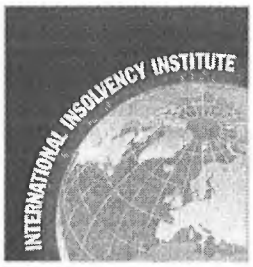

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ONE SIZE FITS SOME: SINGLE ASSET REAL ESTATE BANKRUPTCY CASES†

Kenneth N. Klee††

For several years a debate has raged over whether single asset real estate cases should be singled out for special treatment under the Bankruptcy Code. Under the current $4 million debt cap, these cases involve apartment houses and small office buildings. But both Houses of Congress have passed legislation that will repeal the $4 million cap, potentially subjecting large office buildings, shopping centers, and perhaps hotels to expedited discriminatory treatment in Chapter 11 reorganization cases. In this Article, Professor Klee attempts to inform the debate by presenting empirical data gathered from a national questionnaire and cross-checking the data against the case files of a bankruptcy judge in the most active judicial district in the country. The results are striking. Asset values rather than amounts owing stand out as reliable predictors of plan confirmation. Surprisingly, value-to-loan ratios are less reliable than asset values standing alone. The data show that valuable properties have a much greater probability of confirming a plan than less valuable properties. The Article suggests that if Congress desires to discriminate against single asset real estate debtors, it should draw the line at approximately $7–$8.2 million in asset value rather than changing current law to discriminate against all single asset real estate debtors.

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after the order for relief, unless "the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time,"[10] or the debtor in possession[11] has commenced monthly payments equivalent to interest[12] to each secured creditor.[13]

If the 2001 Amendment becomes law, however, mortgage holders can prematurely flush out of the bankruptcy system some large real estate developers or owners that have liquidity problems before the latter have a reasonable chance to reorganize.[14] By threatening to do so, mortgage holders can control the Chapter 11 process to their benefit. They can decide whether to seize the property for potential upside gain or leave it in Chapter 11 to serve their other purposes.[15] Their benefit will come at the expense of property owners, general unsecured creditors, and the public that subsidizes the cost of operating the bankruptcy system to achieve a public good.

After testifying before Congress about the forerunner of the 2001 Amendment, I recognized the desirability of gathering empirical data to determine whether large SARE debtors differed from small SARE debtors in their Chapter 11 experiences. I examined the case law and gathered information in unreported cases to determine whether SARE debtors confirmed Chapter 11 plans. By analyzing plan confirmation rates over the past twenty years, this Article tests the wisdom of

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ing text (discussing the uncertainty of an extension motion due to judicial hostility toward SARE debtors).

10 11 U.S.C. § 362(d)(3)(A).

11 Although the statute refers to a "debtor," it actually means a "debtor in possession" acting as the legal representative of the bankruptcy estate. *See id.* §§ 323(a), 1107(a).

12 Some courts and commentators mistakenly characterize the statute as requiring the payment of interest. Rather, the payments are "in an amount equal to interest." *See id.* § 362(d)(3)(B). Unless the creditor is oversecured or the debtor is solvent, the statute forbids the payment of postpetition interest. *See id.* §§ 502(b)(2), 506(b), 726(a)(5). In fact, if the creditor is oversecured, although postpetition interest will accrue under § 506(b), the statute might forbid the payment of postpetition interest prior to the conclusion of the case as well. *See* Orix Credit Alliance, Inc. v. Delta Res., Inc. (*In re* Delta Res., Inc.), 54 F.3d 722, 730 (11th Cir. 1995).

13 *See* 11 U.S.C. § 362(d)(3)(B).

14 *See In re* Kkemko, Inc., 181 B.R. 47, 49 (Bankr. S.D. Ohio 1995) (noting that the purpose of § 362(d)(3) is to "impose an expedited time frame for filing a [confirmable] plan" in SARE cases); David B. Young, *Automatic Stay Issues: Selected Recent Developments, in* 2 23rd ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY AND REORGANIZATION 9, 71 (PLI Commercial Law & Practice Course, Handbook Series No. A-820, 2001) ("11 U.S.C. § 362(d)(3) . . . seeks to place the debtor on a fast track and to permit the mortgage lender to foreclose unless the debtor acts swiftly.").

