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In re Kara Homes, Inc.

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Introduction

Recently, the United States Bankruptcy Court for District of New Jersey held in *In re* Kara Homes, Inc., 363 B.R. 399 (Bankr. D.N.J. 2007) that secured construction lenders of affiliated chapter 11 debtors were entitled to expedited relief from an automatic stay of foreclosure pursuant to section 362(d)(3) of the Bankruptcy Code because the court determined each debtor constituted single asset real estate case under section 101(51B) of the Code. The significance of expedited relief under section 362(d)(3) is it imposes an "expedited time frame for filing a plan" of reorganization in chapter 11 for single asset real estate cases, which historically are viewed as abusive postponements of foreclosure filed for the single purpose of holding on to the property, encumbered by a "major lender who is grossly undersecured," with "no real hope . . . [of] a viable confirmable Chapter 11 plan." *In re* Kkemko, Inc., 181 B.R. 47, 49, 51 (Bankr. S.D. Ohio 1995). The expedited time frame requires a debtor to file a reasonable plan of reorganization or commence making monthly payments either within 90 days after an entry of order for relief by the creditor or if there is an issue as to whether the debtor is a single asset real estate case then 30 days after court determines a debtor to be a single asset real estate case under section 101(51B) and if debtor fails to file a plan or commence payments, then the automatic stay will be lifted allowing the creditor to foreclose on the property. *See Kara Homes*, 363 B.R. at 406–07; *see also* Janet Flaccus, *Single Asset Real Estate Case and the Bankruptcy*

Abuse Prevention and Consumer Protection Act, 2007 ARK. L. NOTES 83, 84 (2007) (explaining requirements under section 362(d)(3) of Bankruptcy Code and its ramifications on debtor). Furthermore, in other chapter 11 cases, there is no statutorily specified time period for reorganization and thus debtors would want to avoid being determined a single asset real estate in order to avoid the time constraints set by section 362(d)(3). *See In re* Philmont Dev. Co., 181 B.R. 220, 223 (Bankr. E.D. Pa. 1995). Therefore, the *Kara Homes* approach as to what constitutes a single asset real estate case significantly increases the level of difficulty for large developers to reorganize in bankruptcy as current market conditions are hindering real estate developers from honoring commitments to their lenders.

In order to constitute a single asset real estate case, the debtor must fall within the definition of such a case under section 101(51B) which requires the asset to be (1) a "real property constituting a single property or project, other than residential property with fewer than four units" where (2) the "real property must generate substantially all of the income of the debtor" and (3) "the debtor must not be involved in any substantial business other than operation of its real property and the activities incidental thereto."[i] *Kara Homes*, 363 B.R. at 404 (citing *In re* Philmont Dev. Co., 181 B.R. 220, 223 (Bankr. E.D. Pa. 1995)). The first two requirements of the single asset real estate definition were satisfied according to the *Kara Homes* court because each of the affiliated debtors was a "single real estate project" with developable land and a housing plan and the real property generated "substantially all" of debtor's income. *Id*. The main issue of the case dealt with the third criterion of whether the debtor was involved in any substantial business other than operation of the land or were these merely activities incidental to operation of the real estate. *Id.* at 405. With regard to the third requirement, the affiliated debtors argued their activities consisting of planning, design, marketing and maintenance were a

substantial business, while the lenders argued that each affiliate debtor is simply an owner of a sole real estate project with no business beyond improving the land for its eventual sale. *Id.* at 403. To understand the court's decision in deciding in favor of the lenders and to understand why the court may have over-broadened the definition of singe asset real estate beyond the current case law's application, the following discussion will present an overview of the case law relied on by the court in defining single asset real estate, a brief discussion of the facts of *Kara Homes* and the court's take on the case law in applying it to the affiliated debtors. In addition, there will be a highlight of a case distinguishing *Kara Homes* and possibly limiting the broader application of single asset real estate under *Kara Homes*.

Background Case Law

To begin with, the court in *Kara Homes* relied on the definition of single asset real estate from *In re* Philmont Development Co., which defined it as "a real estate project 'owned by an entity whose sole purpose was to operate that real estate with monies generated by the real estate.'" *Kara Homes*, at 404 (quoting *In re* Philmont Dev. Co., 181 B.R. 220, 224 (Bankr. E.D. Pa. 1995)). Additionally, the *Philmont* court noted a typical single asset real estate case constituted "an apartment building, office building, or 'strip' shopping center owned by an entity whose sole purpose was to operate that real estate with monies generated by the real estate." *Philmont*, 181 B.R. at 224. Moreover, the term single asset real estate was used in the bankruptcy setting for years to apply to numerous "single asset partnerships and corporations, formed only to acquire and manage their one investment asset, [and who] have sought the protection of the bankruptcy court" not in order to reorganize, but instead to further frustrate the efforts of creditors by "postponing foreclosure." *Kkemko*, 181 B.R. 50 (citing H. Miles Cohn, *Single Asset*

Chapter 11 Cases, 26 TULSA L.J. 523 (1991)).

