28th Annual Midwestern Bankruptcy Institute

Case Law Update

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I. Single Asset Real Estate (SARE) Debtors

A. BAPCPA's removal of the $4M cap in the § 101(51B) definition of a SARE debtor becomes more important in the current housing market crisis

1. § 362: Automatic Stay

> (d) On request of a party in interest and after notice and a hearing, *the court shall grant relief from the stay* provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—
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> . . .
>
> (3) with respect to a stay of an act against *single asset real estate* . . . by a creditor whose claim is secured by an interest in such real estate, *unless, not later than the date that is 90 days after the entry of the order for relief* (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later—
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> (A) *the debtor has filed a plan of reorganization* that has a reasonable possibility of being confirmed within a reasonable time; or
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> (B) *the debtor has commenced monthly payments* that—
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> (i) may . . . be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate . . . ; and
>
> (ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor's interest in the real estate
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> . . .
>
> 11 U.S.C. § 362(d).

2. § 101: Definitions

> "The term "single asset real estate" means 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).
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> Text removed by BAPCPA: "~~thereto having aggregate noncontingent, liquidated secured debts in amount no more than $4,000,000~~."[1]

[1] In many places, the BAPCPA amendments seem to have created typos in the Bankruptcy Code. *See, e.g.*, 11 U.S.C. 707(b)(2)(B)(i) (a misplaced "that"). Here, the drafters may have struck out one word too many.

B. Avoidance of the SARE definition

1. *In re Scotia Pacific Co., L.L.C.*, 508 F.3d 214 (5th Cir. 2007).

   a. *Facts*: Debtor owns 200,000 acres of timberlands in northern California and has over 60 employees. Debtor does not harvest timber itself, but sells standing timber, re-plants and manages future timber stands and ensures compliance with various environmental regulations. In selling timber stands, debtor prepares and submits permit applications regarding harvesting activities, develops "Timber Harvesting Plans," which include road planning, design and engineering, and supervises harvesting to ensure compliance with the Plan and state and federal regulations. Debtor is involved with additional specialized programs of parent company such as watershed analysis and litigation support.

   b. *Issue*: Are these activities of debtor merely the business of and incidental to the operation of the real property such that debtor could qualify as a SARE?

   c. *Holding*: No, debtor does not qualify under the third prong of the SARE requirements—it conducts substantial business other than the operation of the real estate. After reviewing several post-1994 cases that apply the definition in § 101(51B), the Court held that Congress in 1994 was only codifying the definition of a SARE that had already been developed by bankruptcy courts, and therefore that it is appropriate to look at pre-1994 case law to determine the definition of a SARE. The Court cited the definition of a SARE found in *In re Little Creek Dev. Co.*, which defined a SARE debtor as generally having few employees, little or no cash flow and no additional sources of income. 779 F.2d 1068 (5th Cir. 1986). The Court held that this debtor "conducts substantial business other than operating the real property and activities incidental thereto," noting that the debtor's timberland is more than a passive investment, that the debtor has over 60 employees, that the debtor conducts sophisticated operations and builds and maintains roads, and that the sale of timber "extends beyond the sale or lease of the underlying land." 508 F.3d at 224-25.

2. *In re Webb MTN, L.L.C.*, 2008 WL 656271 (Bankr. E.D. Tenn. Mar. 6, 2008).

   a. *Facts*: The debtor, a real estate developer, purchased five separate parcels of property, which are contiguous, in order to build a large resort to include, a hotel, condominiums, single family homes, two golf courses, restaurant, spa and more. Development plans were drawn up, without regard to the boundary lines of the original tracts, but no development began, and the developer filed for Chapter 11, owing under notes on four of the five parcels of land totaling nearly $25 million.

   b. *Issue*: Although the real estate in question is comprised of five separate parcels of land and plans exist for a wide variety of business activities to

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It is unlikely that "thereto" was intentionally deleted, and several courts have continued to include the word when quoting the SARE definition.

take place on the single resort yet to be constructed, does debtor still qualify as a SARE?

