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Single Asset Real Estate Debtors: Challenges in the Bankruptcy Code

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Unlike retailers and manufacturers that file for chapter 11 protection, real estate owners and developers must be mindful of the restrictions and special expedited procedures the Bankruptcy Code imposes upon debtors whose estates consist of a single property or project ("Single Asset Real Estate" or "SARE" cases). In those cases, the automatic stay, which typically gives debtors a "breathing spell" from lenders' collection efforts, terminates ninety (90) days after the bankruptcy filing unless the debtor either files a confirmable plan of reorganization or commences monthly interest payments to its secured lenders. Set forth below is a brief discussion of the relevant statutory provisions and interpreting case law regarding SARE cases.

As part of the Bankruptcy Reform Act of 1994, Congress added two new sections to the Bankruptcy Code to expedite single asset real estate cases and enhance the leverage held by secured lenders. First, Congress added section 101(51B) of the Code, which defines "single asset" real estate as:

[R]eal 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 the debtor 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 having aggregate non-contingent, liquidated secured debts in an amount no more than $4,000,000.

Second, Congress amended section 362 of the Bankruptcy Code to require that the automatic stay be terminated if the debtor does not file a plan of reorganization or commence monthly interest payments within ninety (90) days of the petition date. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") eliminated the $4 million cap in section 101(51B), expanding the reach of the SARE provisions and making them applicable to much larger projects and entities, including the many public and private homebuilders facing today's economic pressures.

The text of section 101(51B) does not elaborate as to the meaning of the phrases "substantial business" or "other than the business of operating the real property." Courts interpreting those phrases have benefitted little from the legislative history accompanying the amendments. Without meaningful legislative guidance, courts have focused on whether the real estate is used in the operation of a business or whether it is simply held for "passive" income. Many courts interpreting the 1994 SARE amendments have determined a debtor that actively operates a business on its property, even when the operation of such business centers around the use of a debtor's property, does not constitute a SARE. See In re CBJ Dev., Inc., 202 B.R. 467 (9th Cir. BAP 1996) (finding that hotel operations were not the mere "operation of a property" because, in addition to operating a gift shop, it required (i) a substantial number of employees; (ii) actively maintaining each of the rooms, (iii) cleaning bed sheets and towels; and (iv) providing basic amenities to guests, specifically phone service); Prairie Hills Golf & Ski Club, Inc., 255 B.R. at 228 (Bankr. D. Neb. 2000) (operation of golf and ski facilities connected to residential land developments is not merely operating the property); Larry Goodwin Golf, Inc., 219 B.R. 391 (Bankr. M.D.N.C. 1997) (operation of a golf course and pool with concession stand is not merely operating the property); In re Khemko, Inc., 181 B.R. 47 (Bankr. S.D. Ohio 1995) (marina not a single asset real estate debtor under section 101(51B) because, in addition to providing for the mooring of boats, the marina also stored, repaired and winterized boats, provided showers and a pool, sold gas, and sold concessions); and Whispering Pines Estate, Inc., 341 B.R. 134 (Bankr. D. N.H. 2006) (debtor, which operated an 89-room hotel, conducted operations in connection therewith that were "sufficiently active in nature to constitute a business other than the mere operation of property").

As noted above, however, the elimination of the $4 million cap as part of the 2005 BAPCPA amendments have caused SARE issues to appear with somewhat greater frequency in more substantial cases. Of note in these troubled times for homebuilders is Kara Homes, Inc. v. Nat'l City Bank (In re Kara Homes, Inc.), 363 B.R. 399 (Bankr. D. N.J. 2007). There, a parent entity and several of its subsidiaries filed chapter 11 cases. The parent oversaw the overall residential development business and each debtor subsidiary owned real estate on which it developed residential projects. None of the debtor subsidiaries had its own employees or a separate permanent facility from which to operate. The court found each debtor subsidiary was a SARE because its business operations "[we]re merely incidental to their efforts to sell the homes or condominium[s] and thus did not constitute substantial business."

In contrast, however, is In re Scotia Dev., LLC, 375 B.R. 764 (Bankr. S.D. Tex. 2007). There, the court adopted the "active-versus-passive" criterion in addressing whether a timber harvester was a SARE debtor. The court made detailed findings regarding the debtor's activities and noted those activities are extensive and require hands-on supervision by teams of experts. Taking into account those extensive operations, the court concluded the debtor did not constitute a SARE. The court applied a "practical approach" to construing section 101(51B) of the Bankruptcy Code, and followed the approach of prior courts that "includ[ed] within its [section 101(51B)] ambit only those debtors who have no revenue from their property except the passive collection of rent from tenants and excluding from its reach those entities that undertake and pursue various sorts of active economic, commercial, and business activities on the property."

In sum, the restrictions imposed by the SARE provisions of the Bankruptcy Code are meaningful and create material hurdles for real estate debtors. The ways in which courts apply those provisions will be noteworthy as more real estate entities consider chapter 11 as part of their restructuring strategies.

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