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Navigating Single-Asset Real Estate Status In Bankruptcy

By **Adam Rogoff, David Blabey Jr. and Kelly Porcelli**
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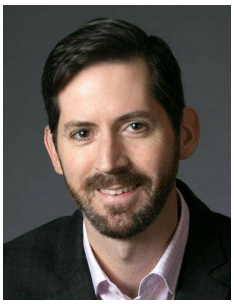

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Among the different policy tensions embedded in the Bankruptcy Code is the balancing act between affording a debtor sufficient time to reorganize versus the impact upon creditors — especially secured lenders — from the delays imposed upon exercising remedies.

While the Bankruptcy Code provides certain protections for a secured creditor for potential impacts of delay — e.g., adequate protection — real estate lenders have a specific remedy in the form of single-asset real estate, or SARE, cases.

To obtain — or conversely from the debtor's vantage point, to be burdened by — these protections, a threshold issue is whether the debtor meets the criteria for being treated as a SARE case.

In Shady Bird Lending LLC v. The Source Hotel LLC (In re: The Source Hotel LLC) in June, the U.S. District Court for the Central District of California adopted the majority view that a non-income-producing property could be a SARE debtor.[1]

The district court held that the hotel, which was not yet producing income, nonetheless met the definition of a SARE.[2]

Relevant Bankruptcy Code Provisions

By way of background, the Bankruptcy Code 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 thereto.[3]

Whether a debtor is designated as a SARE is relevant to requests for relief from the automatic stay and the debtor's enhanced burden regarding a proposed plan. Specifically, a SARE designation allows for a quick termination of the automatic stay under Section 362(d)(3) of the Bankruptcy Code.[4]

That subsection provides that after notice and a hearing, the court "shall grant relief from the stay" in the case of a SARE debtor where the moving creditor's claim is secured by an interest in the real estate, unless within 90 days of the filing — or within 30 days of the court making a SARE determination if the designation is contested — the debtor "filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time," or the debtor commenced monthly payments to the secured creditor at the nondefault contract rate of interest.[5]

It is not sufficient for a debtor to file a placeholder plan — as may be done in non-SARE bankruptcy cases. Rather, SARE debtors must file a plan that has a "reasonable possibility of being confirmed within a reasonable time."[6]

Courts have found that the debtor's burden under Section 362(d)(3) is a lesser standard than that required at plan confirmation.[7]

In In re: RYYZ LLC in 2013, the U.S. Bankruptcy Court for the Eastern District of New York stated that it requires the debtor's plan "delineate a credible path to reorganization," and that hurdles to confirmation are more likely than not to be overcome promptly.[8] While less than a confirmation burden, it nonetheless requires more than merely filing a plan to prevent the loss of exclusivity prior to the applicable deadline.

One of the issues that has come up in a SARE dispute is whether the debtor must be producing income from the real estate to qualify.

Factual Background

Since 2014, The Source Hotel had been developing a hotel and intended to operate the hotel and its related businesses, including a restaurant and bars on the hotel property.[9]

To finance construction, it obtained a $29.5 million loan from Evertrust Bank.[10] In 2019, The Source Hotel stopped construction.[11] In December 2020, Shady Bird Lending purchased Evertrust's interests in the loan.[12]

Shady Bird then filed a complaint against The Source Hotel in state court and took steps to foreclose. The state court appointed a receiver to take possession of the hotel and a few days later, The Source Hotel filed for Chapter 11 bankruptcy. In its voluntary petition, it did not designate itself as a SARE debtor.

Shady Bird Lending moved to designate the debtor's bankruptcy case as a SARE. The U.S. Bankruptcy Court for the Central District of California denied the motion and Shady Bird Lending appealed.

On appeal, the district court found that the bankruptcy court had erred in its interpretation of Section 101(51B) and its finding that The Source Hotel did not satisfy the test for a SARE case, and reversed the bankruptcy court's order, remanding for further proceedings.

District Court Opinion

The district court analyzed the second and third elements of the SARE definition — element one was not disputed.

As to the second element, requiring property that generates substantially all of the gross income of a debtor, there was no dispute that the hotel was not producing income. The bankruptcy court concluded that the second element does not include property that produces no income, acknowledging that its view may be in the minority.[13]

On appeal, the district court adopted what it considered the majority view, finding that the statutory definition of SARE includes property that generates no income.[14] The district court found Section 101(51B) ambiguous with respect to undeveloped or partially developed real property and, thus, looked to the statutory scheme and legislative history for guidance.[15]

It found the reasoning of the U.S. Bankruptcy Court for the Southern District of California in In re: Oceanside Mission Associates in 1996, persuasive.[16]

The Oceanside court concluded that interpreting the statute to exclude raw, or non-income-producing, land would not serve the purpose of the statutory scheme, stating there was no apparent purpose to excuse debtors who own only raw land from the expedited relief from stay in favor of the secured lender and further, the legislative history demonstrated that SARE had been applied to raw, undeveloped land.[17]

Turning to the third element, requiring no substantial business being conducted, the bankruptcy court had considered the intent for which the property was constructed, which included operation of a restaurant, bar, laundry services and other businesses, and concluded that this element was not satisfied.

The district court disagreed with this approach, concluding that Congress' use of the present tense — "is being conducted" — requires courts to evaluate the current business activities of a property rather than the parties' intentions.[18]

Here, The Source Hotel was not currently conducting any business related to the hotel outside of construction and development, and in fact, the hotel and other associated businesses were never in operation. Thus, the third element was satisfied.

