

## Single Asset Real Estate Bankruptcies in the Face of Impending Commercial Real Estate Loan Maturity

by Brendan C. Recupero

The dramatic drop in residential real estate home prices and the resulting tightening within the credit markets and rise in residential foreclosures have received a substantial amount of the media's focus for the last year and a half. Analysts suggest that the commercial real estate sector is set to experience its own difficulties over the next several years. In its recent report, the Congressional Oversight Panel indicated that approximately \$1.4 trillion in commercial real estate loans will mature over the next four years.<sup>1</sup> Refinancing will prove difficult with higher vacancy rates and declining rents, both of which have contributed to a reduction of more than 40% in commercial real estate values over the last three years. Many owners face the prospect of a bankruptcy filing in order to restructure and reorganize their balance sheets. Since many owners are special purpose entities organized for purpose of owning a single parcel or project, it is important for them to have an understanding of the Bankruptcy Code provisions governing single asset real estate.

### *What is Single Asset Real Estate?*

The single asset real estate provisions of the Bankruptcy Code apply to real property (i) that is a single property or project; (ii) that is not residential real property with fewer than four residential units; (iii) that generates substantially all of the debtor's gross income; (iv) that is owned by a debtor that is not a family farmer; and (v) as to which the debtor does not conduct substantial business other than operating the real property and activities incidental thereto.<sup>2</sup> Prior to the enactment of the Bankruptcy Abuse and Consumer Prevention Act of 2005, which significantly amended many provisions of the Bankruptcy Code, the single asset real estate provisions applied only to debtors whose real property value did not exceed \$4 million. This limitation was removed by the 2005 amendment to the Bankruptcy Code, thereby broadening the application of the single asset real estate provisions.

### *Single Asset Real Estate and the Automatic Stay*

A hallmark of bankruptcy protection is the so-called "automatic stay." From the moment of filing a bankruptcy petition, no one can commence or continue any act to collect any obligation owed by the debtor as of the filing date.<sup>3</sup> The purpose of the automatic stay is to provide the debtor some breathing room while it attempts to reorganize and rehabilitate its business. Generally speaking, the automatic stay continues during the pendency of the case through confirmation of a Chapter 11 plan of reorganization, unless relief from the automatic stay is granted to a creditor for cause.

The Bankruptcy Code provisions governing single asset real estate appear in the section governing the application of the automatic stay. The Bankruptcy Code requires a single asset real estate debtor, within 90 days of the commencement of the case, to either file a plan of reorganization

<sup>1</sup> Congressional Oversight Panel, Commercial Real Estate Losses and the Risk to Financial Stability, at 2 (February 10, 2010).

<sup>2</sup> 11 U.S.C. § 101(51B).

<sup>3</sup> 11 U.S.C. § 362(a).

that has a “reasonable possibility of being confirmed within a reasonable time” or commence making monthly payments to each creditor with a claim secured by the real property (other than a judgment lien or unmatured statutory lien) in an amount equal to interest, at the pre-default rate, on the *value* of the creditor’s interest in the real estate.<sup>4</sup> Absent the filing of a reorganization plan or the commencement of such payments, a creditor whose claim is secured by the real estate may obtain relief from the automatic stay to pursue its state law remedies such as foreclosure. The accelerated plan process applicable to a single asset real estate debtor stands in contrast to the 120 days initially afforded other Chapter 11 debtors (who may seek a further extension of up to 18 months).<sup>5</sup> Given the accelerated plan process, a single asset real estate debtor should have a clear strategy of what it hopes to accomplish by filing a Chapter 11 case if it cannot commence interest payments on its secured debt. Because of the different treatment afforded to single asset real estate debtors under the Bankruptcy Code, a bankruptcy commenced on the eve of foreclosure, with little planning or understanding of the single asset real estate provisions, is likely to fail.