To determine whether the affiliated debtor's activities constituted substantial business and not activities incidental thereto under the third requirement of section 101(51B), the *Kara Homes* court looked into several cases determining whether the real estate in question was a "passive investment" or "a site of various income producing activities" which would qualify as substantial business and not activities incidental to operation of the real estate. *Kara Homes*, 363 B.R. at 405 (citing *In re* Prairie Hills Golf & Ski Club, 255 B.R. 228 (Bankr. D. Neb. 2000)). First, in *In re* Kkemko, Inc. it was held that a marina, providing boat storage and repairs, sales of food and fuel, and availability of showers, pool and activities for the boaters constituted substantial business other than mooring rentals and such activities were not incidental to renting boat moorings. *See Kara Homes*, 363 B.R. at 405 (citing *In re* Kkemko, Inc., 181 B.R. 47 (Bankr. S.D. Ohio 1995). Second, several cases involving golf courses, where debtors maintained the property and provided some services avoided falling w/in the definition of single asset real estate cases. *See In re* Prairie Hills Golf & Ski Club, 255 B.R. 228 (Bankr. D. Neb. 2000) (holding debtor was not single asset real estate case because it built and sold residences, built roads to residences, built golf and ski areas leased to third parties, removed snow from golf and ski areas and sold liquor in clubhouse); *In re* CGE Shattuck LLC, Nos. 99-12287-JMD, CM 99-747, 1999 WL 33457789 (Bankr. D. N.H. 1999) (establishing debtor owner of 18-hole golf course containing several buildings on this land used for clubhouse and pro-shop failed to qualify as single asset real estate case where percentage of revenue was derived from pro-shop, golf rentals and other services); *In re* Larry Goodwin Golf, Inc., 219 B.R. 391 (Bankr. M.D. N.C. 1997) (concluding debtor owner of 18-hole golf course providing cart rentals, pool, concessions and availability of undeveloped property for sale generated enough revenue to qualify as

operating a substantial business and not holding property only for income). The third line of cases dealt with hotels, which although are similar to apartment buildings derived income from room rentals, did not constitute single asset real estate cases because of other services and amenities provided by the hotels. *See* Centofante v. CBJ Development, Inc. (*In re* CBJ Dev., Inc.), B.R. 467 (B.A.P. 9th Cir. 1996) (holding full service hotel's bar, gift shop, restaurant and maid service operations were substantial businesses other than mere rental of rooms); *In re* Whispering Pines Estate, Inc., 341 B.R. 134 (Bankr. D. N.H. 2006) (concluding hotel operation was substantial business other than mere management of real property). Therefore, in order to qualify as a substantial business beyond mere operation of the real property for income, as would an apartment building generate income solely from rentals, the debtor-owner must engage in active endeavors and not just sit idly collecting rents.

<u>*In re* Kara Homes Facts and Discussion</u>

Kara Homes, a large New Jersey home builder, owned a ninety percent interest in each of the thirty-two affiliated debtors, each of which owned separate real estate projects for development and construction single family homes and condominiums. *See Kara Homes*, 363 B.R. at 400–01. Kara Homes and its affiliates filed a voluntary petition for bankruptcy relief under Chapter 11 and sought a declaratory judgment that they were not single asset real estate cases as defined by section 101(51B). *Id*. at 402. In addition, the Kara Homes' affiliated debtors also filed a motion to extend the date for filing a reorganization plan or commence payments pursuant to 362(d)(3) from the statutorily allowed thirty days to sixty days after a debtor's status as single asset real estate cases is determined. *Id.* Subsequently, both sides filed motions for summary judgment.

