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# Get a Fresh Perspective: Special-Purpose Entities and Single-Asset Real Estate Insolvencies


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CONCURRENT SESSION

2020

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**Special-Purpose Entities and Single-Asset Real Estate Insolvencies**

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# WHAT IS A SINGLE ASSET REAL ESTATE DEBTOR: AN ANALYSIS OF 11 U.S.C. § 101(51B)

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## I. Statutory Definition

> "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 thereto."
>
> 11 U.S.C. § 101(51B)

**Breaking Down 11 U.S.C. § 101(51B)**:

1. "[R]eal property constituting a single property or project"*

2. "[W]hich generates all of the gross income of a debtor"**

3. "[O]n which no substantial business has been conducted other than the business of operating the real property and activities incidental thereto."

*Does the residential exception apply? If yes, then no single asset real estate.

**Is the Debtor a family farmer? If yes, then no single asset real estate.

## II. "Real Property Constituting a Single Property or Project"

One of the most frequently litigated issues in the SARE context is the "single property or project" element of Section 101(51B) of the Bankruptcy Code. The determination of a single property may be rather straightforward, however, substantial case law exists regarding the determination of whether a debtor has a single project for purposes of SARE. When determining whether multiple parcels of property constitute a "single project" courts look to whether the debtor treats its entire property as a single project or property. *In re JJMM Int'l Corp.*, 467 B.R. 275, 278 (Bankr. E.D.N.Y. 2012) (focus is on the debtor's intended use of the property). To be a single project, courts must determine that multiple properties are subject to a single plan or be linked as part of a coordinated scheme or purpose—common ownership of the various parcels, even if they are contiguous, is insufficient by itself to constitute a single project. Instead, courts routinely look to the debtor's overall purpose with respect to the property as a whole.

**Selected Cases**:

*In re JJMM Int'l Corp.*, 467 B.R. 275 (Bankr. E.D.N.Y. 2012).

- Debtor owned 3 contiguous parcels leased to 2 non-debtor related entities who operated very distinct businesses. The Bankruptcy Court determined that debtor's only purpose was

to hold title to the 3 parcels in order to lease the real property to the non-debtor related entities. The focus of the "single project" is upon the *debtor's* use of the property—not the 2 non-debtor related entities' use of the property. Accordingly, the Bankruptcy Court held the debtor satisfied the "single project" prong of Section 101(51B) of the Bankruptcy Code.

*In re Webb MTN, LLC*, 2008 Bankr. LEXIS 691 (Bankr. E.D. Tenn. Mar. 6, 2008).

- Debtor purchased 5 separate parcels of real property from different parties at different times with the intent to construct a resort upon the combined property consisting of two golf courses, a luxury hotel, a convention center, spa, and retail commercial center. However, at the time the bankruptcy case was filed, the resort development had not yet commenced and the property was not producing any income. The Bankruptcy Court determined that the 5 contiguous parcels were intended by the debtor to be acquired with the singular purpose of constructing the resort which would span over the several parcels and that the transaction documents to acquire the land were consistent with this purpose. Further persuasive of a single project, the Bankruptcy Court found that the project was to be developed in coordinated phases with the singular purpose of constructing the resort. Accordingly, the Bankruptcy Court held that the 5 parcels constituted a single project and the debtor was a SARE.

*In re McGreals*, 201 B.R. 736 (Bankr. E.D. Pa. 1996).

- Debtor owned two separate parcels that shared a partially adjacent border where one parcel was rented and the other parcel was raw land. Debtor testified that it had no plans to combine the two properties in any fashion and had no common plan or scheme coordinating their use. The Bankruptcy Court found that the requisite common plan or scheme was missing and that mere ownership of contiguous properties alone is insufficient to constitute a single project.

*In re Vargas Realty Enters.*, 2009 Bankr. LEXIS 2040 (Bankr. S.D.N.Y. July 23, 2009).

- Debtors each owned residential apartment buildings in Manhattan that were contiguous. By virtue of separately owning a single apartment building each debtor (there were 4) was sufficient to constitute a single property. Alternatively, the separate debtors, given their common ownership and purpose, were sufficient to constitute a single project for purposes of Section 101(51B) of the Bankruptcy Code.

*In re Pioneer Austin E. Dev. I, Ltd.*, 2010 Bankr. LEXIS 2160 (Bankr. N.D. Tex. July 1, 2010).

- Debtor owned 8 parcels of land described by separate metes and bounds. The debtor's stated goal was to provide housing with an emphasis on entry level housing and single family detached homes in connection with building a cohesive and interdependent subdivision. The Bankruptcy Court held that because the development had a unitary purpose, the 8 parcels were sufficient to constitute a single project for purposes of Section 101(51B) of the Bankruptcy Code.

*In re Rear Still Hill Rd., LLC*, 2007 Bankr. LEXIS 3501 (Bankr. D. Conn. Oct. 5, 2007).

- Debtor owned a separate 50 acre lot and 7 acre lot in order to develop the parcels for single family homes. In furtherance of the development, the debtor sought regulatory approval for both parcels on a unified basis. The debtor's intent of developing the two lots in phases was insufficient to overcome the debtor's common plan or scheme to develop as to the overall development of the property and the Bankruptcy Court determined the debtor owned a single project and was a SARE.

