Can a hotel ever be “single asset real estate” for bankruptcy purposes? What is “SARE” and who cares?

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Hotel Lawyer: Increasing Distressed Hotel Loans and Troubled Hotel Assets

This article was published originally in November 2008 on HotelLawBlog.com and then updated in 2010 for our Lenders Handbook for Troubled Hotels. In light of the recent increase in distressed loans provoked by the COVID-19 crisis and resulting economic impact, we thought it might be important to bring the information current through April 2020.

Can a hotel ever be “single asset real estate” for bankruptcy purposes?
What is “SARE” and who cares?

by
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Hotel Lawyers: Lender tips on forbearances, loan modifications, recapitalizations, receiverships, workouts, turnarounds, restructurings, and bankruptcies

CMBS lenders and others use SPEs for expedited remedies

Hotels, resorts, marinas, retail mixed-use, and other hospitality-related assets will likely continue to present challenges to lenders seeking expedited relief from bankruptcy stay provisions available to creditors in “single asset real estate” bankruptcy cases.

Since the mid-1990s, lenders on hotels, resorts, and other hospitality properties have generally required their borrowers to transfer the asset being financed into an entity (generally a corporation, limited liability company, or limited partnership) that was both “bankruptcy remote” (a “BRE”) and “special purpose” (also called “single purpose”) (an “SPE”). An SPE is an entity that owns only the asset being mortgaged, is unlikely to become insolvent due to its own activities, and is generally protected from the effects of the insolvency of its affiliates. A BRE is an SPE that has a further, structural layer of protection for the lender provided by provisions, such as the requirement for an independent director or manager who must approve the commencement of any bankruptcy case, that make its bankruptcy case more difficult.

Under the Bankruptcy Code, if a bankruptcy case involves “single asset real estate” (often called “SARE”), the proceedings will tilt greatly in favor of the lender/creditor secured by that SARE. Intuitively, then, an SPE that holds a single real estate asset would seem automatically to hold “single asset real estate” under the Bankruptcy Code. It is not,
This article will examine why this is important to lenders and borrowers, give an overview of the SARE determination, and provide some practical strategies.

The legal significance of SARE status (or not) for lenders

The determination that a borrower/debtor holds “single asset real estate” has important consequences for its bankruptcy case. In a SARE case, the creditor/lender secured by the real estate asset will be entitled to relief from Bankruptcy Code’s automatic stay as a matter of right unless the debtor does one of two things within 90 days (subject to extension) of commencing its case.

Under Bankruptcy Code section 363(d)(3), to avoid relief from the automatic stay being granted to a secured creditor (if it seeks it) with “single asset real estate” collateral, the debtor that holds that collateral must, within that 90 days, either:

1. File a plan of reorganization in its case that has a reasonable possibility of being confirmed within a reasonable time;
2. Commence making monthly, interest-only payments to the secured creditor at the then-applicable non-default contract rate of interest on the value of the creditor’s interest in the SARE.

These are often difficult to accomplish unless the real estate asset is really viable and cash is flowing.

Delays and difficulties with SARE status

But if the bankruptcy court finds that the real estate asset – such as a hotel or other resort property – is not “single asset real estate,” the creditor will likely be delayed in much more protracted proceedings and much greater costs.

Even having these rights determined can be time-consuming and expensive for the creditor – making or opposing a motion to determine whether the case is a SARE case, making a motion for relief from stay based thereon, determining whether there is any plan that the debtor could file that would have a reasonable possibility of confirmation within a reasonable time, and determining what the value is of the creditor’s interest in the SARE (i.e., is the creditor fully-secured or under-secured, and if the latter, by how much).

But why isn’t every single hotel or other resort property “single asset real estate”? How could a borrower/debtor with a single hotel or other resort asset possibly avoid this SARE rule that is supposed to give the creditor/lender expedited relief from the automatic stay if an expedited plan is not filed or interest payments are not commenced?

When is a hotel NOT “single asset real estate”?