#### *Avoiding the Title of “Single Asset Real Estate” Debtor*

Debtors frequently challenge the applicability of the single asset real estate provisions of Section 362(d)(3) of the Bankruptcy Code by arguing that the nature of the property or their business operations place them outside of the definition of the term “single asset real estate.” In determining whether the subject property or project constitutes a single property or project, multiple properties may qualify as a single property or project.<sup>6</sup> For example, the construction and sale of homes typically fall within the ambit of a single project, even if multiple properties are involved, if they are part of a common plan.<sup>7</sup>

On the other hand, if a debtor provides other services that are not directly related to the sale or lease of the real property, the property or project may not constitute single asset real estate. Courts faced with this issue typically rely on the distinction between active and passive services. The business of operating real property and activities incidental to it are considered passive and include receipt of rent or sale proceeds, maintenance and marketing.<sup>8</sup> The rendering of passive services is likely to lead a bankruptcy court to conclude that the single asset real estate provisions of the Bankruptcy Code apply. Services are considered active if they are a source of revenue other than rent or sale proceeds and exclude application of the single asset real estate provisions of the Bankruptcy Code.<sup>9</sup> For this reason, golf courses, marinas, and hotels may not be considered single asset real estate due to the additional services provided by such debtors.<sup>10</sup>

<sup>4</sup> 11 U.S.C. § 362(d)(3)(emphasis added).

<sup>5</sup> 11 U.S.C. § 1121(b).

<sup>6</sup> *In re Club Golf Partners, L.P.*, 2007 WL 1176010, at \*5 (E.D. Tex. 2007) (separate tracts were owned by golf course and constituted a single project).

<sup>7</sup> *In re The McGreals*, 201 B.R. 736, 742 (Bankr. E.D. Pa. 1996).

<sup>8</sup> *Club Golf Partners*, at \*2 (holding golf course was not a single asset real estate debtor due to substantial business not related to real estate).

<sup>9</sup> *In re Scotia Pacific Co., LLC*, 508 F.3d 214, 223 (5th Cir. 2007) (holding timber company operated substantial commercial business apart from its ownership of real estate).

<sup>10</sup> *In re Whispering Pines Estate, Inc.*, 341 B.R. 134, 136 (Bankr. D.N.H. 2006) (“[T]he operation of a hotel is sufficiently active in nature to constitute a business other than the mere operation of property.”); *In re Kkemko*, 181 B.R. 47 (Bankr. S.D. Ohio 1995) (marina includes operations in addition to mere rental of moorings); *Club Golf Partners*, 2007 WL 1176010 at \*5 (golf course generated revenue other than from the sale of real estate).

*Plan Considerations for Single Asset Real Estate Debtors*

In a typical single asset real estate case, the claims of the debtor's trade creditors are often dwarfed by the deficiency claim of an undersecured lender. Faced with such facts, a single asset real estate debtor may find it difficult to propose a reorganization plan that has a "reasonable possibility of being confirmed" if the undersecured lender's deficiency claim exceeds the threshold (of one-third of the total amount owed unsecured creditors) necessary to block a "cram down" of the plan. Moreover, several Circuit Courts of Appeals have held that a debtor may not separately classify a secured lender's deficiency claim in order to "gerrymander" the voting in favor of plan confirmation.<sup>11</sup> In jurisdictions where separate classification is not an option, a debtor may seek to subordinate the claim of the undersecured creditor, provided that there was inequitable conduct on the part of such lender warranting subordination.<sup>12</sup> Absent facts supporting subordination, a debtor may need to be creative in its efforts to cram down a reorganization plan in face of an objection from an undersecured mortgagee.

*Conclusion*

In order to determine whether a Chapter 11 filing is an appropriate option, pre-bankruptcy planning is essential, particularly given the shortened time frames and special rules applicable to single asset real estate. At Jager Smith, we have significant experience representing owners both in and out of bankruptcy. If you have any questions concerning bankruptcy or single asset real estate, please feel free to contact one of our professionals.

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<sup>11</sup> *In re Boston Post Road L.P.*, 72 F.3d 477 (2d Cir. 1994); *In re Lumber Exchange Building LP.*, 968 F.2d 647 (8th Cir. 1992); *In re Bryson Properties, XVIII*, 961 F.2d 496 (4th Cir. 1992); *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274 (5th Cir. 1991); *but see In re Woodbrook Assoc.*, 19 F.3d 312 (7th Cir. 1994); *Beal Bank v. Waters Edge L.P.*, 248 B.R. 668 (D. Mass. 2000).

<sup>12</sup> 11 U.S.C. § 510(c).