## III. Generates Substantially All Gross Income of the Debtor

The second factor, whether the property generates substantially all of the gross income of a debtor, was designed to exclude debtors that, although they own a single piece of property, have other income generating operations. Often, it is difficult, if not impossible, to dispute that the property at issue does not generate substantially all of the gross income of the debtor, and this factor is often considered in tandem with the third SARE factor. The term "generate" requires that substantially all gross income be from "the property itself, not the fruit of workers' labor and management's services, that is responsible for substantially all of the gross income." *In re Club Golf Ptnrs., Ltd. P'ship*, 2007 Bankr. LEXIS 1225, at *14 (Bankr. E.D. Tex. Feb. 15, 2007). Accordingly, the lynchpin of the second element looks to whether it is the property, or some other aspect of the debtor's operations, that generates substantially all of the debtor's gross income. Notwithstanding, courts have found that the second element of Section 101(51B) has been satisfied even when a debtor's property generates no income, or the property is raw land and incapable of generating income. *In re Oceanside Mission Assocs.*, 192 B.R. 232, 234-35 (Bankr. S.D. Cal. 1996) ("If the debtor has no income, then substantially all of its income could be said to be generated by the property; *i.e.*, substantially all of nothing is nothing."); *In re City Loft Hotel, LLC*, 465 B.R. 428, 434 (Bankr. D.S.C. 2012) ("The absence of income does not preclude a case from being a single asset real estate case, despite the fact that a part of the test for the determination is that the real property 'generates substantially all of the gross income of a debtor . . .").

## IV. Substantial Business Other Than the Operation of Real Property

In evaluating whether a debtor conducts substantial business other than the business of operating real property and activities incidental thereto, *i.e.*, the passive collection of rent, courts analyze the particular business operated on the real property. As stated by one court, "[a] business would not be a SARE if a reasonable and prudent business person would expect to generate substantial revenues from the operation activities—separate and apart from the sale or lease of the underlying real estate." *Kara Homes, Inc. v. Nat'l City Bank (In re Kara Homes, Inc.)*, 363 B.R. 399, 406 (Bankr. D.N.J. 2007). Prototypical SARE cases usually involve the passive collection of rent without other particular or detailed business activities that generate revenue for the debtor. Cases where the "substantial business other than operation of real property" prong was litigated analyzed, among many other things, (i) the extent the debtor's own efforts generated income compared with the mere ownership of the real property; (ii) the sale of services or goods incidental to the type of business being operated on the property; (iii) the extent of the effort, skill or specialized training provided by the debtor's employees contributed to the debtor's business operations; and (iv) the extent of the debtor's regulatory obligations in connection with the operation of its business. Accordingly, the determination of whether a debtor conducts substantial

business other than the receipt of passive rent, *i.e.*, the business of owning real property, is heavily fact intensive.

**Selected Cases**:

*In re Club Golf Ptnrs., Ltd. P'ship*, 2007 Bankr. LEXIS 1225 (Bankr. E.D. Tex. Feb. 15, 2007).

- Debtor owned and operated a golf club, which included an 18-hole golf course, a driving range, tennis courts, and a casual club house with a casual dining restaurant. In furtherance of its business, the debtor: (i) sold memberships; (ii) charged greens fees, cart fees, driving range fees, and tennis court fees to non-members; (iii) sold merchandise in the pro shop; (iv) sold food and alcohol in the restaurant and bar; (v) sold rental space to charities; (vi) charged lessons for golf lessons; and (vii) charged for third parties to host tournaments at the golf course. The Bankruptcy Court focused on the active-versus-passive criterion that inquires into the nature of revenue generation on and by the property, that is, whether the revenue generated by the debtor is 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 a single asset real estate. The key inquiry is whether the real property requires the active, day-to-day employment of workers other than or in addition to the principals of the debtor. And whether the property would not generate substantial revenue without such labor and efforts. Accordingly, the numerous types of activities that are generated by the debtor's employees' efforts and not the real property removed this golf course from the single asset real estate determination.

*In re Scotia Dev., LLC*, 375 B.R. 764 (Bankr. S.D. Tex. 2007).

- Debtor owned approximately 200,000 acres of private timberland and an exclusive right to harvest timber. Debtor's timberland collectively had 9 different and very distinct watersheds. Debtor's active, ongoing and day-to-day business was to manage the entire life cycle of planting, nurturing, harvesting and selling timber. Debtor had over 60 employees including scientists (aquatics, biologists, engineers and geologists) and foresters. Debtor's business had numerous aspects of being in compliance with a multitude of environmental and other natural resources laws including the restoration of wildlife habitats and forestry. The Debtor operated in a highly regulated commercial environment that was contingent upon obtaining regulatory approval before cutting timber. In addition to cutting timber, the Debtor leased cell-phone towers and campgrounds. The Bankruptcy Court held that the Debtor's operation of the land was not merely passive but incredibly active due to regulatory the obligations that were being met by debtor's highly sophisticated workforce which the business depended.

*In re Kkemko, Inc.*, 181 B.R. 47 (Bankr. S.D. Ohio 1995).

