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"Single Asset Real Estate": A Concept in Need of Redefinition

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Almost two decades ago, the Bankruptcy Code was amended to include special treatment for single asset real estate (SARE) debtors. In 2005, the Bankruptcy Code was once again amended to eliminate the $4 million debt limitation on SARE cases, so the special treatment thereafter applied to *all* SARE debtors who met the SARE test, not just small- and medium-sized property owners. In both instances, the purpose of the amendments was to make available expedited relief to secured creditors in SARE cases that are not likely to result in confirmed reorganization plans.[1]

When the current global economic downturn started in 2008, the SARE provisions of the Bankruptcy Code were somewhat untested by market participants, primarily because there had been many years of prosperity in various segments of the U.S. economy, especially in commercial real estate. What we did not know in 2008, we certainly know now: A key battleground in this downturn has been in the area of commercial real estate.

The Congressional Oversight Panel has estimated that more than *$1.4 trillion* in commercial real estate debt will mature between 2010 and 2014.[2] As a direct result of these maturities and declining real estate values, many areas of the country have been awash in commercial real estate workouts, restructurings and liquidations. While our experience suggests that most of these problems have been handled outside of the bankruptcy environment, hundreds of real estate projects of all kinds and sizes have ended up in chapter 11.

Thus, we are several years into testing the SARE provisions in bankruptcy litigation. As discussed above, the clear policy goal of this legislation was to allow secured creditors in SARE cases to be able to obtain expedited stay relief pursuant to § 362(d)(3). It is clear that the SARE provisions have failed to meet this goal. Many SARE cases languish in court for months, merely because a debtor has filed a plan, irrespective of whether the plan stands a reasonable prospect of being confirmed. Debtors often do not come to the table with new money in underwater real estate deals, or months pass with promises, but not commitments, that new money will be obtained. We understand why the dynamic works as it does: A debtor or investor would not normally want to invest substantial sums on an underwater project until the issue of "who wins" in chapter 11 plays out.

The fundamental problem in SARE cases, which relates back to the congressional goal of moving SARE cases along, is not significantly different from a problem that many pundits have identified in the residential real estate arena. The process of "clearing" underwater properties — whether they are residential or commercial — is slow and expensive, and uncertainty about where the market is going results in a transactional burden on American commerce. The faster that the chapter 11 "winner" can be determined (within reason) in a SARE case, the faster that the real estate can be made available to the market for development or improved management at a reset value.

We (the authors) represent both debtors and secured creditors on a regular basis — both in chapter 11, when this issue is directly relevant, and in out-of-court restructurings, when it is in the background. Therefore, we do not seek to push the Bankruptcy Code in favor of one side or the other; rather, we are simply trying to "build a better mousetrap" than the current SARE provisions provide. Although we recognize that other improvements are possible, the focus in this article is on the threshold question of whether the SARE requirements apply at all.

The Current Statute

Debtors have dual incentives to argue that the SARE provisions do not apply to their cases. As in most bankruptcies, time and money are critical. A SARE debtor would prefer not to pay interest or file a plan early in a chapter 11 case, but that is the practical and direct consequence of an admission or a judicial determination that a debtor's property is SARE.[3] This leads us to § 101(51B) of the Bankruptcy Code, which contains the now-well-worn definition of what constitutes SARE:

> The term "single asset real estate" means real property constituting a single property or project, other than residential real property with fewer than [four] residential units, which generates substantially all of the gross income of a debtor who is not a family farm-

1 *See* H.R. Rep. No. 103-835, at 50 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3359; H.R. Rep. No. 109-31, at 140-41 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 199-200.

2 Congressional Oversight Panel, *February Oversight Report: Commercial Real Estate Losses and the Risk to Financial Stability* at 2 (2010) (Feb. 10, 2010), available at www.gpo.gov/fdsys/pkg/CPRT-111JPRT54785/pdf/CPRT-111JPRT54785.pdf.

3 *See* 11 U.S.C. § 362(d)(3). The authors refer to the adequate-protection payments required by this section as "interest" for the sake of simplicity.

er 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.

