



Developers: Are You a Single Asset Real Estate Entity?

By Donald F. Campbell, Jr., Esq.

On March 12, 2007, the Hon. Michael B. Kaplan, U.S.B.J. ruled that the affiliates of real estate developer Kara Homes, Inc. are each a Single Asset Real Estate entity as defined in §101(51B) of the United States Bankruptcy Code, requiring each entity to file a plan of reorganization or make...

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Third Circuit Supports “Gavel Rule” Holding that a Foreclosed Property is “Sold” at the Sheriff’s Sale and Not after Delivery of the Deed

By Donald F. Campbell, Jr., Esq.

For more than ten years, New Jersey Federal Bankruptcy and District Courts have been divided over whether Chapter 13 debtors have the right to cure a default on a mortgage secured by the debtor’s principal residence...

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Can Unsecured Creditors File Claims for Legal Fees Incurred Post-Petition, Based Upon a Pre-Petition Agreement?

By Donald F. Campbell, Jr., Esq.

On March 20, 2007, the Supreme Court, in *Travelers Casualty and Surety Co. of America v. PG&E Co.*, 549 U.S. (2006), found that Bankruptcy law does not prevent unsecured creditors from claiming post-petition legal fees otherwise reimbursable pursuant to terms of a...

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Supreme Court Stops Bad Faith Chapter 7 Debtor’s Conversion to Chapter 13

By Donald F. Campbell, Jr., Esq.

After the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCA), the U.S. Supreme Court’s recent decision in *Marrama v. Citizens Bank of Mass.*, et. al., 549 U.S. (2007) will add a chilling effect to an already frigid court. On February 21, 2007, the Court ended the...

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monthly payments to their secured creditors within 30 days of the Court's decision.

On October 5, 2006, Kara Homes, Inc. filed a petition under Chapter 11 of the Bankruptcy Code and shortly thereafter thirty-two (32) affiliates of Kara Homes (the "Affiliated Debtors") filed separate Chapter 11 petitions. Each Affiliated Debtor owns a separate real estate development project for the construction of single family homes and condominiums. Each Affiliated Debtor marked on their petition that the respective entity was a "Single Asset Real Estate case" as defined by §101(51B). Normally, a debtor has the exclusive right to file a plan of reorganization within 120 days from the date of filing; however, a single asset real estate entity must file a plan of reorganization within ninety (90) days. Failing that, a debtor must commence payments to their secured creditors or the creditors are entitled to seek relief from the automatic stay, which may then result in the commencement or reinstatement of foreclosure on the single asset ultimately destroying any chance of reorganization. On December 19, 2006, the Affiliated Debtors requested a ruling by the Court that the Affiliated Debtors (contrary to their petitions) do not meet the definition of a single asset real estate entity pursuant to §101(51B) and therefore are entitled to the 120 day exclusivity period. The secured creditors objected resulting in the Court's March 12, 2007 decision.

Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), the Court in *In re Philmont Dev. Co.*, 181 B.R. 220 (Bankr. E.D.Pa. 1995), established a four part test to determine whether

a debtor meets the definition of §101(51B). A debtor is a single asset real estate entity if: (1) the single asset is real property constituting a single property or project, other than residential property with fewer than four residential units; (2) the property generates substantially all of the income of the debtor; (3) the debtor is not involved in any substantial business other than the operation of its real property and the activities incidental thereto; and, (4) the debtor's aggregate non-contingent liquidated secured debt is less than \$4,000,000.00. BAPCPA significantly amended §101(51B) by eliminating the \$4,000,000.00 floor which otherwise would have excluded debtors like Kara Homes and the Affiliated Debtors. The Affiliated Debtors unsuccessfully argued that they are involved in other areas of business including, but not limited to research and purchase of other property, planning and construction of homes, marketing of homes, etc. The Court however found that all of these activities are incidental to the operation of the single real estate asset.

The amendments to §101(51B) and this Court's ruling may have a devastating effect on Kara Home's chances at reorganizing and could ultimately change the way developers, like Kara Homes, structure their business enterprise. Ironically, the long-standing practice of protecting the company as a whole by segmenting projects into separate entities may in fact be the company's ultimate demise. Like a mutated virus, §101(51B) may cause an incurable infection amongst the struggling single asset species. In order to survive, developers and other single asset entities must restructure their corporate enterprise and avoid §101(51B) like the plague.