In their motion for summary judgment, the debtors argued each separate affiliate operated a business "sufficiently active" to be excluded from definition of single asset real estate under section 101(51B). *Id*. Specifically, the debtors claimed the "sufficiently active" business consisted of each debtor acquiring developable, designing homes/condominiums suitable to that land, arranging for construction of the homes/condominiums, and marketing and selling the structures to generate cash, which required employees to be assigned to each particular property by Kara Homes. In addition, each debtor had to acquire "site plan approvals or register with the Department of Community Affairs and file Public Offering Statements" and the affiliated debtors also built the common space, amenities and roadways. *Id*. at 402–03. In contrast, the lenders argued each debtor owned a "single real estate project," constituting its sole asset from which revenue is derived solely by means of "improving and selling its real estate" and not by any other business undertakings. *Id*. The court sided with the lenders concluding the business of home construction and sales required all the activities claimed by the affiliated debtors to be substantial business other than operating the real estate and therefore, the activities were not a substantial business, but merely incidental to the operation of the real estate. *Id*. at 406.

In furtherance of its determination that the individual affiliated debtors were single asset real estate cases, the court further expanded its reasoning to devise a "pragmatic approach" to deciding what constitutes as substantial business separate from operating the real estate by establishing "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*. To further illustrate this pragmatic approach, the court stated that a country club or hotel which provides services such as catering, sales of goods, restaurants or casinos could be expected to raise income

from those services separate and apart from the underlying income generated by the real estate. However, despite the court concluding that the activities performed by the affiliated debtors were incidental and that no reasonable business person could expect to generate income from the activities conducted by the debtors without keeping in mind the eventual sale of the land, the court still mentioned in a footnote that the activities performed by the affiliated debtors would qualify as a substantial business if they were performed for third parties. *Id.*, n. 5. For this reason, the court found Kara Homes, Inc., the parent company, did not qualify as a single asset real estate case because it *did* perform such activities *for* the affiliates and does not own the real estate, while each of the affiliated debtors was found to be a single asset real estate case since the activities were performed for themselves and not other home builders. *Id*. In this sense, the *Kara Homes* court is inconsistent in its reasoning under the active/passive distinction of operating real estate and in its application of the newly devised "pragmatic approach." According to the footnote, what the court is essentially admitting is that a reasonably prudent business person would expect to generate income from such services as long as they were not being performed for oneself as the owner of a real estate property, but instead for another landowner, which simply put means these are "active" activities and not "passive" income collection.

In re* Scotia Pacific: Distinguishing *Kara Homes

Following the decision of *Kara Homes*, the Fifth Circuit, in *In re* Scotia Pacific Co., LLC, distinguished the Kara Homes reasoning to hold that the debtor ("Scopac"), a "special purpose" subsidiary, owning 200,000 acres of land and a contractual right to harvest timber on its own land and other land owned by affiliates did not fall within the definition of a single asset real estate case because the timber harvesting operations conducted on the land were more than

just "passive investment." 508 F.3d 214, 216, 225 (5th Cir. 2007). Specifically, the debtors planned, managed and implemented harvesting plans, were responsible for sales of timber and re-planting of future timber, oversaw "varying harvesting requirements and environmental prescriptions of each of the nine watersheds" on the land, and employs over 60 people. *Id*. at 217. When Scopac and several of its affiliates filed for Chapter 11 bankruptcy to avoid foreclosure, its noteholders moved to remove the stay under section 362(d)(3) of the Bankruptcy Code arguing Scopac constituted a single asset real estate case. The motion was denied by the bankruptcy court and the noteholders appealed claiming Scopac was a single asset real estate case.

The court's reasoning, primarily based on the passive/active approach to real estate operations, noted that bankruptcy courts find single asset real estate cases in debtors "who have no revenue from their property except the passive collection of rent from tenants and excluding from its reach those entities that undertake and pursue various sorts of active economic, commercial, and business activities on the property." *Id*. at 221 (citing *In re* Club Golf Partners, L.P., No. 07-40096-BTR-11, 2007 WL 1176010, at *2 (February 15, 2007)). When the noteholders argued Scopac's activities were of the passive investment type and similar to the activities conducted by the affiliated debtors in *Kara Homes* under the "pragmatic approach," the *Scotia Pacific* court disagreed reasoning that sale of timber was different from sales of the underlying land. *Id*. at 223. Moreover, to further support its distinction the court noted Scopac's activities were much more diverse than those discussed in some of the same cases cited by *Kara Homes* pertaining to hotels and golf-courses. The court also looked into the legislative history of the "1994 inclusion" of the "single asset real estate," which stated such property was considered to be held for "passive investment" such as a "'single apartment house or condo complex.'" *Id*.,