15 That is why mortgage holders financed the lobbying effort to press for this amendment. *See generally Bankruptcy, at* http://www.opensecrets.org/news/bankruptcy/index.htm (last visited Mar. 15, 2002) (indicating that during the 1999–2000 lobbying cycle, finance and credit card companies contributed $9 million, and that during the same cycle, commercial banks contributed $29 million, and credit unions contributed $2.1 million—almost two and a half times the amount spent by this industry during the 1996 presidential campaign).

treating large and small SARE debtors alike in a manner different from all other Chapter 11 debtors.

Part I of this Article examines the history and policy behind SARE reorganization and asks a threshold question: Why should SARE debtors have the opportunity to reorganize at all? Compelling policy reasons favor reorganization of SARE debtors, even though theories of allocative efficiency might indicate otherwise. Part II reviews the 2001 Amendment's uniform procedure for all SARE reorganizations by changing the definition of SARE to eliminate the $4 million cap and analyzes the policies that the amendment implicates. Part III discusses original data analyzing real estate cases to see how they fared in bankruptcy and finds that larger SARE debtors above the $4 million cap have higher Chapter 11 confirmation rates. In Part IV, this Article argues that these findings do not justify Congress's proposal to repeal the SARE $4 million cap because Chapter 11 functions well for larger SARE debtors. Congress acted on the basis of a hunch instead of doing its homework.

I
WHY REORGANIZE SARE CASES AT ALL?

The question whether or under what conditions single asset real estate cases should be able to reorganize under the Bankruptcy Code requires an evaluation of the costs and benefits of reorganization as compared to foreclosure under state law. To place the evaluation in context, this Part begins with a brief history of real property reorganizations and describes how Chapter 11 reorganization cases work. It examines the arguments for and against allowing SARE cases access to Chapter 11 at all and focuses on the political motivations that led to the adoption of the 2001 Amendment rather than exclusion of SARE debtors from Chapter 11.

A. The History of Real Property Reorganization Cases

During the 1930s, the deteriorating economic climate in the United States led to massive defaults in the repayment of real property mortgages.[16] Economic disaster threatened not only the debtors who owed mortgage obligations, but also the financial institutions, particularly savings banks, that held the mortgages.[17] As debtors defaulted,

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16 *See* Homer F. Carey, *Real Property: Post Depression and Future*, J. LEGAL & POL. SOC., Apr. 1943, at 101, 101 ("Foreclosures reached staggering proportions [from 1931 to 1935] and bankruptcies were occurring at an ever accelerating rate.").

17 *See* ELMUS WICKER, THE BANKING PANICS OF THE GREAT DEPRESSION 16 (1996) ("Real estate lending, primarily nonfarm, . . . was an important source of unsettled banking markets during the Great Depression."); Milton Esbitt, *Bank Portfolios and Bank Failures During the Great Depression: Chicago*, 46 J. ECON. HIST. 455, 457 (1986) ("[F]ully 95% of the bank troubles in Chicago were predicated on real estate." (internal quotation marks omitted));

mortgage holders commenced foreclosure proceedings and financial institutions began to hold record title to enormous amounts of real property.[18] Many of these financial institutions faced the Hobson's choice of holding real estate that generated little income but carried tax, maintenance, and insurance liabilities, or selling the real estate into a thin market with few buyers and distressed prices.[19] Yet in many states, financial institutions could not intervene to protect their interests by foreclosing on mortgaged properties, because the states had imposed moratorium laws to suspend foreclosures.[20] As a result, the United States faced the prospect of numerous financial institution insolvencies.[21] In addition, Congress saw a risk of undermining the U.S. economic system by allowing real property defaults to cause pervasive dispossession of private ownership. Partially to ameliorate this situation, Congress enacted Chapter XII of the Bankruptcy Act to permit individual and partnership debtors who owned real property the opportunity to reorganize.[22] By enacting Chapter XII, Congress cre-

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Thomas S. Stone, *Mortgage Moratoria*, 11 WIS. L. REV. 203, 206 (1935) ("The wave of foreclosures . . . was of little benefit to creditors."); Current Legislation, *Emergency Mortgage Legislation*, 8 ST. JOHNS L. REV. 204, 206 (1933) ("Savings banks and insurance companies with their millions in mortgages . . . were caught in the deluge of foreclosure and in this time of chaos, President Roosevelt declared the Banking Holiday.").