“Single asset real estate” is defined in Bankruptcy Code section 101(51B). This section sets out three tests that must each be satisfied to qualify one or more parcels of real property as SARE, as follows:

1. The real property must constitute a single property or project (other than residential real property with fewer than
four residential units);
2. The real property must generate substantially all of the gross income of the debtor (other than a family farmer); and
3. The debtor must not be engaged in any substantial business other than the operation of the real property and
activities incidental

(A fourth, original, requirement – a limitation on the amount debt secured by the real estate to $4 million – was eliminated by the Bankruptcy Code amendments in 2005, so now the SARE rules apply even to hotels and other resort properties with small loans outstanding.)

SARE status created for expedited relief for Lenders

The expedited relief from stay provisions of Bankruptcy Code section 362(d)(3) for cases that involve SARE were enacted in 1994 to address what Congress, the courts, and many commentators felt had been a long-time abuse of the bankruptcy process by larger, single real estate borrowers – generally real estate developers – in what were already in the bankruptcy parlance known as “single asset real estate” cases. These cases, often in substance two-party disputes (debtor and secured creditor), typically led to “bad faith” bankruptcy case filing litigation and protracted plan disputes, and had high rates of the debtors’ inability to confirm a plan. All this overlay a general antipathy in Congress and the courts, and of many commentators, to real estate – as opposed to operating business – bankruptcy cases anyway. The idea was that secured creditors should not be unduly delayed from foreclosing where there was a single real estate asset and a debtor with an inability to make interest payments and minimal chances of a successful bankruptcy reorganization. Unfortunately for secured creditors, however, many of these views have changed over time, and in a direction favorable to real estate developers.

Historically, the classic “single asset real estate” case involved a single office building or apartment house, or integrated office or apartment complex, passively held for income by its debtor owner, with minimal services provided and no real business other than the operation of the real property conducted by that owner. Properties involving an operating business, like hotels and other resort properties, however, are much more problematic.

What the courts say about SARE cases with hotels and other special assets with operating businesses

Thus, the 9th Circuit Bankruptcy Appellate Panel, in In re CBJ Dev., Inc., 202 B.R. 467 (B.A.P. 9th Cir. 1996), held that at least a full-service hotel, which included a restaurant, bar, and gift shop, did not qualify as SARE because the third “prong” – debtor not engaged in any substantial business other than the operation of the real property and activities incidental thereto – of Bankruptcy Code section 101(51B)’s SARE definition was not satisfied. The bankruptcy court had held that the “hotel is sufficiently active in nature to constitute a business other than the mere operation of property,” and observed that the gift shop, restaurant, and bar, among other things included in the operation of the 63-room hotel, constituted other “substantial business” than the operation of real property, and the Appellate Panel agreed.

Both the bankruptcy court and the Appellate Panel observed that hotels were not automatically not SARE, but also that not every hotel was SARE.

The Appellate Panel recognized that it was not clear what constituted merely “operating property” and what constituted other business activity, and there was little authority on the issue. It observed that the level of services provided by
apartment and office building owners was generally minimal, whereas hotels generally provide maid, linen, and other services; and that apartment and office building owners generally have few employees, whereas hotel owners often have numerous employees. Analytically, it concluded that hotels and similar properties needed to be evaluated under the SARE definition on a “case-by-case” basis. (Wherever courts are to determine issues on a “case-by-case,” the opportunity for debtor delay is, unfortunately, significant.)

More on the case-by-case approach to hospitality properties and SARE rules

As part of a changing attitude toward real estate cases, and perhaps, to ameliorate the hard SARE rules, some bankruptcy courts have found a wide range of hospitality properties not to be SARE, including marinas, golf courses and clubs, and ski resorts, each on a “case-by-case” analysis of what sources of income the debtor had, whether the debtor was an active or passive receiver of income, and what business or businesses it was conducting on or with respect to the real estate in question. The common theme, as articulated by a New Hampshire bankruptcy court in In re MTM Realty Trust, 2009 WL 612147 (Bankr. D.N.H. 2009), is whether the debtor has other business operations that are “separate and distinct from owning and managing real estate” or its “revenues are passive in nature (i.e. collection of rent) and [it] is not conducting any active business, other than merely operating the real estate and conducting incidental activities such as arranging for maintenance.”