To meet their clients' goal of preserving cash and creating a longer breathing spell, debtors' counsel have regularly and justifiably tested this definition in bankruptcy court. Much litigation has turned on whether particular real estate holdings represent "a single property or project." For example, if a debtor has only a single property but is part of a corporate family with other operations, do the SARE provisions apply?[4] What if a debtor leases all of its properties to affiliates?[5] Is the result different if the debtor leases *most* of its properties to affiliates but has one or more unoccupied parcels?[6] Another fertile ground for controversy is whether a debtor's operations represent "substantial business … other than the business of operating the real property and activities incidental thereto."[7]

Litigation over the SARE definition can involve considerable expense and delay. In our experience, delay is related more to a debtor's hope that the market will rebound than to a true need for time to raise cash to implement a confirmable plan. It also has been our experience that a typical SARE case is straightforward enough that a debtor and its principals should not require several months to raise money — assuming that the project is viable — unlike cases that involve debtors with complex business operations and capital structures.

Against this backdrop, we suggest revisions to the definition of what constitutes SARE that should help debtors and creditors avoid threshold disputes and move forward to the merits of their chapter 11 cases (in those cases that truly should be in chapter 11). A clear delineation of cases that may move forward on a normal chapter 11 path and those that will face early deadlines may also result in some debtors deciding not to file for bankruptcy protection at all, thereby potentially resolving matters without the additional expense and delay of the bankruptcy process.

Moving Away from "Single Asset"

As it is currently written, § 101(51B) imposes the burdens of SARE — principally the requirement to file a confirmable plan or begin paying interest to a secured creditor within 90 days post-petition — on many owners of real estate "on which no substantial business is being conducted." However, there are several exceptions, some of which make more sense than others. For example, because Congress has created a separate reorganization system in chapter 12 of the Bankruptcy Code, it would be anomalous for family farmers to be subject to the expedited procedures applicable to SARE. Congress might have also thought that small residential investment properties are less likely to produce abusive bankruptcy filings than larger properties or commercial investments.

The requirement that SARE be "a single property or project," however, does not readily correspond with the goals of the SARE provisions. The premise of those provisions is that debtors who have little or nothing more than ownership of real estate are not very likely to be able to compose confirmable plans, so that they should at least compensate their secured creditors with interest payments while they make the attempt. But those problems are equally present if a debtor's holdings consist of multiple properties or multiple projects, as well as if a debtor's passive holdings form only part of a larger project. Litigation about whether real estate is considered a single property or project is thus not a productive exercise.

We suggest that the Bankruptcy Code move away from the "single asset" concept and focus instead on whether a debtor's real property is part and parcel of a business that might be reorganized or instead merely produces an income stream (or no income at all) through the efforts of third parties, which may or may not be affiliates of the debtor. Our proposed revision of § 101(51B) thus replaces the "single asset real estate" terminology with a more descriptive phrase: "passive ownership real estate" (PORE). It also allows for the possibility that ownership of property and operation of a business on that property may be housed in separate affiliates, and the definition would exclude such an enterprise from the definition of PORE if both affiliates are debtors in bankruptcy. In other words, the new phrase would permit affiliates to qualify collectively as a business that may attempt to reorganize on a standard timetable if their owners are willing to place the collective enterprise under court supervision, thus minimizing or eliminating the contentious problem of a debtor's payment of management fees to a nondebtor affiliate.

Eliminating the Gross-Income Requirement

For similar reasons, the requirement that a SARE debtor produce substantially all of the gross income from its assets does not correlate well with the Bankruptcy Code's goal of protecting secured creditors of debtors that are not likely to be able to reorganize their real estate holdings. For example, there is little functional difference between a company that owns a retail store and an income-producing parking lot, and another company that organizes its retail and parking operations into separate subsidiaries. Under the current definition of SARE, the mortgagee of the parking lot in the former scenario can be dragged along with the restructuring of the operating business unless other grounds for relief from the automatic stay are present, while the mortgagee of a parking lot that produces all of the income of a separate subsidiary can take advantage of the SARE provisions.

