quickly to seek a judicial determination of the debtor's SARE status. Notably, a debtor tactically may benefit from having a SARE determination made sooner rather than later once its case is commenced, so that it is not squeezed into a 30-day window in which to muster its resources to either present a confirmable plan of reorganization or commence making payments to its secured creditors.

Extending Time for "Cause"

If the debtor cannot avoid the conclusion, ultimately, that it is a SARE debtor, it still may seek to establish "cause" for an extension of the 90-day "pay or plan" deadline. Some courts have acknowledged the special deference of section 362(d)(3) to the interests of single asset real estate mortgagees and have found that "cause" to defer payment or a plan filing should "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."¹⁷ Debtors often try to buy time by arguing that they are on the verge of selling the asset in question. However, the prospect of a sale should not constitute cause unless the debtor is able to demonstrate that a specific sale is likely to close promptly and will generate enough proceeds to satisfy the secured debt.¹⁸

Other Delay Tactics

(i) *File a plan, any plan*

At least one debtor has proven that filing a non-confirmable plan is much more effective than filing no plan at all within the 90-day period. The debtor in *In re The Terraces Subdivision, LLC*¹⁹ within the 90-day period, filed a motion to extend the deadline and also filed a facially-feasible plan, but did not file a disclosure statement. The court dismissed the motion to extend time as moot, because of the timely plan filing. The fully-secured lender then moved to terminate the automatic stay under section 362(d)(3) because the plan paid too little and therefore could not be confirmed as filed. Although the court agreed, it was persuaded by expert testimony that the debtor "had the capability of presenting a feasible and workable Chapter 11 plan," and therefore chose to exercise its discretion to extend the automatic stay for a period of approximately three months and to enable the debtor to amend and seek confirmation of its plan within that time.²⁰ This conditional extension of the stay apparently satisfied the statutory mandate that the court grant some form of relief upon a debtor's failure to timely file a feasible plan.

(ii) *Litigate asset value*

The value of the lender's interest in the real estate apparently must be determined before the debtor can calculate the correct amount of interest to be paid under section 363(d)(3). So a debtor may seek to delay payment by litigating that value. A lender anticipating such a dispute may find it advantageous to expedite the process by bringing its own valuation motion promptly after the commencement of the case. Although a valuation may be heard as a contested matter,²¹ valuation most frequently requires a longer litigation track that

encompasses discovery, including depositions of experts, and an evidentiary hearing. A debtor may buy substantial delay if the valuation process does not commence until 60 or 80 days into the case.

(iii) *Trigger intercreditor strife*

The SARE provisions may enable the debtor to foment complex intercreditor disputes that may tie up the case. Section 362(b)(3)(B)(i) authorizes a debtor, in its sole discretion, and regardless of whether it has obtained lender consent or a bankruptcy court order authorizing the use of cash collateral, to satisfy its obligations to pay postpetition interest to secured parties "from rents or other income generated before, on or after the date of the commencement of the case by or from the property." It thus appears that a debtor may use rents to make adequate protection payments to a junior creditor without providing adequate protection of the senior creditor's interest in such cash collateral. The debtor's conduct may precipitate intercreditor litigation over the proper use and application of cash collateral, particularly in circumstances where the terms of an intercreditor agreement may be ambiguous on the issue, and the debtor may seek to defer the ultimate making of payments or filing of a plan until the creditors' respective rights (and the debtor's obligations) are resolved. To minimize the effect of this strategy, creditors would be well-advised to require the debtor to pay the postpetition interest into an escrow account, which they can battle over at a later date.

In the current environment, the SARE provisions, set forth in 11 U.S.C. §§ 101(51B) and 362(d)(3), compel the attention of all parties in cases that involve a single real estate asset or project. The new provisions will likely have the effect of expediting single-asset real estate cases and may prove to skew the outcome of these cases in favor of lenders. However, they also may have unintended consequences, such as devaluation of real estate in areas with large numbers of foreclosures. Moreover, given the risks of devaluation, and of waste on partly-completed projects, SARE lenders can be expected to leverage their positions by agreeing to provide DIP financing in exchange for tight controls over the debtor's sale or reorganization process, very possibly imposing bench-

marks and timelines even more constrictive than SARE, and coercing expedited sales of properties or projects to new and better capitalized developers. The money has receded, but it hasn't left the market yet.