c. *Holding*: Yes, debtor is a SARE. First, the court decided that it was not dispositive that there were originally five separate tracts of land involved, since they are contiguous and "were at all times contemplated by the Movants and the Debtor as comprising one large parcel of real property to be developed by the Debtor as one large resort project." 2008 WL 656271 at *4. The SARE definition encompasses single projects in addition to single properties. Secondly, while the debtor has plans to develop many different businesses, those plans "are still part and parcel of one large land development." The court noted that no development had actually commenced on the land in question. Therefore, the court held that the debtor is not conducting any active business, but merely "mowing the grass and waiting for the market to turn." *Id.* at *6 (quoting *In re Scotia Pacific Co., L.L.C.*, 508 F.3d at 221 (quoting *In re Club Golf Partners, L.P.*, 2007 WL 1176010, *5 (E.D. Tex. Feb. 15, 2007))).[2]

3. *In re Club Golf Partners, L.P.*, 2007 WL 1176010 (E.D. Tex. Feb. 15, 2007).

   a. *Facts*: The debtor owns and operates a golf club that includes an eighteen hole golf course, a driving range, tennis courts, and a restaurant. Its revenue is derived from memberships, greens fees, golf cart rental, driving range fees, tennis court fees, merchandise sales, food and beverage sales and special events rental. It has a number of third party employees.

   b. *Issue*: Does this golf club constitute a SARE debtor?

   c. *Holding*: No, this debtor is not a SARE. The court found persuasive four prior decisions holding that a golf course is not a SARE because "running a golf course is a substantial business other than the operation of the real property itself" and "involves significant income-producing activities that exist independently of the operation of the real estate." 2007 WL 1176010 at *3. In applying the definition in §101(51B), The court "interpret[ed] the definition according to an active-versus-passive criterion that inquires into the nature of the revenue generation on and by the property, that is, whether the revenue is the product of entrepreneurial, active labor and effort . . . or is simply and passively received as investment income," finding that such an interpretation was consistent with the provisions of the code. *Id.* at *4.

4. *In re Kara Homes, Inc.*, 363 B.R. 399 (Bankr. D.N.J. 2007).

   a. *Facts*: A group of affiliated debtors filed under Chapter 11, identifying themselves as SARE cases. After the appointment of a Chief Restructuring

[2] The phrase originally was used by the manager of a debtor real estate developer to describe current business activities, which the court quoted in holding that the debtor could not be reorganized under Chapter 11, for "[t]he 'business' of Humble Place, as Conner acknowledged, had for several years consisted of 'mowing the grass and waiting for market conditions to turn.'" *In re Humble Place Joint Venture*, 936 F.2d 814, 817 (5th Cir. 1991).

Officer, the debtors filed amended petitions and schedules to reflect that they were not SARE entities. Each debtor owns a separate real estate development project for the construction of single family homes or condominiums. These entities in turn are 90% owned by Kara Homes. The debtors business consists of acquiring developable land, designing homes or condominiums for the land, arranging for the construction of the buildings, which they then market and sell. The debtors also build common spaces, amenities and roadways.

b. *Issue*: Do the business activities of these debtors qualify as sufficiently active that they do not meet the third requirement for a SARE under § 101(51B)?

c. *Holding*: The debtors meet the first two requirements of SARE without question. Adopting a "pragmatic approach" to gauging the substantiality of the debtors' business operations, the court held that the business activities of the debtor "are merely incidental" to selling homes and condo units. 363 B.R. at 406. In reaching its holding, the Court "querie[d] whether the nature of the activities are of such materiality, that a reasonable and prudent business person would expect to generate substantial revenues from the operation activities—separate and apart from the sale or lease of the underlying real estate." *Id*. As to these debtors, the answer was clearly no.

5. *In re Whispering Pines Estate, Inc*., 341 B.R. 134 (Bankr. D.N.H. 2006).

a. *Facts*: The debtor operates an eighty-nine room hotel that serves continental breakfast, maintains a swimming pool and common areas, provides phone and internet service, and provides room-cleaning and towel-laundering services. The hotel does not have additional services such as a gift shop or restaurant.

b. *Issue*: Is a hotel that does not operate additional businesses to the business of running the hotel meet the third requirement of the SARE definition?

c. *Holding*: No, the debtor is not a SARE because it does not meet the third requirement—the hotel operations, even without additional services, constitute more than the business of operating the real property. The Court held that while in previous cases hotels that were not considered SAREs did often have additional services and businesses operated on-site, the absence of such additional businesses was not determinative.