The fact that the hotel and its related businesses were never in operation distinguished this case from In re: CBJ Development Inc., in which the Bankruptcy Appellate Panel for the Ninth Circuit in 1996 found a hotel was not a SARE because the debtor had operated other businesses — a gift shop, restaurant and bar on the property — shortly before filing for Chapter 11 relief, and they were under temporary renovation.[19]

Why This Case Is Interesting

Whether a debtor is a SARE affects the trajectory of a Chapter 11 case. In particular, if a debtor is designated a SARE, a creditor secured by that real property can obtain expedited relief from the automatic stay.

A SARE debtor may be able to defeat a request for relief from the stay if it can show that it has filed a plan that has a reasonable possibility of being confirmed within a reasonable time, or if it is making monthly post-petition payments at the nondefault contract rate to the secured lender.

Thus, a SARE designation affects a debtor's ability to retain control over its case and its primary asset, and dictates the type of plan it can file and the duration that the debtor can remain in bankruptcy.

Alternatively, to the type of plan that can be filed, a SARE designation could affect the debtor's cash flow if the estate opts to start paying post-petition debt service at the nondefault contract rate. Oftentimes, SARE debtors may have little to no available cash, thereby necessitating a cash infusion, either from equity or another permissible lending source.

If a case was commenced to obtain a stay of a mortgage foreclosure, the SARE designation is particularly relevant if a debtor filed for bankruptcy hoping to take advantage of its breathing spell while waiting for market conditions to improve.

Because of the effect that a SARE designation has on a bankruptcy case, debtors may look for ways to avoid a SARE designation by, for example, obtaining an interest in nondebtor entities.

For example, in Sutton 58 Associates LLC v. Pilevsky before the Appellate Division of the New York State Supreme Court in 2020, the plaintiff-lender brought state law claims against various affiliated persons and entities alleging that defendants had tortiously interfered with the loan agreements between the plaintiff and nonparty borrowers.

The plaintiff alleged that as part of this scheme, the defendants transferred three rental apartments to the mortgage borrower so that it would no longer be a SARE entity, and transferred to the defendants an indirect interest in the borrowers and a development project. The mortgage borrower filed for bankruptcy and did not designate itself a SARE debtor.

While the issue of whether the mortgage borrower was properly a SARE debtor was briefed, the motion seeking dismissal on that ground was withdrawn and thus, the bankruptcy court never decided the issue.

With the Shady Bird decision, the California district court joined the majority of courts that have found that the statutory definition of SARE includes undeveloped, non-income-producing land or, in the instant case, property that is being developed but has not yet started producing income because the hotel and its related businesses were never operational.

Where a debtor was previously operational and conducted other businesses, the court's reasoning might lead to the conclusion that it may not fall within the statutory SARE definition.

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Disclosure: Kramer Levin represented the lender in the related bankruptcy filings and in the tortious interference litigation in Sutton 58 v. Pilevsky.

[1] Shady Bird Lending LLC v. The Source Hotel LLC (In re: The Source Hotel LLC), 2022 WL 2072673, Case No. 8:21-cv-00824-FLA (C.D. Ca. June 8, 2022).

[2] Id. at *8.

[3] 11 U.S.C. § 101(51B).

[4] Section 362(d)(3) of the Bankruptcy Code was intended to "address perceived abuses in single asset real estate cases, in which debtors have attempted to delay mortgage foreclosures even when there is little chance that they can reorganize successfully." 3 Collier on Bankruptcy ¶ 362.07 (16th ed. 2022) (citing S. Rep. No. 168, 103d Cong., 1st Sess. (1993); 140 Cong. Rec. 10764 (daily ed. October 4, 1994), reprinted in App. Pt. 9(b) infra).

[5] 11 U.S.C. § 362(d)(3) (emphasis added).

[6] 11 U.S.C. § 362(d)(3).

[7] See In re RYZZ, LLC, 490 B.R. 29, 37 (Bankr. E.D.N.Y. 2013) ("[T]he debtor's plan will be measured against . . . § 1129's confirmation requirements. However, the debtor's burden is less onerous under Section 362(d)(3)(A) . . . a debtor need not prove that its plan shall be confirmed."); In re MDM Golf of Gillette Ridge, LLC, Case No. 14-21565 (ASD), 2014 Bankr. Lexis 5126, at *8 (Bankr. D. Conn. Dec. 23, 2014) ("[B]ankruptcy courts have concluded that the standard for determining whether a plan has a reasonable possibility of being confirmed within a reasonable period of time a lesser standard than that required to be shown at confirmation.").

[8] In re RYZZ, LLC, 490 B.R. at 37; see id. at 32 (granting relief from stay where debtor had not shown it could obtain acceptance of its plan by at least one validly impaired class and/or that the plan did not violate the absolute priority rule). Courts have looked to the standard under section 362(d)(2) for guidance. See, e.g., See In re 68 West 127 Street, LLC, 285 B.R. 838, 847, 848 (Bankr. S.D.N.Y. 2002) (noting the standards under sections 362(d)(2)(B) and 362(d)(3)(A) are similar, if not identical and stating "the Debtor must show only that its plan has a reasonable prospect of success within a reasonable time").

[9] 2022 WL 2072673, at *1.

[10] Id.

[11] Id.

[12] Id.

[13] Id. at *3.

[14] Id. at *4.

[15] Id.

[16] 192 B.R. 232 (Bankr. S.D. Cal. 1996).

[17] Id. at *4-5.

[18] Id. at *7.

[19] Id. at *8.