18 *See* Carey, *supra* note 16, at 104 ("[P]roperty passed in great volume to the creditor class during the interval from 1930 to 1937."). Contemporary literature contains the following hyperbole: "When one realizes that approximately 50 per cent of the farm lands in Central and Northern California are controlled by one institution—the Bank of America—the irony of these 'embittered' farmers defending their 'homes' against strikers becomes apparent." CAREY MCWILLIAMS, FACTORIES IN THE FIELD: THE STORY OF MIGRATORY FARM LABOR IN CALIFORNIA 233 (1939).

19 *See, e.g.*, Stone, *supra* note 17, at 206 ("[T]he past few years have found banks and other lending institutions loaded down with physical properties which they cannot operate."); Arthur E. Sutherland, Jr., *Foreclosure and Sale: Some Suggested Changes in the New York Procedure*, 22 CORNELL L.Q. 216, 217 (1937) ("The great lending institutions are reluctant to load themselves with foreclosed real estate . . . .").

20 *See, e.g.*, Robert H. Skilton, *Mortgage Moratoria Since 1933*, 92 U. PA. L. REV. 53, 88 (1943) ("The chief criticism that may be made of the New York moratorium is that it was too inclusive. Commercial properties . . . were protected against the consequences of default in principal."); *see also* William L. Prosser, *The Minnesota Mortgage Moratorium*, 7 S. CAL. L. REV. 353, 355, 360–63 (1934) (discussing Minnesota's executive and legislative responses to the wave of foreclosures and forced sales); Stone, *supra* note 17, at 219–20 (discussing the Wisconsin Mortgage Moratorium Law of 1933); Current Legislation, *supra* note 17, at 206–09 (discussing New York's mortgage moratorium statutes).

21 *See* Raymond J. Mischler, *After the Mortgage Moratorium—What?*, 19 IOWA L. REV. 560, 561 (1934) ("Foreclosures and forced sales were reaching proportions that threatened state and national stability.").

22 *See* Morris W. Macey & M. William Macey, Jr., *The Chapter XII Chrysalis*, 52 AM. BANKR. L.J. 121, 123 (1978) ("Chapter XII was . . . developed principally to meet an emergency situation prevalent in Illinois and, to some extent, Massachusetts."). Congress enacted Chapter XII as part of the Chandler Act of 1938, Pub. L. No. 75-696, ch. XII, 52 Stat. 840, 916–30 (repealed by Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 401, 92 Stat. 2549, 2682), and at the same time it passed Chapter X of the Bankruptcy Act to facilitate corporate reorganization of different kinds of businesses, including those owning real property. *See id.* ch. X, 52 Stat. at 883–905 (repealed by Bankruptcy Reform Act of

ated a beneficial legal mechanism to prevent financial institutions from either conducting massive resales of foreclosed real estate into depressed markets or retaining concentrated ownership of real property on their balance sheets. Before the enactment of Chapter XII, SARE debtors either renegotiated consensually with their mortgage holders or liquidated the property under the Bankruptcy Act of 1898 or state mortgage foreclosure laws.

When Congress enacted the Bankruptcy Code in 1978, it continued to permit SARE debtors to reorganize under the same laws and rules as other kinds of Chapter 11 debtors. A property owner was eligible to file for relief under Chapter 11 whether the owner was an individual, partnership, or corporation.[23] The 1978 Bankruptcy Code gave all kinds of SARE debtors a breathing spell to permit them to restructure their property and their mortgage.

In 1994, however, the law changed fundamentally for some SARE property owners when Congress adopted special rules for SARE debtors with secured debts of less than $4 million ("small" SARE debtors). In those cases, Congress restricted small SARE debtors to an expedited Chapter 11 procedure designed to confirm a plan quickly or force the debtor to pay the mortgage holder. Debtors who could do neither faced losing their property to foreclosure. To protect mortgage lenders in SARE cases having secured debts not greater than $4 million,[24] the 1994 amendments added an additional procedure by which a real property mortgage holder could obtain relief from § 362 of the Bankruptcy Code's automatic stay against lien foreclosure.[25]

1978, § 401, 92 Stat. at 2682); *see also* Charlestown Sav. Bank v. Martin (*In re* Colonial Realty Inv.), 516 F.2d 154, 158 (1st Cir. 1975). The court stated:

> The power to prevent secured parties from availing of their contractual remedies . . . , and to compel those creditors . . . in possession at the time of filing to return the debtor's property is essential to preserve the possibility of a successful rearrangement of the debtor's affairs. Little hope of resuscitation would remain for the debtor disembowelled just prior to filing.

Id.