Research References: Norton Bankr. L. & Prac. 3d §43:48

West's Key Number Digest, Bankruptcy
 ⇨ 2422.5(1)

Notes

1. *In re Philmont Dev. Co.*, 181 B.R. 220, 223 (Bankr. E.D. Pa. 1995) (each debtor owned multiple semi-detached, contiguous houses that it "operated under a common design or plan," as a "single project," and therefore was subject to SARE rules). See also, *In re Rear Still Hill Road, LLC*, 2007 WL 2935483 *5 (Bankr. D. Conn. 2007) (despite substantial evidence that debtor owned two legal parcels, SARE rules would apply where parcels constituted a "single... project" consisting of the debtor's plan to develop land for single family homes).
2. *In re Philmont Dev. Co.*, 181 B.R. at 223, (general partner of SARE debtors, which also owned two undeveloped building lots was not itself a SARE debtor; "rental income [it received] was not its main source of income...").
3. See *In re Oceanside Mission Assocs.*, 192 B.R. 232 (Bankr. S.D. Cal. 1996) (logic compels that, if a debtor has no gross income, and owns a single parcel of real property that generates no income, that parcel should be considered to produce substantially all of the debtor's income).
4. See, e.g., *In re Scotia Pacific Co., LLC*, 508 F.3d 214, 221-24 (5th Cir. 2007) (debtor which conducted significant tree farming activities was not within SARE); *In re Club Golf Partners, L.P.*, Slip Opinion, 2007 WL 11176010 (E.D. Tex. April 20, 2007) (SARE debtors engage only in "those passive types of activities [that] are the mere receipt of rent and truly incidental activities such as arranging for maintenance or perhaps some marketing activity, or, in the Fifth Circuit's memorable phrase, 'mowing the grass and waiting for the market to turn.'" citing *Humble Place Joint Venture v. Fory*, 936 F.2d 814, 818 (5th Cir. 1991)).
5. 11 U.S.C. §362(d)(3).

6. See *800 S. Wells Commercial LLC v. WRT Mart RC, LLC*, slip opinion, 2007 WL 2156678 at *2 (N.D. Ill. 2007).
7. See *In re Webb MTN, LLC*, 2008 WL 361402 *4.5 (E.D. Tenn.) (reversing lower court's dismissal of SARE case as bad faith filing; SARE factors may be bad faith indicia, but do not, without more, constitute adequate evidence of bad faith to support dismissal of case).
8. *In re Kkemko, Inc.*, 181 B.R. 47 (Bankr. S.D. Ohio 1995).
9. *In re CBJ Dev., Inc.*, 202 B.R. 467 (9th Cir. 1996).
10. See, e.g., *In re Whispering Pines Estate, Inc.*, 341 B.R. 134 (Bankr. D. N.H. 2006) (debtor hotel that served continental breakfast, maintained a swimming pool and common areas, provided phone and Internet services and operated room-cleaning and towel laundering services, "is sufficiently active in nature to constitute a business other than mere operation of property," even though such activities generated little additional revenue).
11. See, e.g., *In re Euro-American Lodging Corp.*, 357 B.R. 700 (Bankr. S.D. N.Y. 2007) (involuntary debtor owner of hotel property contracted with separate entity to operate hotel business, including hiring of employees and contracting with vendors, and therefore was subject to SARE provisions).
12. *In re Kara Homes, Inc.*, 363 B.R. 399 (Bankr. D. N.J. 2007).
13. *Kara Homes, Inc.*, 363 B.R. at 401.
14. *Kara Homes, Inc.*, 363 B.R. at 402.
15. *Kara Homes, Inc.*, 363 B.R. at 405.
16. *Kara Homes, Inc.*, 363 B.R. at 405 (the court also denied the debtors' motion for a 30-day extension of the pay or plan deadline).
17. *In re Heather Apts. L.P.*, 366 B.R. 45, 48-50 (Bankr. D. Minn. 2007) ("any proffer of cause ... must include a concrete substitute for the creditor's statutorily-fixed expectation").
18. *Heather Apts.*, 366 B.R. at 48-50 ("At a minimum, it seems, there should be a binding purchase agreement... ; a binding lending commitment in favor of the prospective purchaser; and demonstrated substantial progress in satisfying the ministerial minutiae for closing.").
19. *In re The Terraces Subdivision, LLC*, Slip Copy 2007 WL 2220448 (Bankr. D. Alaska 2007).
20. *In re The Terraces Subdivision, LLC*, Slip Copy 2007 WL 2220448 (Bankr. D. Alaska 2007).
21. See Bankruptcy Rule 3012.

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BAD MEDICINE: CRAM DOWN, § 1111(B)(2) ELECTIONS AND FEDERAL REGULATIONS

Ronald Barliant

Mr. Barliant, together with Kathryn A. Pamenter, represented Airadigm in the case discussed in this article. From 1988 until 2002, Mr. Barliant was a bankruptcy judge in the Northern District of Illinois. Mr. Barliant is now a principal in the Chicago law firm of Goldberg Kohn Bell Black Rosenbloom & Moritz, Ltd.

The Seventh Circuit addressed the intersection of two of the most complex and controversial sections of the Bankruptcy Code, § 1111(b) and § 1129(b), in *Airadigm Communications, Inc. v. FCC (In re Airadigm Communications, Inc.)*.¹ In so doing, the court clarified the requirements that a plan of reorganization must meet to be confirmed, or crammed down, over a secured creditor's rejection when that creditor has elected to have its entire claim be treated as a nonrecourse secured claim. The result, which some may find surprising, is to permit a Chapter 11 plan to eliminate a secured creditor's due-on-sale clause and effectively cash out the lien at the present market value despite the § 1111(b) election.

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