II. Rule 6003

On December 1, 2007, the Federal Rules of Bankruptcy Procedure were amended and now specifically weigh in on the practice of first day motions, seeking to slow down the process by which so many critical decisions are made in many business bankruptcy cases. Before we turn to new Bankruptcy Rule 6003, a little history may be beneficial. It is not unusual for a flurry of activity to take place once a business has decided to commence a case under title 11 of the United States Code (the "Bankruptcy Code"). For some time now, a number of bankruptcy courts have been receptive to the use of first day motions to ensure a relatively smooth transition for a business as it enters bankruptcy. These bankruptcy courts will entertain motions to retain professionals for the debtor, pay employees, provide adequate assurance to utility service providers, use cash collateral, obtain postpetition financing, maintain cash management systems, honor gift cards and warranty claims, and pay critical vendors. These "first day orders" are defended on the grounds that granting them on limited notice and before formation of any official committees keeps the going concern value of a company in tact, benefits the estate, and does not compromise any ultimate objections by parties in interest who had little or no notice of these motions. Critics of these procedures turn to the emerging reality that these decisions made early in a case are practically difficult to revisit once the momentum and pulse of the case has developed, that often the burden of proof has drifted to the objectant, and that "putting the toothpaste back in the tube" may be impracticable. New Rule 6003 is an attempt to compromise the competing camps.

Rule 6003 provides:

> **Rule 6003. Interim and Final Relief Immediately Following the Commencement of the Case — Applications for Employment; Motions for Use, Sale, or Lease of Property; and Motions for Assumption or Assignment of Executory Contracts**
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> Except to the extent that relief is necessary to avoid immediate and irreparable harm, the court shall not, within 20 days after the filing of the petition, grant relief regarding the following:
> (a) an application under Rule 2014;
> (b) a motion to use, sell, lease, or otherwise incur an obligation regarding property of the estate, including a motion to pay all or part of a claim that arose before the filing of the petition, but not a motion under Rule 4001; and
> (c) a motion to assume or assign an executory contract or unexpired lease in accordance with § 365.

Thus, new Rule 6003 sets forth new guidelines limiting relief in the early stages of a bankruptcy case. Rule 6003 limits the granting of interim and final relief by a bankruptcy court during the first 20 days after commencement of a case on certain delineated issues. Specifically, absent a showing of immediate and irreparable harm, a

bankruptcy court cannot grant relief during the first 20 days of a case on applications for the employment of professional persons, motions for the use, sale, or lease of property of the estate, motions to pay claims (presumably including critical vendors, warranty claims, and gift cards), and motions to assume or assign executory contracts and unexpired leases. This Rule is intended to protect parties in interest and to ensure that full consideration will be given to matters that are likely to have a fundamental impact on the bankruptcy case. The 20-day bar to the motions identified in the Rule may be overcome by a showing that such relief is necessary to "to avoid immediate and irreparable harm." Mere allegations in the motions are not enough; rather, the movant must introduce evidence in the record that makes the case of immediate and irreparable harm, a heightened standard for relief.

A perusal of the Advisory Committee Notes on Rule 6003 flesh out the importance of this new Rule. The purpose given for the Rule is to "alleviate some of the time pressures present at the start of a case so that full and close consideration can be given to matters that may have a fundamental impact on the case." The committee noted that the "flurry of activity" in the beginning of a bankruptcy case often happens before the formation of a creditors' committee. The standard for relief is taken from Rule 4001(b)(2) and (c)(2), and the committee noted that "decisions under those provisions should provide guidance for the application of this provision."

A recent case addressed the application of Rule 6003 to a debtor's retention of counsel through a first-day application. In *In re First NLC Financial Services, L.L.C.*, 382 B.R. 547 (Bankr. S.D. Fla. 2008), the bankruptcy court confronted the situation where a chapter 11 debtor in possession requested the entry of an order at the first-day hearings to approve, on an interim basis, the application for employment of counsel. In response, the United States Trustee objected, arguing that Rule 6003 does not provide for such interim relief. The court approved the retention application. In support, the bankruptcy court held that, notwithstanding the Rule 6003 twenty-day bar, the Advisory Committee directly suggested that in interpreting the new Rule 6003, courts refer to Rule 4001(b)(2) and (c)(2), which "provide for bifurcation of relief into interim and final components." 382 B.R. at 549. Furthermore, the court noted that a corporation, such as the debtor, may not appear in court *pro se*, but required legal representation in order to present first-day requests for relief. The court finally noted that Collier on Bankruptcy, which noted that no party would be prejudiced by the 20-day wait because a court could allow for full compensation from day one, overlooked the "unwieldy" procedure in which a court would have to enter several orders approving past compensation and then denying further employment in order to ensure compensation for a professional who is ultimately not approved for employment. *Id*. at 550.

