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Coverage Gap: Rethinking SBRA's Exclusion of SARE Affiliates

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The Small Business Reorganization Act of 2019 (SBRA) added new subchapter V to chapter 11 of the Bankruptcy Code, with the goal of providing eligible small businesses a faster, more efficient and more cost-effective opportunity to reorganize.[1] By all indications, the SBRA's first year-and-a half was a success, partly because Congress expanded eligibility by temporarily increasing the debt ceiling from $2,725,625 to $7.5 million.[2] Although that higher debt threshold, combined with cases broadly interpreting the SBRA's eligibility standards, has helped many businesses and individuals take advantage of subchapter V, a different eligibility restriction lingers that has limited, and complicated, the effectiveness of the SBRA: the statute's exclusion of single-asset real estate (SARE) affiliates from opting into subchapter V.

The SBRA's exclusion of SARE affiliates from subchapter V continues more than a century of treating SARE debtors differently. That exclusion, however, creates many substantive and procedural challenges when affiliated SBRA and SARE debtors attempt to reorganize in simultaneous chapter 11 cases under different statutory frameworks. Not only are the historical policy rationales for treating SARE debtors differently in bankruptcy cases less applicable when an SBRA-eligible affiliate is present, but the exclusion of SARE debtors from the SBRA also limits the effectiveness of the SBRA and undermines its goals by adding new risks — and costs — to chapter 11. Ultimately, only a legislative change to allow certain SARE debtors access to the SBRA will ensure that the benefits of the SBRA are maximized and its goals are fully realized, while still protecting against chapter 11 misuse.

Special Rules for SARE Debtors

Section 101(51D) of the Bankruptcy Code defines what entities qualify as "small business debtors" for purposes of eligibility for subchapter V.[3] The definition excludes "a person whose primary activity is the business of owning single asset real estate."[4] While a SARE affiliate cannot access subchapter V, its liabilities are still counted against the SBRA affiliate's liabilities for purposes of eligibility, presenting another challenge for debtors.[5]

Although the SBRA is relatively new, special treatment of SARE debtors is not so new. The SBRA continues more than a century of treating SARE entities differently in bankruptcy. Historically, the practice of distinguishing SARE debtors from other debtors arose primarily from concerns about SARE cases being filed in bad faith to halt foreclosures or other adverse consequences, without any realistic hope of timely reorganizing in chapter 11. In fact, reference to SARE entities dates back at least to chapter XII of the Bankruptcy Act of 1898.[6] More recently, abuse concerns intensified in the 1980s and early 1990s, when a downturn in the real estate market led to an increase in SARE entities filing for chapter 11. With little to no equity and inadequate or unreliable cash flow, these debtors were viewed as unlikely to reorganize, prompting outcry about abuse of chapter 11.[7]

For years, courts addressed these concerns by dismissing SARE cases on the basis of bad-faith filings, although courts adopted different standards.[8] In response to growing concerns (and effective lobbying), the term "single-asset real estate" was eventually added to the Bankruptcy Code in 1994,[9] although the term existed in bankruptcy jurisprudence well before its codification.[10] Also in 1994, Congress revised § 362 of the Code to provide that the automatic stay terminates if a SARE debtor does not file a plan or commence monthly interest payments within 90 days of the petition date. A decade later, the Bankruptcy Abuse