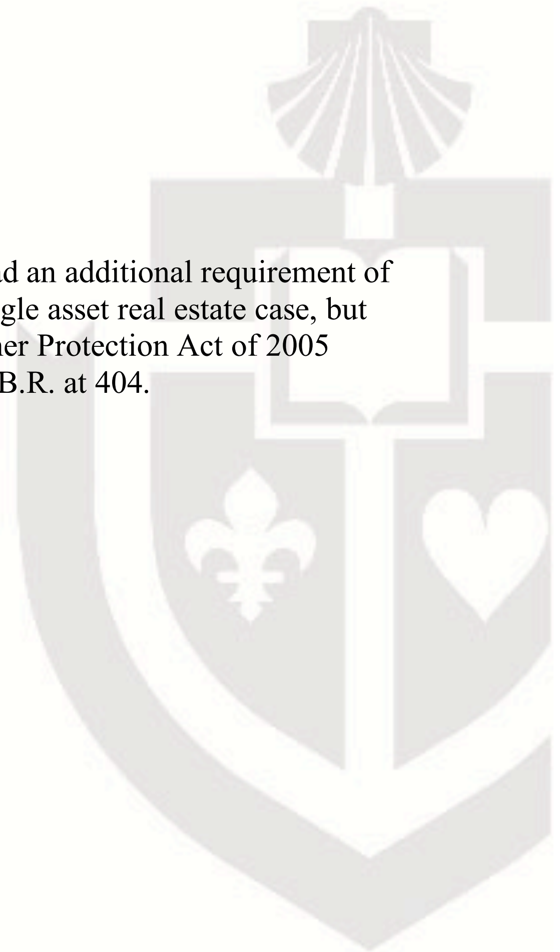
n. 7 (quoting 138 Cong. Rec. S8241-01, *S8264 (daily ed. June 16, 1992) (statement of Sen. Reid)).

In further determining the meaning of single asset real estate, the *Scotia Pacific* court established that even before the 1994 Act, this term was already recognized by courts to pertain to debtors who used bankruptcy filing as a means of preventing creditors from foreclosing even when reorganization was hopeless. *Id*. (citing *Kkemko*, 181 B.R. at 50). Thus, typical single asset real estate case was where the debtor had only one asset encumbered by the secured creditor's lien, there are practically no employees or cash flow, and few or no unsecured creditors. *Id*. (quoting Little Creek Dev. Co. v. Commonwealth Mortgage Corp. (*In re* Little Creek Dev. Co.), 779 F.2d 1068, 1073 (5th Cir. 1986). Scopac, on the other hand, engaged in "[s]ophisticated operations . . . as planning, growing, and maintaining the timber as well as building and maintenance of roads . . . . [and] Scopac's sale of timber is an activity which extends beyond the sale or lease of the underlying land." *Id*. at 224–25. Furthermore, the court cautioned against expanding the single asset real estate case definition beyond its traditional meaning in order to find Scopac as a single asset real estate case because this would broaden the "narrow exception" to the general bankruptcy process and include within the definition "entities as owners of land or mineral interests who operate sophisticated businesses such as mining, oil and gas drilling, and large commercial farms simply by virtue of the debtor owning the land." *Id*.

<u>Conclusion</u>

The original purpose of the expedited relief to creditors afforded by section 362(d)(3) for single asset real estate cases was to address bankruptcy abuse by single asset partnerships and corporations that typically acquired and managed a single developed property such as an

apartment house or office building intended to passively produce income, but the decision of *Kara Homes* brings large residential development companies within the statutory scope even though their activities are not primarily passive investment. Since the affiliated debtors own the underlying land, they would be deemed as a single asset real estate cases even if their operations taken separately may qualify as substantial business because those operations are tied to the ultimate sale of the land. *See* Craig M. Rankin & Daniel H. Reiss, *Single Asset Real Estate*, 30 NAT'L L.J. 12, col. 1 (2008) ("Because large developers often create a single-purpose entity for each new project, many individual projects are in jeopardy due to the current credit crunch and may become SARE debtors"). Therefore, possibly a developer could avoid being deemed a single asset real estate case either by refraining from transferring single parcels of land or single projects to affiliates or the affiliates could perform the above-discussed services for each other as a possible loophole in the *Kara Homes* decision.



[i] Under the Bankruptcy Reform Act of 1994, section 101(51B) had an additional requirement of the secured debt being no more than $4 million to qualify as a single asset real estate case, but after the enactment of Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA), this limitation was removed. *See Kara Homes*, 363 B.R. at 404.