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between the time the residence is sold at the foreclosure sale and the time the Sheriff delivers the deed. In *In re Connors*, D.C. Civ. No. 05-cv-02236, the Third Circuit Court of Appeals (the "Court") ruled that, under applicable bankruptcy law, the debtor does not have the right to cure default after the gavel falls at the foreclosure sale.

In *Connors*, the debtor defaulted on his home loan with Deutsche Bank (the "Bank") causing the Bank to foreclose on Connors' principal residence. At the foreclosure sale, the Sheriff's Office sold the property to the successful bidder, 41 Lakeridge, LLC ("*Lakeridge*"). Four days after the Sheriff's sale, Connors filed for Chapter 13 Bankruptcy Protection and two weeks after filing, submitted a Chapter 13 Plan proposing to cure the pre-petition arrears owed to the Bank. However, Connors failed to exercise his statutory right to object to the sale or redeem the property within sixty (60) days of filing his Chapter 13 Petition as permitted under R. 4:65 of the New Jersey Court Rules and Section 108(b) of the Bankruptcy Code. Due to the expiration of the 60-day redemption period, Lakeridge filed a motion with the Bankruptcy Court seeking to lift the stay to permit Lakeridge to tender the balance of the purchase price and receive the Sheriff's Deed. The Bankruptcy Court granted Lakeridge's motion, which was affirmed by the District Court.

Connors filed an appeal with the Third Circuit based upon an interpretation of Section 1322 of the Code, which states that a default with respect to a lien on the debtor's principal residence may be cured "until such residence is sold at a foreclosure sale that is

conducted in accordance with applicable non-bankruptcy law....” 11 U.S.C. §1322(c)(1). Connors cited numerous cases holding that the foreclosure “sale” is not concluded until after the Sheriff has delivered the deed. Chisolm v. Cendant Mortgage Corp., 2005 WL 1522232, at *1 (D.N.J. 2005); In re Randall, 263 B.R. 200, 201 (D.N.J. 2001); and In re Downing, 212 B.R. 459, 467 (Bankr. D.N.J. 1997). Lakeridge opposed the motion citing numerous cases holding that the sale is concluded after the “gavel falls” at the sheriff’s sale (a.k.a. the “*Gavel Rule*”). In re Manganano, 253 B.R. 339, 344-45 (Bankr. D.N.J. 2000); In re Hric, 208 B.R. 21, 26 (Bankr. D.N.J. 1997); and In re Cain, 423 F.3d 617, 619 (6th Cir. 2005).

The Third Circuit ruled in favor of Lakeridge finding that the meaning of “foreclosure sale” only refers to the foreclosure auction and not the entire foreclosure process terminating with the delivery of the deed since the word “at” signifies a “discrete event rather than an ongoing process.” Furthermore, New Jersey practitioners refer to the foreclosure auction as the “sale” and distinguish between the sale and delivery of the deed. Though the Third Circuit’s decision may decrease a debtor’s opportunity to save their home resulting in more foreclosure sales, the ruling should promote the finality of sheriff’s sales and, as a result, could increase the quantity and price of bids, which would ultimately benefit both creditors and debtors.

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pre-petition contract. In Travelers, PG&E filed a Chapter 11 Bankruptcy in April of 2001. Prior to such filing, Travelers issued a \$100

million dollar surety bond on PG&E’s behalf guaranteeing PG&E’s payment of state workers’ compensation benefits. In connection with the surety bond, PG&E agreed to indemnify Travelers against any loss Travelers may incur due to PG&E’s connection with the bonds, including any legal fees incurred in pursuing, protecting or litigating Traveler’s rights in connection with the bonds. Travelers incurred legal fees in Traveler’s bankruptcy proceedings and filed a general unsecured claim for such fees. PG&E objected to the claim arguing that Travelers could not recover attorney’s fees incurred while litigating issues of bankruptcy law.

The Bankruptcy Court agreed and rejected Traveler’s claim based upon the long-standing “Fobian rule” first developed in In re Fobian, 951 F.2d 1149 (CA9 1991), which states that, absent bad faith or harassment by the losing party, attorney’s fees will not be awarded if the litigated issues involve issues peculiar to federal bankruptcy law. Other circuits rejected the Fobian rule resulting in a split by the Circuit Courts. The Supreme Court in Travelers ended the division finding that the contract-based claims for attorney’s fees incurred litigating issues of bankruptcy law are allowed. The Court focused on 11 U.S.C. §502(b), which set forth nine specific exceptions any of which will result in the disallowance of a claim. None of the nine exceptions preclude post-petition attorney fees. The Court determined that a creditor’s rights arise under substantive state law and Congress has left the determination of property rights in assets of a bankrupt’s estate to state law. In other words, if state law permits a party to the reimbursement of

attorney fees, then the bankruptcy court must honor the state law and cannot overrule the creditor’s right to payment.