Although the court in *NLC* steered a pragmatic tack in addressing the application of new Rule 6003 to the retention of legal counsel for the debtor, one should be careful in reading too much into the opinion. I would suggest that interim relief for the retention of legal counsel does constitute immediate and irreparable harm in that without counsel, a corporate debtor is legally dead in the water. This is not the same with other professionals, including special or litigation counsel, who may be necessary for an effective reorganization but not necessary for the legal proceeding itself. Only time will tell whether courts will limit the rationale of *NLC* to its particular situation or whether the "camel's nose is in the tent."

III. Reclamation Claim

Currently, the months and days prior to the filing of a bankruptcy case are spent getting financing in order, determining what professionals will need to be hired, determining who may be a critical vendor, and like activities. With the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"), a few additional items will need to be added to the list: Ensuring necessary goods are available, but not purchased within 45 days of the petition if not covered by a floating lien, ensuring that goods that will not be used immediately prior to the filing or postpetition are not ordered within 20 days of the petition date; the analysis process for non-residential real property leases will need to be substantially underway – particularly if there are a significant number of leases; and some idea regarding the exit strategy will need to be considered, particularly if there are competing constituencies who may wish to offer differing plans.

Goods Sold in the Days Before the Petition Date

Prior to the 2005 Act, Title 11 of the United States Code (the "Bankruptcy Code")[3] provided some level of protection to sellers of goods who delivered those goods to the debtor in the days preceding the filing of the debtor's petition by incorporating state law reclamation rights, as provided by the Uniform Commercial Code ("UCC"), into the Bankruptcy Code in the form of Section 546(c). However, the amendments made by the 2005 Act via amended Section 546(c)[4] and the inclusion of Section 503(b)(9) dramatically change these rights.

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[3] Unless otherwise specified, Section numbers refer to Sections of the Bankruptcy Code.

[4] 11 U.S.C.A. § 546

> (c)(1) Except as provided in Subsection (d) of this Section and in Section 507(c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of a the trustee under Sections 544(a), 545, 547, and 549 ~~of this title~~ are subject to ~~any statutory or common law~~ the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case under this title, but ~~—(1)~~ such a seller may not reclaim ~~any~~ such goods unless such seller demands in writing reclamation of such goods~~—~~
>
> (A)~~before 10~~ not later than 45 days after the date of receipt of such goods by the debtor; or
>
> (B) not later than 20 days after the date of commencement of the case, if ~~such 10 day~~ the 45-day period expires after the commencement of the case.~~, before 20 days after receipt of such goods by the debtor; and~~
>
> (2) If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in Section 503(b)(9).
>
> ~~(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court—~~
>
> ~~(A) grants the claim of such a seller priority as a claim of a kind specified in Section 503(b) of this title; or~~
>
> ~~(B) secures such claim by a lien.~~

UCC No Longer Governs

An example may be in order. In *In re Georgetown Steel Company, LLC*,[5] the seller of goods was disputing the status of its reclamation claim regarding twelve supersacks of silicomanganes ("SMI"). There, the court determined that reclamation was a state law right, and thus, to prevail, the seller must prove up not only the timely written notice requirement contained in Section 546(c), but also the elements of the state law right: (1) that the goods sold to the debtor on credit were of a type within the ordinary course of business of both parties; (2) that the debtor was insolvent pursuant to the bankruptcy code at the time of delivery of the goods; and (3) that the goods were still in the possession of the goods or that the goods were not in the hands of a good faith purchaser at the time the demand for reclamation was received.[6] In that case, the seller was unable to prove that the debtor had possession of the goods or that they were not in the hands of a good faith purchaser, thus the seller could not prevail.[7] The replacement of the words "any statutory or common law" with the word "the" in Section 546(c)(1) appears to change the outcome of this case by rendering the possession requirement moot.

Rights of Reclamation as Amended

What if the seller in *Georgetown Steel* had prevailed? Old Section 546(c)(2) gave the court the ability to deny reclamation (i.e. not require the debtor to return the goods) where the elements of reclamation were shown if the court granted the seller either a lien in property to secure its claim or granted a priority claim for the value of the goods. The elimination of old Section 546(c)(2) in its entirety seems to divest the court of any option: If the seller shows that the goods were sold within 45 days of the commencement of the case to an insolvent debtor, and that a written demand was timely made, the seller appears to have an absolute right to reclaim the goods. How this will work with the definition of Property of the Estate as described by Section 541 of the Bankruptcy Code and the Automatic Stay provided by Section 362 is yet to be seen. The first instances of litigation may well come when the debtor seeks to sell the goods as part of a larger parcel of goods free and clear of liens and interests pursuant to Section 363.