- Debtor operated a marina in an inlet connected to the Ohio River. The marina had slips for 270 boats. The marina occupied about 40 acres of real estate with several buildings located thereon including a picnic area for the use of boaters. The debtor offered miscellaneous services for boaters such as boat repair, winterizing and dry land storage. Food, supplies

and fuel were stocked for boaters to purchase as they accessed the river. Given the services and sale of supplies, the Bankruptcy Court determined that the debtor's marina was not the prototypical income producing asset or raw land that is associated with a single asset real estate debtor. The debtor operated an active business upon the 40 acres and did not passively hold the real estate for the collection of rent.

*In re MTM Realty Tr.*, 2009 Bankr. Lexis 580 (Bankr. D. N.H. 2009).

- Debtor owned a commercial building that had 4 tenants which generated substantially all of its revenue as evidenced on its statement of financial affairs. The Bankruptcy Court focused upon whether the debtor conducted any substantial business activities outside the ownership of real property. The Bankruptcy Court rejected the debtor's efforts to characterize payment of ordinary expenses incidental to ownership of commercial real estate, *i.e.*, utilities, signage, phone services, insurance, taxes and CAM, as being a substantial business being operated other than operation of the real property. Importantly, the business operations must be separate and distinct from owning and managing real estate such that the revenues generated are not passive in nature and incidental to the ownership of real property.

## V. Multi-Debtor Cases and the "Whole Business Enterprise" Exception

In the context of multiple debtor entities, the SARE determination is made on a debtor-by-debtor basis. Absent piercing the corporate veil, or substantive consolidation, the legal separateness of each debtor will be respected, *i.e.*, one debtor entity may meet the qualifications to be a SARE and another related debtor entity may not be a SARE. The case law in the Tenth Circuit on this issue is limited to *In re The Aspen Club & Spa, LLC*, 2019 WL 4233621 (Bankr. D. Colo. July 23, 2019).

**Selected Cases**:

*Meruelo Maddux Props.-760 S. Hill St., LLC v. Bank of Am., N.A. (In re Meruelo Maddux Props., Inc.)*, 667 F.3d 1072 (9th Cir. 2011).

- An operating company along with 50 of its subsidiaries filed for bankruptcy. The debtors operated their business on a consolidated basis such that revenue from operations of the subsidiaries was swept daily into a single general operating account to pay expenses for all subsidiaries. The conglomerate of debtors filed consolidated financial reports, SEC filings and tax returns. One of the subsidiaries owned a 92-unit apartment complex and the debtors filed a motion to designate that particular debtor, along with all other debtors, as not collectively being single asset real estate debtors due to the fact that they were part of a single business enterprise. The 9th Circuit rejected the debtors' efforts to remove the 92-unit apartment complex debtor from the ambit of being single asset real estate due to the absence of any evidence that it was or should have been substantively consolidated. The 9th Circuit affirmed the District Court that there is no basis in Section 101(51B) that gives rise to a "whole business enterprise" exception. Accordingly, absent substantive consolidation, a Bankruptcy Court must treat a debtor's legal status as a separate and

distinct entity from its parent and/or sister entities and look only to the particular debtor's assets, income and operations for making a single asset real estate determination.

*Kara Homes, Inc. v. Nat'l City Bank (In re Kara Homes, Inc.)*, 363 B.R. 399, 400-01 (Bankr. D.N.J. 2007).

- Debtor, along with 32 affiliates, filed Chapter 11 petitions. The affiliated debtors owned separate real estate development projects for the construction of single family homes and condominiums. In an adversary proceeding, the debtors contended that each affiliate acquired developable land, designed homes and/or condominiums suitable for that land, completed construction of the project and then marketed for sale the particular properties to generate cash. Additionally, each affiliate obtained site approval and marketed for sale each property separately. Lastly, the debtors contended that each affiliate built the commons space, amenities and roadways to the particular project. Contrary to these allegations, the lenders argued that the sole asset for each debtor was the particular property and no other business operations were being conducted. The evidence showed that the debtors' only source of income was from the sale of homes and/or land, and not from any other source. The Bankruptcy Court determined that the services performed by the Debtors were incidental to the purchase and sale/lease of real property and in furtherance of their efforts to purchase and sell/lease. These efforts do not constitute a substantial business and from a pragmatic perspective, "materiality" should focus upon what a reasonable and prudent business person would expect to generate substantial revenues from the operation activities—separate and apart from the sale or lease of the underlying real estate.

*In re The Aspen Club & Spa, LLC*, 2019 WL 4233621 (Bankr. D. Colo. July 23, 2019) (Judge Rosania).