Traveler’s is not significant for what it did (overturning Fobian) but for what it did not do. Many Courts have disallowed creditor’s claims for post-petition attorneys pursuant to an interpretation of 11 U.S.C. §506(b). That section of the Code states that an allowed secured creditor is entitled to reimbursement of attorney fees permitted under an agreement or state statute if the value of the property securing their claim is greater than the claim itself. Stated inversely, if a secured creditor incurs legal fees and is entitled to reimbursement from the debtor for such fees under an agreement or statute, a claim for such fees will not be allowed if the creditor is under-secured. Since unsecured creditors are not secured at all, many courts have denied unsecured creditor’s claims for legal fees citing §506(b). PE&G’s brief and arguments to the Court relied not upon Fobian, but their interpretation and lower court reliance upon §506(b); however PE&G did not raise this argument during the appeal and therefore, the Supreme Court would not consider the argument leaving this issue unresolved. Based upon the Court’s strict interpretation of §502(a), unsecured claimants should undoubtedly seek reimbursement of post-petition legal fees. That is, until the Court’s next ruling?

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long-standing practice of debtors invoking an “automatic right” to convert their bankruptcy case from Chapter 7 liquidation to Chapter 13 individual plan of reorganization. The Court’s decision will now

permit creditors to object to a debtor's conversion, which was typically sought after a creditor or trustee discovered assets concealed by the debtor.

In Marrama, the debtor, Robert Marrama, filed a voluntary petition under Chapter 7 of the Bankruptcy Code seeking a discharge of his pre-petition debts. In schedules attached to his petition, Marrama failed to disclose that he was the beneficiary of a trust, which he created, and that he transferred the Maine property into the trust seven months prior to filing his petition for no consideration. The Chapter 7 Trustee discovered the undisclosed asset and informed Marrama that he would seize the Maine property for sale and distribution for the benefit of creditors. Marrama's apparent fondness for his Maine retreat outweighed his desire for a Chapter 7 discharge and, pursuant to §706(a) of the Code, he filed a notice to convert his case to Chapter 13, which would have permitted Marrama to keep the Maine property in exchange for repaying a portion of his debts to creditors as opposed to walking away from his debts entirely in a Chapter 7. Marrama's main creditor, Citizens Bank, and the Trustee objected to the conversion and the Bankruptcy Court agreed stating that "there is no 'Opps' defense to concealing assets" and ruled the attempted conversion an act of "bad faith."

Marrama appealed the Bankruptcy Court's decision all the way up to the Supreme Court relying upon numerous lower-court decisions that have, in many jurisdictions including New Jersey, given the debtor an automatic right to convert to Chapter 13. Marrama also cited the U.S. Senate Reports on §706(a), which states that the debtor has a "one-time absolute

right of conversion" from Chapter 7 liquidation to a Chapter 13 plan of repayment giving the debtor "an opportunity to pay his debts." The Supreme Court, in a 5-4 decision written by Justice Stevens, ended the long-standing debate among the Courts ruling that the debtor's right to convert to Chapter 13 is expressly conditioned upon a debtor's right to qualify as a "debtor." If the Court finds the debtor, like Marrama, acted in bad faith, the debtor will not qualify as an individual entitled to a discharge under the Bankruptcy Code under either Chapter, giving the Court cause to deny the debtor's requested conversion.

Within days of Marrama, the New Jersey Bankruptcy Court issued an unpublished decision in In re Truong denying a Chapter 7 debtors' conversion to Chapter 13. In that case, the Hon. Novalyn L. Winfield, citing Marrama, found that the debtors fraudulently transferred property and failed to cooperate with the Chapter 7 Trustee, and therefore filed their petition in "bad faith" and were "unworthy of and therefore ineligible for the benefits of Chapter 13." While the vast majority of conversions by debtors will remain unopposed and permitted by the Court, after Marrama and Truong, debtors and the Courts can expect many more such objections by Chapter 7 Trustees and astute creditors. A conversion to Chapter 13 not only permits the debtor to retain property, but buys the debtor time (sometimes years) and rids the debtor of a hostile Chapter 7 Trustee. A successful motion denying conversion will force the debtor to either settle with their creditors or risk the loss of property and rights to a discharge.



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