

Life as a SARE Debtor: the Good, the Bad, and the Ugly

by Corali Lopez-Castro¹
Mindy Kubs

I. WHAT IS A SARE DEBTOR?

A. Definition

“Single asset real estate” is defined 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.” 11 U.S.C. § 101(51B).

A debtor with multiple properties can constitute a SARE debtor if the properties encompass one project. See *In re Webb Mtn, LLC*, 2008 WL 656271 (Bankr. E.D. Tenn. March 6, 2008) (debtor owning five parcels of land was SARE debtor because land was to be used as one large parcel in construction of resort).

Pre-BAPCPA, the Bankruptcy Code limited a SARE case to one involving property with no more that \$4 million of secured debt. This cap was removed with the BAPCPA amendments, thereby extending the reach of the single asset real estate provisions to a greater number of debtors.

¹ Ms. Lopez-Castro is a shareholder at Kozyak, Tropin & Throckmorton. She concentrates her practice on bankruptcy matters, including bankruptcy reorganizations, business liquidations, workouts, debt restructuring, and creditors’ rights. Her practice also involves commercial litigation matters that arise from receiverships and liquidations. She previously served on the panel of Trustees for the Southern District of Florida, and was President of the Cuban American Bar Association (CABA). Ms. Kubs is a former law clerk to the Honorable Raymond. B. Ray, United States Bankruptcy Judge.

The reasoning behind the removal of the cap is expressed in the legislative history of the statute. “The present \$4 million cap prevents the use of the expedited relief procedure in many commercial property reorganizations, and effectively provides an opportunity for a number of debtors to abusively file for bankruptcy in order to obtain the protection of the automatic stay against their creditors. As a result of this amendment, creditors in more cases will be able to obtain the expedited relief from the automatic stay which is made available under section 362(d)(3) of the Bankruptcy Code.” H.R. REP. 109-31(i), 2005 U.S.C.C.A.N. 88.

B. Courts Disagree on the Meaning of “Substantial Business”

While the “SARE” definition seems relatively clear, its application by the courts remains uncertain. Specifically, courts disagree as to the nature and extent of business activity on the property that is necessary to remove a debtor from the application of the SARE provisions of the Bankruptcy Code. The conflict among the courts is easily illustrated by the following cases:

In re Scotia Pacific Co., LLC, 508 F.3d 214 (5th Cir. 2007). The court determined that the debtor, engaged in the harvesting of timber on 200,000 acres of timberland, did not qualify as a single asset real estate debtor because it conducted a “substantial business” other than the operation of the real estate. The court stated that, in order to be single asset real estate, the revenues received by the owner must be passive in nature. The owner must not be conducting any active business.

In re Club Golf Partners, L.P., 2007 WL 1176010 (E.D. Tex. Jan. 23, 2007).

The debtor's business consisted of an 18 hole golf course, driving range, tennis courts, and a club house with casual dining. The debtor sought a determination that it was not subject to § 362(d)(3) and the mortgage holder objected. The court considered the BAPCPA amendments and determined that the golf course, which generated revenues from the efforts of management and employees who brought in customers and sold goods and services to them, was not a SARE debtor.

In re Kara Homes, Inc., 363 B.R. 399 (Bankr. D.N.J. 2007). The debtors, owning tracts of land for development, sought a determination that § 362(d)(3) did not apply. The debtors each derived their income from acquiring land, planning communities on the land, marketing homes and maintaining the properties. The court determined that these activities were incidental to the operation of the real property and did not preclude the debtors from being designated as SARE debtors.

II. **IMPLICATIONS OF BEING LABELED A SARE DEBTOR**

A. **90-day deadline:** Secured creditors are given relief from the automatic stay 90 days after entry of the order for relief unless the debtor either (i) files a plan with a reasonable likelihood of success; or (ii) commences monthly interest payments to the creditor. [If a case is not filed as a SARE case, the deadline is 30 days from the time the court determines § 363 is applicable.²]

Extensions of the 90-day deadline can be obtained if a debtor demonstrates cause³.