We suggest that the gross-income requirement, and thus the anomaly described above, be eliminated. Under this formulation, a secured creditor of PORE would be entitled to stay relief, absent the filing of a confirmable plan or the payment of interest within 90 days post-petition, regardless of whether a debtor owns other income-producing businesses or properties. We acknowledge that in some situations — particularly if PORE is included in the same entity as complex operating businesses — it may not be realistic to expect a plan to be filed within 90 days. However, a debtor in such

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4 *See In re Meruelo Maddux Properties Inc.*, 667 F.3d 1072, 1077 (9th Cir. 2012) (SARE).

5 *See In re JJMM International Corp.*, 467 B.R. 275, 278 (Bankr. E.D.N.Y. 2012) (SARE).

6 *See In re Hassen Imports Partnership*, 466 B.R. 492, 510 (Bankr. C.D. Cal. 2012) (not SARE). *See generally In re The McGreals*, 201 B.R. 736, 743 (Bankr. E.D. Pa. 1996) (not SARE where debtor had leased one parcel to third party and adjacent parcel was undeveloped).

7 *Compare In re Scotia Pacific Co. LLC*, 508 F.3d 214, 224-25 (5th Cir. 2007) (timberland owned by debtor that managed property and sold timber was not SARE), *with In re Kara Homes Inc.*, 363 B.R. 399, 405-06 (Bankr. D.N.J. 2007) (property of debtor that planned, constructed, marketed and sold homes was SARE).

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a situation always retains the option to commence interest payments under § 362(d)(3)(B) instead, and we would expect a debtor to do so if the PORE is essential to its business operations or valuable in its own right. A debtor that cannot afford to make interest payments on its PORE because of a negative cash flow in its other operations stands little chance of reorganizing successfully in any event.

Focusing Restructuring on Situations with Employment at Stake

Our revisions also align the SARE provisions with one of the policy goals that is the subject of much discussion nowadays: job preservation. When an operating company's reorganization fails, or if stay relief is granted and a lender forecloses, unemployment is a distinct possibility for the company's employees. This problem is significantly less in SARE situations, in which there often are few or no employees. SARE cases often (but not always) have little at stake beyond the interests of owners seeking to retain their interests, a secured lender pursuing foreclosure, and a relatively small amount of unsecured debt.

Our proposed language is consistent with these realities. If a piece of real estate involves a third-party business, such as a tenant or a management company, the likelihood of job losses following a change of ownership is not significant. If, on the other hand, the debtor conducts a business through its own employees or employees of an affiliated debtor, greater disruption is possible if a secured lender forecloses. The definition excludes such a property from the definition of PORE so that the debtor has an opportunity to propose a restructuring within a normal timeline.

A New Definition of SARE (PORE)

With these considerations in mind, we propose that § 101(51B) be rewritten as follows:

The term "passive ownership real estate" —

(A) means real property —

(i) on which no substantial business is being conducted, other than the business of operating the real property and activities incidental thereto; or

(ii) on which any substantial business is conducted primarily by persons other than the debtor, employees of the debtor, and employees of an affiliate of the debtor that also is a debtor in a case under this title; and

(B) does not include residential real property with fewer than [four] residential units or real property owned by a family farmer.

Conclusion

The purpose of the SARE provisions is to allow simple real estate cases to work their way through the system, if at all, on an expedited basis. Section 101(51B) in its present form simply fails to align chapter 11 outcomes with this goal. Although there are other aspects of the SARE provisions that need fine-tuning, and SARE cases could be handled more effectively by the courts, amending § 101(51B) in the manner suggested in this article would result in a more efficient bankruptcy process in relatively simple real estate cases.

At least when jobs are not seriously at risk, a debtor should demonstrate its desire to retain ownership of its real estate by either making interest payments during its breathing spell or filing a facially confirmable plan. Our clearer definition of the PORE threshold should allow the parties (and the court) to focus on the real problem rather than debating whether the case qualifies for expedited treatment at all. abi

Editor's Note: *For an in-depth study of SAREs, pick up a copy of* The Single Asset Real Estate Case: Basic Principles and Strategies *(ABI, 2012) from the ABI Bookstore (bookstore.abi.org).*