23 Individuals (human beings), partnerships, and corporations are eligible to be Chapter 11 debtors. *See* 11 U.S.C. §§ 101(41), 109(b), (d) (2000); Toibb v. Radloff, 501 U.S. 157, 166 (1991) (holding that an individual debtor not engaged in business was eligible to file under Chapter 11). *See generally infra* note 30 (discussing the meaning of the terms "individual" and "corporation" in the Bankruptcy Code). Individual debtors with regular income and noncontingent, liquidated secured debts less than $871,550 and noncontingent, liquidated unsecured debts less than $290,525 may file Chapter 13 cases instead of Chapter 11 cases. *See* 11 U.S.C. § 109(e) (2000) (as amended effective April 1, 2001). Generally, Chapter 13 cases are less expensive and more effective than Chapter 11 cases. Thus, an individual SARE debtor who is eligible might choose to file a Chapter 13 case instead of a Chapter 11 case. This Article assumes that the debtor files for relief under Chapter 11.

24 For the Code's definition of "single asset real estate," see *supra* note 6.

25 *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 218(b), 108 Stat. 4106, 4128 (codified as amended at 11 U.S.C. § 362(d)(3) (2000)); *see infra* note 26. Lenders with secured loans of at least $4 million did not receive the benefits of these protections,

Section 362(d)(3) permits a SARE mortgage holder to get relief from the automatic stay to foreclose unless, within ninety days after the order for relief, the debtor files a confirmable plan or begins making monthly payments to the mortgage holder.[26] Thus the amendments minimize the mortgage holder's out-of-pocket loss by shortening the Chapter 11 process or forcing the debtor to "pay to play" by making cash payments to the lender. This shifts the risk of delay from the secured lender to the debtor. It also creates a barrier to entry that discourages small real estate owners from filing for Chapter 11 relief.[27] Mortgage holders and their lobbyists justified the provision based on an alleged "shared experience" that, in most real estate cases, debtors file solely to delay foreclosure.[28] They convinced Con-

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although they could seek relief from the automatic stay under § 362(d)(1) or (2). *See* 11 U.S.C. § 362(d)(1)–(2). Presumably Congress adopted the $4 million cap in 1994 because it thought that different policy concerns governed larger cases.

26 Section 362(d)(3) provides as follows:

> [The court shall grant relief from the automatic stay of § 362(a)] (3) with respect to a stay of an act against single asset real estate under subsection (a), 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)—
>
> (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
>
> (B) the debtor has commenced monthly payments to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien), which payments are in an amount equal to interest at a current fair market rate on the value of the creditor's interest in the real estate.

11 U.S.C. § 362(d)(3).

27 One commentator believed that the 1994 amendments would cause the bankruptcy courts to experience increased efficiency because the amendments would "minimize filings where no real probability of confirmation exists." *See Commercial and Credit Issues in Bankruptcy: Hearing Before the Subcomm. on Courts & Admin. Practice of the Senate Comm. on the Judiciary*, 102d Cong. 89 (1991) [hereinafter *Commercial and Credit Hearing*] (statement of Mary Jane Flaherty). Although it is obvious that a debtor would prefer a ninety-day delay to immediate foreclosure, as a matter of cost/benefit analysis, the foregoing speculations appear to be sound. Debtors that own small real estate projects will be less inclined to pay a bankruptcy attorney's retainer, a Chapter 11 filing fee, the quarterly U.S. trustee's fees, and the other substantial incremental costs of filing for Chapter 11 when the limitations of § 362(d)(3) operate to compress and restrict their opportunity to reorganize. *See* 28 U.S.C. § 1930(a)(3), (6) (Supp. V 1999). At the margin, they will walk away and allow lenders to foreclose or give lenders a deed to the property in lieu of foreclosure. Another commentator has speculated that the 1994 amendment would discourage small real estate debtors from filing for Chapter 11 relief, thereby resulting in earlier foreclosures under state law. *See* John C. Murray, *The Lender's Guide to Single Asset Real Estate Bankruptcies*, 31 REAL PROP. PROB. & TR. J. 393, 448 (1996).

28 *See, e.g., Commercial and Credit Hearing, supra* note 27, at 88–89 (statement of Mary Jane Flaherty) ("The problem with single asset cases is that there is usually no reasonable prospect of reorganization. The bankruptcy filing is simply used as a legal method to delay foreclosure. Lenders typically receive relief from the stay, but only after substantial delay and expense.").