- Two Debtors (the "**Operating Entity**" and "**Real Estate Entity**") filed Chapter 11 petitions which were jointly administered but not substantively consolidated. The Debtors' secured lender filed a motion to designate the Real Estate Entity as a single asset real estate debtor to which both Debtors objected. At an evidentiary hearing, the Bankruptcy Court found that: (i) the Operating Entity was initially formed as a tennis and racket club in 1976; (ii) the Operating Entity owned and operated a five acre of real property and a spa building; and (iii) the Operating Entity expanded its lines of business to a spa, salon, sports medicine, personal training, and food and beverage services. Eventually, the title to the real property, consisting of 5 separate parcels, was transferred to the Real Estate Entity to "compartmentalize liabilities." The Real Estate Entity's schedules and statement of financial affairs reflected the real property was the only asset of the Real Estate Entity and that it did not conduct business, never had employees or generated any income. The secured creditor argued that the Bankruptcy Court must make a single asset real estate determination on a debtor-by-debtor basis and because the Operating Entity and Real Estate Entity are legally distinct and have not been substantively consolidated. The Debtors, on the other hand, argued that the determination can be made on the "Whole Business Enterprise" theory, *i.e.*, the Debtors' situation should be viewed "holistically" amongst all Debtors when there is a coordinated development plan. Relying on *Meruelo Maddux Props.-760 S. Hill St., LLC v. Bank of Am., N.A. (In re Meruelo Maddux Props.,*

*Inc.)*, 667 F.3d 1072 (9th Cir. 2011), which provides that, absent substantive consolidation, the Bankruptcy Court is required to accept a debtor's chosen legal status as a separate and distinct entity and look only to that particular debtor's assets, income, and operations in determining whether a debtor is a single asset real estate entity. Accordingly, the Bankruptcy Court determined that the Real Estate Entity was a single asset real estate debtor.

## VI. 10th Circuit Case Law Regarding SARE Determinations

*In re Mt. Edge Ltd. Liab. Co.*, 2012 Bankr. LEXIS 4784 (Bankr. D.N.M. Oct. 10, 2012) (Judge Thuma).

- Debtor owned 24 lots, had no employees and was owned by the debtor's principal and his wife. Other than some water rights, no real or other personal property were scheduled. Debtor intended to use the water rights to support the 24 lots for living and recreational purposes. It was alleged that debtor's only prepetition business had been: (i) the maintenance of a sales office for the 24 lots, (ii) the sale of the lots on appropriate terms, and (iii) the sale of water to third parties. However, debtor's statement of financial affairs indicated no sales of water in the last 2 years prepetition, and no sales of water post-petition were referenced in Chapter 11 operating reports. After analyzing the 3 elements of Section 101(51B), the Bankruptcy Court stated that "[a]n absence of active business operations with only passive and truly incidental activities such as the mere receipt of rent will render the property single asset real estate . . . [whereas] varied business activities will render a debtor outside the scope of § 101(51B). The inquiry focuses between entrepreneurial, active labor and efforts versus merely passive investment income." Debtor held to be a SARE as the sale of water was incidental, and relatively minor, to the ownership of the 24 lots.

*In re Kachina Vill., LLC*, 538 B.R. 124, 125 (Bankr. D.N.M. 2015) (Judge Thuma).

- Debtor owned a 1.259 acre parcel of undeveloped land in a ski village in Taos, New Mexico. Debtor's Schedule B listed bank accounts with negligible cash, office furniture and equipment, and a 2014 Subaru. The real property was zoned for mixed use and could not be subdivided and the restrictive covenants bound the property to require mixed-use development or multiple residences. Prepetition, Debtor originally obtained a conditional use permit that allowed for commercial and residential development which included construction of more than 4 residential units. Postpetition, Debtor intended to build 5 single-family houses, a three-unit town house and a fringe commercial building although such plans were not approved by the ski village. It was unclear when construction would actually begin for the project. To avoid the SARE determination, debtor sought to invoke the "residential exception" which excepts properties that consist of fewer than 4 residential units. However, the Bankruptcy Court held that the "residential exception" does not apply to undeveloped land which is consistent with the dearth of single asset real estate case law. There could be, hypothetically, circumstances where undeveloped land that could qualify for the "residential exception", *e.g.*, three lots zoned exclusively for residential use.

However, the facts of the case could not render the "residential exception" applicable due to the debtors' past and current intentions.

*In re Brutsche*, 2012 Bankr. LEXIS 529 (Bankr. D.N.M. Feb. 16, 2012) (Judge Starzynski).

- Debtor was an experienced residential subdivision developer for at least 20 years and had worked on a high-end subdivision which consisted of different names and had 15 different phases, but are all stages of one grand project. Individual lots in the subdivision ranged from $300,000 to over $1,500,000, while houses in the subdivision ranged in price from $700,000 to over $3,000,000. The Bankruptcy Court determined that the project, despite being acquired in different phases, was: (i) part of a single project, (ii) the only source of income for the debtor, and (iii) debtor was not engaged in any substantial business other than operation of the real estate and activities incidental thereto. Accordingly, debtor was determined to be a SARE.

*In re Tejal Inv., LLC*, 2012 Bankr. LEXIS 5760 (Bankr. D. Utah Dec. 12, 2012) (Judge Thurman).

- Court briefly reviewed the debtor's Schedules and noted that the debtor held accounts receivable, furniture, fixture, equipment, and deposits which removed the debtor as a single asset real estate despite its primary asset being a 60-room hotel property

## VII. Different Types of Businesses and the SARE Determination

- Hotel ***not*** a SARE when it operates significant other businesses, *e.g.*, restaurant, bar and gift shop, and provides room cleaning services and phone services for guests. *See Centofante v. CBJ Dev., Inc. (In re CBJ Dev., Inc.)*, 202 B.R. 467 (9th Cir. B.A.P. 1996); *In re Whispering Pines Estate, Inc.*, 341 B.R. 134 (Bankr. D. N.H. 2006).