This approach has been followed by several bankruptcy and district courts over the ensuing years to decline to apply the SARE rules to hotels, for example in In re Whispering Pines Estate, Inc., 341 B.R. 134 (Bankr. D.N.H. 2006) (89 room, full-service hotel – without bar, restaurant, or gift shop, however – was not SARE because substantial other business conducted by debtor); and In re Iowa Hotel Investors, LLC, 464 B.R. 898 (Bankr. N.D. Iowa 2011) (two separate, 64 room, full-service hotels – SARE rules apply to each property separately – was not SARE because substantial other business conducted by debtor); to golf clubs, for example in In re Club Golf Partners, L.P., 2007 W.L. 1176010 (E.D. Tex. 2007) (18 hole golf course with golf carts, pro shop, driving range, tennis courts, club house, and restaurant was not SARE because of substantial other business conducted by debtor); or to marinas, for example in In re Kkemko, Inc., 181 B.R. 47 (Bankr. S.D. Ohio 1995) (marina with slip rentals, sales of gas and concessions, other stores, a pool and showers, and boat repairs, maintenance, and storage was not SARE because of substantial other business conducted by debtor.

The same “case-by-case” approach has also been followed to apply the SARE rules, such as, for example, to a hotel property in In re City Loft Hotel, LLC, 465 B.R. 428 (Bankr. D.S.C. 2012) (debtor owned real estate with 23 room boutique hotel, coffee shop, and fitness facility, each separately leased—hotel to debtor affiliate; real estate was SARE because debtor conducted no business other than operating real estate); and to a tennis club and spa property in In re Aspen Club & Spa, LLC, No. 18-14158-JGR, 2019 BL 338892 (Bankr. D. Colo. July 23, 2019) (debtor owned real estate leased, in part, to affiliate – also a debtor – tennis and racket club with food and beverage service, spa, salon, sports medicine, and multiple other amenities, on which real estate were also located townhouses, condominiums, and affordable housing units; real estate was SARE because owner debtor conducted no business other than operating real estate).

Other bankruptcy courts, perhaps reflecting the general antipathy toward real estate cases and, particularly possible “single asset real estate” cases, have just applied the SARE rules without much analysis, as in, to a hotel, in In re 5877 Poplar, L.P., 268 B.R. 140 (Bankr. W.D. Tenn. 2001) (debtor’s 126 room Comfort Inn was assumed to be SARE, but case was not about SARE rules).
Clever debtor arguments to avoid SARE rules

But even where the debtor clearly holds SARE, clever arguments have been made to avoid the SARE rules. In *In re Meruelo Maddux Props, Inc.*, 667 F.3d 1072 (9th Cir. 2012), a subsidiary of the debtor, itself, along with more than 50 other subsidiaries of the debtor, a debtor and clearly holding SARE, sought an order determining that this was not a SARE case because it, its parent, and its parent’s other debtor subsidiaries were together a single, consolidated, interrelated business operation. Even though the bankruptcy court below found that the subsidiary “appeared to be” a SARE debtor, that court declined to apply the – mandatory – SARE relief from stay rules under a so-called “whole business enterprise” exception: the debtor and its debtor-affiliates were to be regarded as a single business enterprise with substantial business beyond just operating real estate. On appeal to the district court, that court reversed the bankruptcy court, holding there was no “whole business enterprise” exception to the SARE rules. On further appeal to the Ninth Circuit, that court upheld the district court and squarely rejected the claimed exception, noting that if Congress wished such an exception to apply in SARE cases, it could amend the Bankruptcy Code to add one.

What does this all mean in terms of debtor or creditor strategy?

As noted above, a debtor that has a gift shop or other outlet and business on its hotel or other hospitality property may defeat SARE status (one bankruptcy commentator has suggested, perhaps only half tongue-in-cheek, that debtors should open gift shops to defeat SARE status). Otherwise, it faces relatively short bankruptcy proceedings unless it either files a plan of reorganization within the first 90 days of the case (or a court-approved extension), or starts making monthly, interest-only payments to the secured creditor.

Where it is clear that the debtor holds SARE (like an office or apartment building or complex), the strategy is generally for the secured creditor to wait out the 90 days. Then, if the debtor has not either filed a plan or started making interest payments during that period, the secured creditor should file a motion for relief from stay under Bankruptcy Code section 362(d)(3) (and any other applicable provision as well).

