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# From the Bankruptcy Courts

Benjamin Weintraub\* and Alan N. Resnick\*\*

## REJECTION OF TIME-SHARE PURCHASER AGREEMENTS IN BANKRUPTCY—LET THE BUYER BEWARE!

Recent legislative proposals designed to amend the Bankruptcy Code for the purpose of protecting purchasers of vacation time-share interests highlight the current risk that many time-share consumers assume, perhaps unknowingly.<sup>1</sup> These bills are reactions to the unfavorable treatment given to time-share interest holders in the bankruptcy case of *In re Sombrero Reef Club, Inc.*<sup>2</sup> where the bankruptcy court in Florida allowed the rejection of time-share purchase agreements as executory contracts.

### *In re Sombrero Reef Club, Inc.*

The debtor in *Sombrero Reef* owned a resort-marina complex in the Florida Keys. Prior to filing a

chapter 11 petition, it entered into approximately 200 time-share purchase agreements in an unsuccessful attempt to turn the property into a time-share operation. The debtor moved to reject the time-share purchase agreements as executory contracts under Section 365 of the Bankruptcy Code in conjunction with a motion for leave to sell the real property. The debtor also filed a complaint for a declaratory judgment against the time-share purchasers declaring that they would have no further rights in the underlying property upon such rejection. In particular, the debtor sought an order declaring that the time-share agreements were not protected by the special provisions contained in Section 365(h) protecting nondebtor lessees of real estate,<sup>3</sup> or by Section

<sup>3</sup> Section 365(h) provides:

(1) If the trustee rejects an unexpired lease of real property of the debtor under which the debtor is the lessor, the lessee under such lease may treat the lease as terminated by such rejection, or, in the alternative, may remain in possession for the balance of the term of such lease and any renewal or extension of such term that is enforceable by such lessee under applicable nonbankruptcy law.

(2) If such lessee remains in possession, such lessee may offset against the rent reserved under such lease for the balance of the term after the date of the

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<sup>1</sup> See S. 1013 (Subtitle G) and H.R. 217, 98th Cong., 1st Sess. (1983).

<sup>2</sup> 18 Bankr. 612 (S.D. Fla. 1982).

365(i)<sup>4</sup> protecting purchasers of real estate who are in possession of the property prior to the bankruptcy of the seller.

rejection of such lease, and any such renewal or extension, any damages occurring after such date caused by the nonperformance of any obligation of the debtor after such date, but such lessee does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset.

<sup>4</sup> Section 365(i) provides:

(1) If the trustee rejects an executory contract of the debtor for the sale of real property under which the purchaser is in possession, such purchaser may treat such contract as terminated, or, in the alternative, may remain in possession of such real property.

(2) If such purchaser remains in possession—

(A) such purchaser shall continue to make all payments due under such contract, but may, offset against such payments any damages occurring after the date of the rejection of such contract caused by the nonperformance of any obligation of the debtor after such date, but such purchaser does not have any rights against the estate on account of any damages arising after such date from such rejection, other than such offset; and

(B) the trustee shall deliver title to such purchaser in accordance with the provisions of such contract, but is relieved of all other obligations to perform under such contract.

See also § 365(j), which provides:

A purchaser that treats an executory contract as terminated under subsection (i) of this section, or a party whose executory contract to purchase real property from the debtor is rejected and under which such party is not in possession, has a lien on the interest of the debtor in such property for the recovery of any portion of the purchase price that such purchaser or party has paid.

Under the prototype agreement used by the Sombrero Reef developer, labeled "Latitude 24 degree Vacation Club Membership Agreement," consumers paid an initial price which, depending on the type of accommodation and the season chosen, ranged from under \$1,000 to over \$3,000. Annual dues charged ranged from \$42 to \$84. In exchange, purchasers were granted the right to use the type of accommodation initially selected for one week per year over a thirty-year period. Reservations had to be made not less than sixty days and not more than one year in advance of the desired week from a list of available accommodations. Purchasers could not specify particular units for their use. Sombrero Reef guaranteed the maintenance of facilities and services. The agreement provided for the payment of the purchase price, either in full or in installments, and the payment of the annual dues, whether or not the accommodations were, in fact, used by the purchaser.