- Golf course ***not*** a SARE when it also offers golf cart rentals, a pool, and concessions. *See In re Larry Goodwin Golf, Inc. d/b/a Uwharrie Gold Club*, 219 B.R. 391 (Bankr. M.D.N.C. 1997); *In re CGE Shattuck LLC*, 1999 WL 33457789 (Bankr. D.N.H. Dec. 20, 1999). Golf course ***not*** a SARE when it is connected to a residential land development and not simply operating a golf course. *In re Prairie Hills Golf & Ski Club, Inc.*, 255 B.R. at 228 (Bankr. D. Neb. 2000).

- Marina ***not*** a SARE when, in addition to providing for the mooring of boats, the marina offers concessions, fuel, stores and winterizes boats. *In re Khemko, Inc.*, 181 B.R. 47 (Bankr. S.D. Ohio 1995).

- Ownership of timberland is ***not*** a SARE when the debtor operates a heavily regulated business thereon that is heavily dependent upon a highly educated labor force. *See In re Scotia Dev., LLC*, 375 B.R. 764 (Bankr. S.D. Tex. 2007).

- Ownership of contiguous parcels is not a SARE when there is no common purpose to combine the parcels or enter into a coordinate plan for their development. *In re McGreals*, 201 B.R. 736 (Bankr. E.D. Pa. 1996).

- Apartment buildings ***are*** a SARE. *In re Vargas Realty Enters.*, 2009 Bankr. LEXIS 2040 (Bankr. S.D.N.Y. July 23, 2009).

- Coordinated real estate developments consisting of multiple parcels ***are*** a SARE even when constructed in phases. *In re Webb MTN, LLC*, 2008 Bankr. LEXIS 691 (Bankr. E.D. Tenn. Mar. 6, 2008); *In re Pioneer Austin E. Dev. I, Ltd.*, 2010 Bankr. LEXIS 2160 (Bankr. N.D. Tex. July 1, 2010); *In re Rear Still Hill Rd., LLC*, 2007 Bankr. LEXIS 3501 (Bankr. D. Conn. Oct. 5, 2007); *In re Kachina Vill., LLC*, 538 B.R. 124, 125 (Bankr. D.N.M. 2015) (Judge Thuma); *In re Brutsche*, 2012 Bankr. LEXIS 529 (Bankr. D.N.M. Feb. 16, 2012) (Judge Starzynski).

Automatic Stay Implications in SARE Cases

An SARE designation has significant implications on the automatic stay. To remedy perceived abuse caused by SARE debtors filing bankruptcy to delay foreclosure when it is highly unlikely that the SARE debtor can successfully reorganize. S. Rep. No. 168, 103d Cong., 1st Sess. (1993) ("This amendment will ensure that the automatic stay provision is not abused, while giving the debtor an opportunity to create a workable plan of reorganization."); 140 Cong. Rec. 10764 (daily ed. October 4, 1994).

Section 362(d)(3) states that: "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 nondefault contract rate of interest on the value of the creditor's interest in the real estate;

11 U.S.C. § 362(d)(3). Section 362(d)(3) attempts to shorten such cases by requiring that the court grant relief from the stay if a reasonable plan is not filed promptly or payments are not commenced.

In short, the SARE debtor has two options to avoid relief from stay and eventual foreclosure. First, the SARE debtor can propose a plan that has a reasonable possibility of being confirmed within a reasonable time. "While a hearing on a (d)(3) motion should not be a mini confirmation hearing, the debtor must show some reasonable possibility of confirming a plan. As one court has artfully stated, 'the terms ... 'reasonable possibility' within a 'reasonable time' are rather vague and hopeful terms that require a far lower standard of proof than what will be required of the Debtor [at the confirmation hearing]." Thus, the Court should not expose the debtor to the same level of scrutiny that it will endure if its plan makes it to confirmation, but the Court does require that debtor demonstrate that its plan has "a realistic chance of being confirmed [and] is not

patently unconfirmable." *In re RIM Dev., LLC*, 448 B.R. 280, 288-289 (Bankr. D.Kan. 2010) citing *In re Hope Plantation Group, LLC*, 393 B.R. 98, 104 (Bankr. D.S.C.2007) and *In re Carlsbad Development I, LLC*, 2009 Bankr. LEXIS 754, 2009 WL 588662 at *3 (Bankr. D.Utah 2009). A court will look at the sixteen confirmation requirements in § 1129(a) to determine whether a plan proposed by an SARE debtor has a reasonable possibility of being confirmed within a reasonable time. *Id.*

Second, the SARE debtor can commence payments to the lender with a lien on the real property. Section 362(d)(3) requires the payment of interest at the then applicable nondefault contract rate of interest. Some courts refer to this as an interest payment. However, other courts have held that Section 362(d)(3) only governs the amount, not the application of the payment. *In re Erie Playce LLC*, 441 B.R. 905, 908-909 (Bankr. N.D. Ill. 2010). "These payments are unique to single asset real estate cases and do not qualify as adequate protection or payments of interest, though some cases fail to make this distinction." *Id*. In addition, the interest amount is based on the value of the creditor's interest in the real estate. Thus, the payment amount could be less than the amount required by the applicable loan documents if the value of the property is less than the loan amount.