A presumption exists in favor of granting relief from stay in favor of a

² See In re ACA Real Estate LLC, 2008 WL 4899024 (Bankr. M.D. N.C., Nov. 12, 2008); In re Hope Plantation Group, 393 B.R. 98 (Bankr. D.S.C. 2007).

mortgagee. In re Heather Apartments Ltd. Partnership, 366 B.R. 45 (Bankr. D.Minn. 2007). The Heather court explained, “If a debtor is to be excused from having to surrender that cash right away, it must demonstrate a very substantial likelihood that the creditor would receive an equivalent value from another source, quickly enough to minimize its risks of recovering the time value of money.” Id. at 51.

A prospective sale of the property is not “cause” for an extension. Id.

Modification of Stay. Courts need not grant complete stay relief for noncompliance with § 363. See In re Hope Plantation Group, LLC, 393 B.R. 98 (Bankr. D.S.C. 2007) (court can modify stay instead of terminating); In re Archway Apartments, Ltd., 206 B.R. 463 (Bankr. M.D. Tenn. 1997) (court conditioned stay relief upon drop dead date for confirmation).

B. Payment is not based on the full contract amount. Debtors pay an interest amount based on the value of the creditor’s interest in the collateral rather than the full contract amount. As a result, the debtor’s monthly payment may be reduced.

C. Interest May Actually Be Principal. Although the debtor’s payment is measured by interest, it may actually count as principal under § 506.

Collier’s explains: “[P]ayments are not necessarily payments of interest, but are in an amount ‘equal to’ interest at the then applicable nondefault contract rate of interest. This suggests that the payments may be applied to principal rather than interest, which, if the creditor is undersecured, would reduce the obligation with which the debtor must deal in a plan.” 3 Collier on Bankruptcy, ¶ 362.075[5], p. 362-103 (15th Rev. Ed. 2007).

Note that the applicable rate of interest was amended. Prior to BAPCPA, SARE

debtors paid the current market rate of interest. Now, a secured creditor is paid at the applicable nondefault contract rate of interest.

Result: In a market where interest rates are falling, a SARE debtor would be required to pay the higher contract rate of interest. Conversely, when interest rates are on the rise, this amendment is beneficial to SARE debtors in that they are locked into a lower rate.

D. The secured creditor's cash collateral can be used to make required payments. BAPCPA also amended § 362 to provide that payments to the secured creditor may be made from pre- and post-petition rents or other income. *See* 362(d)(3)(B)(1).

III. STRATEGIES FOR AVOIDING OR DELAYING SARE STATUS

A. Don't check that box. A debtor may buy time by failing to designate itself as a SARE debtor on its petition. The debtor can later file a motion with the court seeking a declaration that it is not subject to § 363, or it could wait for the secured creditor to bring a motion. For example, in Kara Homes, the debtor waited two and half months before filing their declaratory motion. It took the court about three months to rule, and then the debtor had an additional thirty days following the ruling to file its plan or commence making payments.

B. Substantively consolidate with a non-SARE debtor. However, this may violate negative covenants with loan documents.

C. Generate business on the property. Example: the operation of a restaurant or gift shop in a hotel can remove it from the requirements of § 363. In re CBJ Development, Inc., 202 B.R. 467 (9th Cir. BAP 1996).

D. File a plan, even if there may be questions as to its confirmability. See In re The Terraces Subdivision, Slip Copy 2007 WL 2220448 (Bankr. D.Alaska 2007) (debtor filed facially-feasible plan that ultimately proved to be unconfirmable; court granted additional three months for debtor to amend and seek confirmation of plan); In re Hope Plantation Group, LLC, 2007 WL 3051533 (Bankr. D.S.C. 2007) (the obligation to file a plan does not require the debtor to prove its confirmability by the 90th day).

E. Litigate the value of the asset. Before a debtor can start making interest payments, the value of the lender's interest in the asset must be determined. A debtor can buy additional time by initiating the valuation process close to the 90-day deadline.

Research references:

Kimerly S. Winick and Stuart M. Rozen, *SARE: New Rules for the Current Downturn*, 2008 No. 7 Norton Bankr. L. Adviser 3 (July 2008).

Single Asset Bankruptcy Cases: Drawing the Line Between Operating the Property and Operating a Substantial Business, 28 No. 2 Bankruptcy Law Letter 1 (February 2008).