### The Court's Reasoning

The court held that the time-share agreements are executory contracts even if the entire purchase price had been paid. The court found that these agreements left substantial obligations to be performed on both sides and, therefore, they are executory contracts.<sup>5</sup> The debtor was obligated

<sup>5</sup> The court applied the definition of

under these agreements to provide services and maintain the premises in the future, while the purchasers agreed to pay annual dues (\$42 to \$84) which the court characterized as "not a de minimis obligation." The court approved rejection of these contracts, concluding that rejection would benefit the estate.

The court focused on the nature of the time-share interests to determine whether the special protections for lessees (§ 365(h)(1)) or for purchases of real estate under land sale contracts (§ 365(i)(1)) were applicable and concluded that this form of time-share agreement did not constitute a lease, despite the existence of nondisturbance agreements with mortgagees, and did not constitute a sale of real property ("no delivery of title of any kind was contemplated").<sup>6</sup> Thus, the rejection of these contracts gave the purchasers only unsecured claims against the estate and enabled the debtor to sell the premises free of the time-share consumers' right to use the premises.

It is interesting that the time-share agreements were rejected despite a state statute designed to protect time-share consumers in the event of a sale of the premises. Florida enacted the Real Estate

Time Share Act<sup>7</sup> which prohibits a sale of the real estate unless it is made subject to the rights of the time-share purchasers. The time-share agreements expressly provide that no sale will occur unless the buyer of the premises agrees to assume the obligations of the seller with respect to the time-share agreements. Nonetheless, the court concluded:

If the Florida statute is an attempt to prohibit such a breach by a time-share developer it is preempted by Federal bankruptcy law. . . . The Florida legislature presumably had the intent of protecting time-share owners, an intent which this court is in sympathy with, but to the extent that Chapter 721, Fla. Stats. frustrates the operation of bankruptcy law, the statute is invalid. Therefore, it is not a bar to rejection of the contracts.<sup>8</sup>

### Lessons to Be Learned

*Sombrero Reef* is a warning to purchasers of time-share interests. If the owner of the vacation resort winds up in a bankruptcy case, rejection of time-share agreements may mean the termination of the purchasers' interests in the resort. However, there are several observations that should be made.

First, *Sombrero Reef* involved time-share agreements that were not leases and gave purchasers no interest in the land. A different re-

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executory contract set forth by Professor Countryman. See Countryman, "Executory Contracts in Bankruptcy," 57 Minn. L. Rev. 439, 460 (1973).

<sup>6</sup> 18 Bankr. at 618.

<sup>7</sup> Fla. Stats. ch. 721.

<sup>8</sup> 18 Bankr. at 620.

sult might have occurred if time-share purchasers had received an interest in land by deed (such as tenancies in common) or if purchasers had received recordable leasehold interests, either by giving a legal representative a lease on behalf of all time-share consumers or by granting individual leases.

Second, although the reader may respond to *Sombrero Reef* with nothing but sympathy for the consumer who prepaid for time-share vacation privileges, the court treated such consumers the way most consumers are treated under the Code. Section 507(a)(5) of the Code gives consumers who prepaid for goods or services an unsecured claim with a fifth level priority up to \$900. Why should the time-share purchaser have superior rights when compared with the consumer who has a long-term prepaid contract for orthodontic services? Perhaps a broader congressional look at the rights of consumer creditors would be appropriate.

Third, the time-share purchasers' position in *Sombrero Reef* and the proposed legislation would give time-share purchasers the same rights as lessees under Section 365(h) or purchasers of land in possession under Section 365(i). Yet this may be inconsistent with the original purpose of these subsections. Congress intended to protect those in possession of real estate from the detriment and hardship associated with losing possession upon the landlord's/seller's bankruptcy. It is doubtful that the loss of the right to possess a room in a resort for one or two weeks each year was what Congress had in mind.

It is difficult to predict with certainty whether the *Sombrero Reef* holding will be followed by other courts or whether it will be left undisturbed by Congress. In any event, however, until further judicial or legislative action, counsel for consumers contemplating the purchase of time-share interests should read *Sombrero Reef*.