Relief from stay under § 362(d)(3) does not eliminate or replace the other grounds for relief from stay available under § 362(d). In addition, the relief available under (d)(3) is the same as under any motion for relief from stay such that the Court may terminate, annul, modify or condition the automatic stay. Some courts have conditioned continuation of the stay on a deadline to file a plan or make interest payments. *See In re Sterling Dev., Inc.*, 2009 Bankr. LEXIS 172 (Bankr. D.N.M. Jan. 26, 2009).

Plan Considerations in SARE Cases

An SARE debtor will face many issues trying to get a plan confirmed, including classification of claims, cramdown, new value and § 1111(b).

1. Classification of Claims

Section 1123(a) requires a plan to designate classes of claims of interests. This classification is governed by § 1122, which states that a plan may only place claims in the same class if they are substantially similar. To approve the separate classification of similar claims, courts have required a good business reason, a reasonable or rational justification, a legitimate business or economic justification, credible proof of any legitimate reason, or a reason that does not offend one's sensibility of due process and fair play. *In re LightSquared, Inc.*, 513 B.R. 56, 83 (Bankr. S.D.N.Y. 2014).

SARE debtors will, for obvious reasons, attempt to separately classify the secured creditor's deficiency claim. Otherwise, the secured creditor would control two classes (and likely the only two) of the plan. SARE debtors have made a number of arguments in an effort to separately classify claims.

a. The existence of a guaranty or additional non-estate collateral.

b. The secured creditor's claim is subject to litigation.
c. A deficiency claim is different than a general unsecured claim.
d. The ability to make and the effect of a § 1111(b) election.

Each of these arguments will be reviewed in detail by the court. Because this is a fact intensive analysis, courts have ruled in favor of and against these arguments.

2. New Value

The absolute priority rule prevents equity holders from receiving anything, including their ownership interests, unless unsecured creditors are paid in full. Courts have created an exception, the new value exception, that allows an equity holder to retain their ownership interest if they contribute new value to the debtor. *See Bank of America Nat. Trust & Sav. Assoc'n v. 203 North LaSalle Street P'ship*, 526 U.S. 434 (1999). "New value contributions must be substantial, necessary to the success of the reorganization, and equal to or exceeding the value of the retained interest in the estate." *In re Summers*, 594 B.R. 707, 711 (Bankr. D. Colo. 2018) *citing Unruh v. Rushville State Bank of Rushville, Mo.*, 987 F.2d 1506, 1510 (10th Cir. 1993).

3. Cramdown/Accepting Class

Section 1129(a)(8) requires acceptance of a chapter 11 plan by each class of impaired claims or equity interests to be consensually confirmed. Section 1129(b)(1) provides an exception and allows confirmation of a plan despite the rejection of the plan by a class or classes if the plan (1) does not unfairly discriminate and (2) must be fair and equitable.

An SARE debtor may encounter trouble obtaining an accepting impaired class to use to obtain confirmation of its plan.

4. Section 1111(b)

Pursuant to 1111(b), in certain circumstances, a secured creditor with a non-recourse loan that is undersecured may elect to treat its entire claim as a secured claim. If an election is made, the entire face amount of the claim must be paid in full under the plan. The SARE debtor may have difficulty proposing and confirming a feasible plan that provides for payment in full of the secured debt.

Bad Faith Filing in SARE Cases

An SARE debtor must file its Chapter 11 case in good faith. Just like any other Chapter 11 case, an SARE case can be subject to dismissal or relief from stay for lack of good faith (i.e. a bad faith filing). Frequently, SARE cases are filed on the eve of foreclosure in an effort to avoid foreclosure. In addition, SARE debtors have limited operations to reorganize.

> Bad faith is commonly found in single asset cases involving debtors with no current business operations to reorganize. *See, e.g. In re Pacific Rim Investments, LLP*, 243 B.R. 768 (D. Colo. 2000)

> (Debtor, which owned an office building, filed bankruptcy petition to avoid adverse outcome of state court litigation. Bad faith found even though debtor had equity in the asset and had filed a plan.); *In re Little Creek Dev. Co.*, 779 F.2d 1068 (5th Cir. 1986) (Developer filed chapter 11 case when unable to afford bond required to stay state court foreclosure. Court discussed elements common to abusive filings.); *In re Laguna Associates Ltd. Partn.*, 30 F.3d 734 (6th Cir. 1994), *as amended on denial of reh'g and reh'g en banc* (Sept. 9, 1994) (Affirmed finding of bad faith filing where debtor had single heavily encumbered asset, limited cash flow, no ongoing business, and few unsecured creditors.); *In re Nursery Land Dev., Inc.*, 91 F.3d 1414 (10th Cir. 1996) (Among other factors, debtor filed petition to stop foreclosure, lacked reasonable prospect of reorganization, had no ongoing business, and had only one asset.).