But, when there is doubt about whether the collateral property is SARE – as there will normally be with hotels, resorts, marinas, and sports facilities – the secured creditor should generally move quickly to file a motion for the bankruptcy court to determine if the real property is SARE, and it should also be prepared to respond quickly to a motion by the debtor that the property is not SARE, which the debtor or an affiliate may make as a defensive maneuver. Even in a jurisdiction where there is good decisional authority on the SARE question, since these are “case-by-case” matters, making such a motion early is probably the better practice.

Some lender strategies for SARE cases

The secured creditor wants a determination of the SARE status early because, if it turns out that that status applies, Bankruptcy Code section 362(d)(3) gives the secured creditor relief from the automatic stay on the *later* of 90 days after the case was commenced (or any extension given) and 30 days after the court determines the property is SARE.

Another strategy that may be used in appropriate situations is including in any workout or forbearance agreement an acknowledgment and representation by the borrower that the real property in question is SARE under the Bankruptcy Code and that the secured creditor is entering into the agreement in reliance on this representation and acknowledgment.
This may be unenforceable in bankruptcy, or simply ignored by the court, but it may be worth a try, and many covenants may be enforceable if made in a workout that would not have been enforceable when the loan was originated.

In light of the development and application of the SARE law as discussed above, with its “case-by-case” analysis and focus on whether the debtor has other substantial business operations on the property that are separate and distinct from owning and managing the property, and whether its income is passive or active nature, perhaps the most important thing the originator of a loan to be secured by a hotel or other hospitality property can do is, just as with general SPE and BRE requirements, require upfront that the structure of the ownership and operation of the property be clearly divided between the property ownership by the borrower and the operation and management of the active hotel and other outlets thereon (restaurants, bars, gift shops and other concession, spas and fitness centers by third-parties, even if affiliates, under leases, so that the borrower owner has only passive income from the leases and engages itself in no substantial business on the property.

If this structure and property characterization was not created at loan origination, special servicers or lenders handling a distressed asset may wish to seek such structuring and documentation in a workout to effectuate the same result.

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From our Global Hospitality Group® library of free resources, here are a few updated and classic articles on workouts and bankruptcies:

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This is Jim Butler, author of www.HotelLawBlog.com and hotel lawyer, signing off. We’ve done more than $87 billion of hotel transactions and more than 100 hotel mixed-used deals in the last 5 years alone. Who’s your hotel lawyer?
Nicolas De Lancie is a partner in JMBM’s Bankruptcy Group. His practice of 40 years has concentrated on commercial credit and commercial real estate finance transactions, and on creditors’ rights and bankruptcy matters.

Nick has significant experience in commercial and real estate finance and related areas, including loan structuring and documentation; loan syndications and participations; CMBS special servicing and other asset securitization matters (Regulation RR); hotel financings; mutual funds liquidity facilities; ESOP loans; power generation project financing; probate estate and trust matters; merchant bank credit card matters; loan sales and other secondary market transactions; forward purchase agreements, interest rate, and other derivative transactions; troubled commercial credit, commercial real estate loan, public finance, and distressed debt investment transactions; collection litigation; bankruptcy cases, and relief from stay, cash collateral, post-petition lending, plan confirmation, and appeals; and lender liability defense. For more information, please contact Nicolas De Lancie at 415.984.9675 or at NDE@jmbm.com.

Robert Kaplan is a partner in JMBM’s Bankruptcy Group which is recognized by U.S. News & World Report / Best Law Firms® with a Metropolitan First-Tier Ranking (San Francisco) for Bankruptcy Litigation and Bankruptcy and Creditor Rights/Insolvency and Reorganization Law.

Bob represents lenders, special servicers, hard money lenders, community banks, national banking associations, distressed debt investors, and equity investors, positioning them for the best possible outcome by acting expeditiously to preserve value and increase cash flow. His industry experience and his knowledge of the current capital markets — where distressed assets often include complex deal structures and securitized loans — allows him to bring creative and effective strategies to the table. When aggressive litigation is the best strategy, he is a vigorous and effective advocate for his clients. For more information, please contact Robert Kaplan at 415.984.9673 or at RBK@jmbm.com.