Within 20 Days – De Facto Critical Vendors?

The reality is that in most cases, asset based financing provides a prior perfected lien on most goods such that the right of reclamation is rendered moot. Further, where a lien does not act to moot the reclamation rights, many vendors fail to provide the timely written notice.[8] So why all the concern about goods sold in the days immediately before the filing? The fact that the right to reclaim, and thus potentially put a serious dent in the debtor's ability to operate, is one answer. Another answer is found in New Section 546(c)(2) which refers to Section 503(b)(9) which grants administrative expense status for the:

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[5] 318 B.R. 336 (Bankr.S.C. 2004).

[6] *Id*.. at 339.

[7] *Id*. At 340.

[8] Query, however, whether the increased time to provide that notice, and the absence of the requirement that the seller show that the goods are in the possession of either the debtor or an entity that is not a good faith purchaser, taken with the absolute right to reclaim, will increase the instances of reclamation demands.

> the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.[9]

This provision, in essence, appears to deem all vendors delivering goods within 20 days of the petition date "critical." Thus, as a result of this provision, it will become increasingly critical that the debtor not order any goods for product lines or stores that will be shutdown at. or immediately after, the filing of the petition which will require additional planning on the part of the debtor and its advisors to avoid unnecessary administrative expenses.

Phar-Mor

In *Phar-Mor, Inc. v. McKesson Corporation,* 534 F.3d 502 (6th Cir. 2008), the Sixth Circuit breathed new life into reclamation claims by refusing to follow a long line of cases that have rendered the reclamation near useless in most bankruptcy cases. These cases had found their genesis in the conflicts between reclamation claims and either the pre-petition lender or the post-petition lender. Based on these conflicts, some courts held that the vendor's right to reclaim was extinguished by a secured creditor with liens on after-acquired inventory.[10] These cases essentially killed the reclamation claim. However, the majority position that developed in the 1990's was that reclamation claims were subordinate to security interests in after-acquired inventory.[11] Although this line of cases did not *kill* reclamation altogether, they rendered it virtually useless. At best, a reclaiming creditor could hope for an administrative expense, no lien, and no ability to reclaim its goods.

In *Phar-Mor*, the Sixth Circuit addressed the question of whether a reclamation claim was extinguished in a roll-over plan scenario. The Sixth Circuit affirmed both the bankruptcy court and the district court. Those courts had held "that even though the reclamation claims were "subject to" the claims of the post-petition lender, they still had administrative expense priority over general unsecured claims." In its reasoned opinion, the Sixth Circuit returned to the genesis of the remedy of reclamation, that is, the remedy expanded rights of a "defrauded seller." As such, these goods never became the debtor's property, remaining the property of a vendor induced to sell by an insolvent buyer who

[9] 11 U.S.C.A. § 503(b)(9).

[10] *See, e.g., In re Lawrence Paperboard Corp.,* 52 B.R. 907, 911 (Bankr. D. Mass. 1985); *In re Shattuc Cable Corp.,* 138 B.R. 557, 563 (Bankr. N.D. Ill. 1992).

[11] *See, e.g., In re Pester,* 964 F.2d 842, 846 (8th Cir. 1992); *In re Arlco,* 239 B.R. 261, 267 (Bankr. S.D.N.Y. 1999).

bought on credit. In essence, these early cases found that the buyer holds these goods in trust for the seller.

Phar-Mor's holding that the reclamation claims have administrative priority was based on two findings:

> We find that Ohio Rev. Code § 1302.76(B) (UCC 2-207(2)) [sic] grants a properly reclaiming vendor, such as McKesson, a right to reclaim its goods and that § 1302.76(C) (UCC 2-207(3)) [sic] does not allow a secured creditor's claim to defeat that right. But, correspondingly, we find that 11 U.S.C. § 546(c)(2)(1998) grants the bankruptcy court the power to deny a properly reclaiming vendor, such as McKesson, its right to reclaim the goods, but only by granting the denied vendor either an administrative-expense priority in the amount of the goods or a lien on the proceeds resulting from the use of those goods by the debtor. In this case, the bankruptcy court granted McKesson an administrative-expense priority, and we have no basis to overturn its decision in this matter.