*In re Platte River Bottom, LLC*, 2016 Bankr. LEXIS 186 (Bankr. D. Colo. Jan. 19, 2016). In Platte River Bottom, Judge Tallman pointed to the discussion of bad faith filing in *In re Little Creek Dev. Co.*, 779 F.2d 1068, 1072-73 (5th Cir. 1986):

> Determining whether the debtor's filing for relief is in good faith depends largely upon the bankruptcy court's on-the-spot evaluation of the debtor's financial condition, motives, and the local financial realities. Findings of lack of good faith in proceedings based on §§ 362(d) or 1112(b) have been predicated on certain recurring but non-exclusive patterns, and they are based on a conglomerate of factors rather than on any single datum. Several, but not all, of the following conditions usually exist. The debtor has one asset, such as a tract of undeveloped or developed real property. [✔check]. The secured creditors' liens encumber this tract. [✔check]. There are generally no employees except for the principals [✔check], little or no cash flow [✔check], and no available sources of income to sustain a plan of reorganization or to make adequate protection payments pursuant to 11 U.S.C. §§ 361, 362(d)(1), 363(e), or 364(d)(1). [✔check]. Typically, there are only a few, if any, unsecured creditors whose claims are relatively small. [✔check]. The property has usually been posted for foreclosure because of arrearages on the debt and the debtor has been unsuccessful in defending actions against the foreclosure in state court. [✔check]. Alternatively, the debtor and one creditor may have proceeded to a stand-still in state court litigation, and the debtor has lost or has been required to post a bond which it cannot afford. Bankruptcy offers the only possibility of forestalling loss of the property. There are sometimes allegations of wrongdoing by the debtor or its principals. The "new debtor syndrome," in which a one-asset entity has been created or revitalized on the eve of foreclosure to isolate the insolvent property and its creditors, exemplifies, although it does not uniquely

> categorize, bad faith cases.

*In re Platte River Bottom, LLC*, 2016 Bankr. LEXIS 186, *citing In re Little Creek Dev. Co.*, 779 F.2d 1068, 1072-73 (5th Cir. 1986). In short, an SARE bankruptcy is potentially bad faith when there is "no going concern to preserve, there are no employees to protect, and there is no hope of rehabilitation . . ." *Little Creek Dev. Co*., 779 F.2d at 1073.

Bankruptcy Remote Real Estate Structure

By: James Bentley

A. Overview

1. What is an "SPE?"

(a) A special purpose entity, single purpose entity, or bankruptcy remote entity.

(b) An SPE is organized for a specific and limited purpose.

(c) The vast majority of SPEs are used in real estate transactions, although they are also used in the CLO and CDO markets, as well as elsewhere.

(d) SPEs may be corporations, limited partnerships, or limited liability companies. Most are Delaware limited liability companies.

(i) Delaware is attractive for robust body of case law, knowledgeable court system, and Delaware law provides that the bankruptcy of a member of owner will not automatically cause the SPE to terminate or dissolve.

(ii) Done in part by creating the role of the "springing member" under the operating agreement.

(iii) A "springing member" is a person who agrees to become a special member automatically upon the happening of the event specified in the operating agreement.

(e) Not all SPEs are bankruptcy remote. Bankruptcy remote SPEs must have specific "bells and whistles." Rating Agencies will require that a single purpose vehicle that is an SPE have bankruptcy remote features.

2. Bankruptcy Remoteness

(a) What makes an SPE bankruptcy remote? Some of the factors that should be included in an SPEs organizational documents are:

(i) Required to have at least one independent director or manager who is unaffiliated with the SPE or its affiliates. This director or manager typically disclaims its fiduciary duty to equity holders so lenders have comfort that bankruptcy is a less likely alternative.

(ii) Limited number of creditors.

(iii) Restriction and/or limitations on incurring indebtedness and granting liens.

(iv) Limitations on activities.

(v) Requirement that organizational documents and the transaction documents require separateness between the SPE and affiliates.

(vi) Prohibition on liquidating or filing for bankruptcy without the authorization of the independent director or manager for so long as the securities are outstanding.

(vii) Restrictions on the merger of the SPE and sale of all or substantially all of the assets of the SPE without the prior written consent of the lender.

(viii) If the SPE is a limited partnership, then the general partner must also be an SPE. In fact, most lenders require a depositor entity that is an SPE to sit between the Issuer and the transferor.

(b) Limitations on the Purpose of an SPE. An SPEs purpose should be expressly limited in the organizational documents. Many transaction documents also include the same limitations found in the organizational documents.

(i) SPE Mortgage Borrower. The borrower's purpose should be limited to owning and operating the mortgaged property that is collateral for the debt supporting the rated securities and activities necessary and incidental to that purpose.

(ii) SPE Equity Owner. The equity owner's purpose should be limited to owning the SPE's equity.

(iii) Depositor. The depositor's purpose should be limited to depositing the mortgage loans into the trust that will issue the rated securities.

3. When is an SPE Required?

(a) Oftentimes in a commercial loan issuance and mezzanine financing.

(b) If the loan is destined for pooling with other commercial real estate loans for a CMBS issuance, then rating agencies will want to ensure the SPEs that hold that loans are bankruptcy remote.

4. Bankruptcy Opinions

(a) Rating agencies typically require a "true sale" and/or "non-consolidation" opinion. "Would" vs. "Should" vs. "Either/Or."

