© 2012 Thomson Reuters. Originally appeared in the Winter 2013 issue of Real Estate Finance Journal. For more information on that publication, please visit store.westlaw.com. Reprinted with permission.

Eighth Circuit Holds Automatic Stay Inapplicable to Action Challenging Transfer of Collateral to Real Estate Improvement District

*Nelly Almeida**

A recent decision by the U.S. Court of Appeals for the Eighth Circuit is important for real estate developers and real estate finance, limiting the protections of Chapter 11 in cases where valuable assets may have been transferred to a real estate improvement district, homeowners association, or other similar entity.

The automatic stay is one of the most valuable protections for a Chapter 11 debtor and courts often construe the stay broadly to effectuate the rehabilitative goals of the Bankruptcy Code. The stay does have limits, however, and generally applies only to actions against the debtor or its property, not to actions against third parties, except in rare cases that present "unusual circumstances."

The United States Court of Appeals for the Eighth Circuit recently explored the boundaries of the "unusual circumstances" exception in *In re Panther Mtn. Land Dev., LLC*.[1] In *Panther Mountain*, the Eighth Circuit declined to apply the automatic stay to actions against property of a real estate improvement district, reversing a decision of the Bankruptcy Court for the Eastern District of Arkansas and the Bankruptcy Appellate Panel for Eighth Circuit, which had found the stay applicable. The decision is important for real estate developers and real estate finance, limiting the protections of Chapter 11 in cases where valuable assets may have been transferred to a real estate improvement district, homeowners association, or other similar entity.

Background

Panther Mountain Land Development, LLC—the debtor—was originally created for the purpose of managing the development of two tracts of real estate. In 2008 Panther Mountain formed property owners' improvement districts in accordance with Arkansas law and transferred to the improvement districts certain parcels of undeveloped land then owned by the company. These improvement districts were, as the court of appeals described, "separate, pseudo-governmental entities with certain powers including the abilities to sue or be sued, incur expenses for development purposes, and impose priority liens on properties included within the districts."

*Nelly Almeida, an attorney in the New York office of Weil, Gotshal & Manges LLP, can be reached at nelly.almeida@weil.com.

In November 2008 the National Bank of Arkansas, a secured creditor holding mortgages on some of the debtor's land, initiated a foreclosure action and shortly after, on September 20, 2009, Panther Mountain filed for Chapter 11. One day after the filing, the bank submitted its first of four motions for relief from the automatic stay, seeking to continue its foreclosure action, which was denied. The bank subsequently filed three other motions for relief from stay.

In its fourth motion—the one at issue—the National Bank of Arkansas was "seeking a ruling that a proposed state court action against the improvement districts would not violate the automatic stay." The bank alleged that the districts were formed without the constitutionally required notice that the bank's collateral (the undeveloped land) was transferred to the improvement districts.

The bankruptcy court found that the automatic stay applied to the bank's action and relief from stay was not warranted. Acting *sua sponte*, the court also found that the bank's motion was barred by laches—an equitable doctrine permitting the dismissal of a claim if there is both unreasonable delay and change in position in reliance upon the delay—and that it was not filed in good faith; the court described the various motions for relief as "repetitive" and saw them as attempts to run up costs for the debtor. The bank immediately appealed to the bankruptcy appellate panel, which affirmed the bankruptcy court's decision with regards to the automatic stay (the BAP did not address laches or good faith).

Circuit Court Ruling

The bank further appealed to the Eighth Circuit, which ultimately reversed the decisions, finding that the automatic stay *did not* apply to the bank's action against the improvement districts. In reaching this conclusion, the court of appeals first considered against whom the proposed state court action was targeted. Noting that the Bankruptcy Code provides that the automatic stay applies only to actions against the debtor[2] and actions "to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate,"[3] the court determined the proposed action was *not* an action against the debtor but rather against the improvement districts themselves and the validity of their creation. The court of appeals relied on Arkansas state law in finding that the improvement districts "enjoy an existence separate from the debtor." While not private corporations in a traditional sense, the improvement districts had the capacity to sue and be sued, enjoyed a limited power of eminent domain, and had the authority to enter into contracts, incur debts etc.

The court of appeals also noted that the proposed action only challenged the existence of the improvement districts, which was *not* an attempt to "obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."

Upon finding that the proposed state court action was against a "third party," the court of appeals went on to consider whether there were any "unusual circumstances" that would justify a departure from the general rule and allow the automatic stay to apply against the improvement district. The debtor argued that the improvement districts were so integrally related to the estate property that under an alter-ego theory they should not be treated as separate. Further, the debtor argued that the proposed action might have an adverse

© 2012 Thomson Reuters

impact on the value of the estate and thus pursuant to 11 U.S.C.A. § 362(a)(3) it should be treated like an action "to obtain possession" or "exercise control over" estate property. The court rejected both theories stating that the improvement districts were not controlled or owned by the debtors. Even if one could characterize the improvement districts as subsidiary corporations owned by the debtor, the court relied on case law to show that the automatic stay "does not, in general, apply to actions against parties who enjoy factual or legal relationships with a debtor, such as a debtor's wholly owned subsidiaries."

Regarding the debtor's impact on value argument the court found that there was no evidence to show that the potential change in value of the debtor's property from the proposed action would justify the extension of the stay. The debtor never quantified the value of estate property with and without the improvement districts and failed to show that the improvement districts added "so much value to the property that their possible elimination would effectively divest the debtor of a property interest."

The debtor also argued, in the alternative, that the bankruptcy court's ruling can be supported by the authority of 11 U.S.C.A. § 105, which "permits the bankruptcy court to issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." The Eighth Circuit dismissed this argument stating that nothing in the bankruptcy court's oral or written orders show that it intended to exercise power under Section 105.

As for the laches argument, the court of appeals found that the application of the doctrine was improper. The bank argued—and the court of appeals agreed—that the bankruptcy court received no evidence and made no findings regarding the unreasonableness of any delay or the issue of detrimental reliance. Furthermore, the bank was not given an opportunity to explain the timing of its motions.

Conclusion

The case was ultimately remanded for further proceedings and the lender ultimately succeeded in obtaining a ruling that it could proceed with its challenge to the formation of the improvement district. The debtor was unable to bring forth enough evidence to show why or how a state court action against the improvement districts would affect the estate. While the automatic stay is one of the most significant protections a Chapter 11 debtor has, when a proposed action is not directly against the debtor or his property, such debtor must be prepared to show—*at all stages*—how and why it affects the debtor itself or the estate.

NOTES:

[1] *In re Panther Mountain Land Development, LLC*, 686 F.3d 916, 56 Bankr. Ct. Dec. (CRR) 226 (8th Cir. 2012).

[2] 11 U.S.C.A. § 362(a)(1).

[3] 11 U.S.C.A. § 362(a)(3).

© 2012 Thomson Reuters