(i) True sale opinions provide that the conveyance of the asset is in fact a sale, and not a secured loan.

(ii) Non-Consolidation opinions provide that the SPE will not be consolidated with its owner or family of affiliated owners should one or all of them file for bankruptcy.

5. Recycled SPEs

(a) A pre-existing SPE may be used in a transaction. When it is, the SPE must typically make certain representations and warranties to provide lenders and rating agencies with comfort that nothing in its prior dealings would threaten its status as an SPE:

(i) Has been duly formed and always has always been validly existing and in good standing where organized and qualified to do business.

(ii) No litigation, judgments, bankruptcy, or liens.

(iii) Compliance with all laws, regulations, and orders.

(iv) No dispute with taxing authorities.

(v) SPE has filed all required tax returns and paid all taxes.

(vi) Limited scope of purpose since inception.

(vii) Has always conducted business operations consistent in all material respects with the separateness covenants contained in its operating agreement.

(viii) No contingent or actual obligations unrelated to its purpose.

(b) Independent review by SPE's counsel may be necessary, including prior SPE organizational documents and search reports for UCC financing statements, liens, judgments, and bankruptcies.

6. Substantive Consolidation

(a) Doctrine arises under a bankruptcy court's equitable powers (11 U.S.C. § 105(a)). There is no specific statutory authority. Courts apply substantive consolidation on a case-by-case basis and it is very fact-specific

(b) An extreme remedy.

(c) Specific factors and considerations:

(i) Commingling of assets;

(ii) Inadequate record keeping;

(iii) Difficulty in separating assets of the entities;

(iv) Overlapping operations; and

(v) Creditors thought they were dealing with a single entity.

(d) If an SPE is substantively consolidated with another affiliated entity, then the entire pool of assets owned by both entities becomes available for creditors of both entities. Put another way, the SPE's lender must now share its collateral pro rata with the creditors of the substantively consolidated entity.

B. Creditor Default Remedies

1. Bankruptcy Remote vs Bankruptcy Proof. There is no bankruptcy proof. The reason is the prohibiting an entity from filing for bankruptcy would offend public policy. Thus, the goal of a lender is to decrease an SPEs likelihood of filing for bankruptcy.

2. GGP – A Story for Lenders.

(a) GGP was one of the largest owners of shopping malls in the United States. GGP owned directly or indirectly many single purpose entities. Each such entity owned a real estate development, primarily commercial real estate such as shopping malls. GGP's single purpose entities granted liens on owned real estate that secured a commercial mortgage. GGP's ownership structure was designed so that each single purpose entity would qualify as a so-called bankruptcy remote entity. However, when GGP filed its petition, numerous of its supposedly bankruptcy remote affiliates filed petitions as well. Throughout each single purpose entity's case, its separateness was respected by the bankruptcy court and the parties and no motion or adversary proceeding was filed that sought a substantive consolidation of GGP or any of its subsidiaries with any of the bankruptcy remote entities.[1] The issues raised by GGP mainly concern the bankruptcy remoteness of single purpose entities rather than their separateness and substantive consolidation of their assets.

(b) Shortly after GGP and its affiliated co-debtors filed their bankruptcy cases, several secured lenders and servicers for secured lenders filed motions to dismiss the Chapter 11 cases filed by some of the GGP subsidiaries. Those motions argued that the bankruptcy cases should be dismissed because they had been filed in "bad faith" or lacked "good faith". The Bankruptcy Court denied those motions on August 11, 2009.[2]

(c) The motions alleged both "objective bad faith" and "subjective bad faith". The motions' "objective bad faith" argument asserted that (i) based on the financial condition of the particular subsidiaries at the relevant time, the bankruptcy filings were premature; (ii) the subsidiaries' decision to file for bankruptcy had improperly considered the interests of the aggregate GGP group; and (iii) those subsidiaries would be unable to confirm a Chapter 11 plan without the secured lender's support.[3]

(d) The "subjective bad faith" argument was based on allegations as to (i) a failure to negotiate the filing with the secured lenders or their representatives, and (ii) the

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[1] It should be noted that most of GGP's single purpose subsidiaries exited bankruptcy through separate, confirmed chapter 11 plans before the bankruptcy court confirmed the plan of reorganization for GGP's holding company and its remaining subsidiaries on October 21, 2010.

[2] In re Gen. Growth Props., Inc., 409 B.R. at 71.

[3] Id. at 57.

manner in which certain independent managers of some of those subsidiaries were discharged and replaced with others.[4]

(e) The Bankruptcy Court did not find sufficient evidence to support the motions' allegations and did determine that relevant facts existed that did not warrant a dismissal of the relevant cases.[5]

3. State Law Remedies. Lenders may pursue foreclosure remedies under state law if the SPE defaults.

4. Non-Recourse Guarantees. SPE affiliate guarantees are typically limited in recourse.

### C. Practical Considerations

1. What remedies does a lender have when its SPE borrower defaults?

2. How real is the threat that non-lender creditors of the SPE will exist and exercise remedies against the SPE?

3. Costs of structuring SPEs and bankruptcy remote entities in commercial real estate transactions.

4. SPE must comply with its SPE covenants to work.

[4] Id. at 66-67.
[5] Id. at 69.