1 11 U.S.C. §§ 1181-1195.
2 COVID-19 Bankruptcy Relief Extension Act of 2021, 117 P.L. 5, 135 Stat. 249, March 27, 2021; Coronavirus Aid, Relief and Economic Security (CARES) Act, 116 P.L. 136, 134 Stat. 281, March 27, 2020; *see also* Bob Keach & Adam R. Prescott, "Fixing Ch. 11 for Small Biz: The SBRA Is Working as Intended," *Law360* (Feb. 12, 2021), *available at* law360.com/articles/1356936/fixing-ch-11-for-small-biz-the-sbra-is-working-as-intended (last visited Aug. 30, 2021; subscription required to view article).
3 11 U.S.C. § 101(51D).
4 *Id.*
5 *See* 11 U.S.C. § 101(51D)(B)(i); *In re 305 Petroleum Inc.*, 622 B.R. 209, 211 (Bankr. N.D. Miss. 2020) (holding that although § 101(51D)(A) excludes SARE debtors from eligibility, subsection (B) does not exclude SARE entities from the definition of "affiliates").
6 H. Miles Cohn, "Single Asset Chapter 11 Cases," 26 *Tulsa L. Rev.* 523, 524 (1990).
7 Lawrence Ponoroff, "New Value Plans in Single Asset Cases: Is the Commission's Proposal an Effective Bar to Reorganization?," 7 *J. Bankr. L. & Prac.* 291, 294 (1998) ("[M]ortgage lenders bitterly complained that their resources were being depleted while the SARE debtor engaged in what amounted to nothing more than a risk-free roll of the dice that the real estate market would improve enough to alleviate the debtor's financial crunch."); *see also* Lisa H. Fenning, "The Future of Chapter 11: One View from the Bench," 1993 *Ann. Surv. of Bankr. L.* 2 (1993) (discussing SARE plans and challenges of reorganizing SARE debtors).
8 *See, e.g., In re Little Creek Dev. Co.*, 779 F.2d 1068, 1073, n.3 (5th Cir. 1986) (compiling cases).
9 Bankruptcy Reform Act of 1994, H.R. 5116, 103rd Cong. § 218 (1994).
10 *See, e.g., In re Kkemko*, 181 B.R. 47, 50 (Bankr. S.D. Ohio 1995) ("[T]he Bankruptcy Reform Act of 1994 did not introduce the phrase 'single asset real estate' into bankruptcy cognizance. It is, indeed, a common term in bankruptcy, and has been used for many years in the bankruptcy area.").

continued on page 51

Prevention and Consumer Protection Act of 2005 eliminated the $4 million cap in § 101(51B), expanding the reach of the Code's SARE provisions.[11]

The Many Problems with Filing SBRA and SARE-Affiliated Debtors

Outside of bankruptcy, many small business owners who own real estate used for operations utilize a multi-entity corporate structure by creating a real estate holding entity and a separate operating entity that manages the business, controls cash and owns other personal property used for operations. This structure generally works well as an asset-protection, risk-management and tax-liability strategy. The challenge, however, becomes managing bankruptcy cases when affiliated debtors are eligible for different types of chapter 11 relief.

It is common in chapter 11 for affiliated debtors to file petitions at the same time, and most of those multidebtor cases are managed with little fuss. For example, debtors often move to jointly administer cases under Rule 1015(b) of the Federal Rules of Bankruptcy Procedure, which permits a shared docket and joint pleadings. Debtors also may move to substantively consolidate through the bankruptcy court, or they could proceed along parallel tracks and exit through a joint plan. Although not without challenges, these cases generally proceed under the same rules and timelines, and therefore, they typically do not present significant procedural or substantive issues.

Proceeding in parallel SBRA and SARE cases poses more issues and risks. Some of those challenges effect substantive powers in the SBRA case, while others involve procedural hurdles that can be overcome with careful planning. Either way, requiring SBRA and SARE debtors to proceed under different rules limits the effectiveness of the SBRA and undermines the goals of the SBRA by adding new risks — and costs — to chapter 11.

As one example, the Code provides 90-day deadlines for filing plans in both SBRA and SARE cases. However, the Code's mechanisms for enforcing these requirements differ. Section 1189(b) provides that an SBRA debtor must file a plan no later than 90 days after the petition date (unless extended by the court), but no confirmation deadline is set.[12] In a SARE case, on the other hand, the plan timeline is enforced through § 362(d)(3) of the Code, which provides that the automatic stay is terminated unless the plan "has a reasonable possibility of being confirmed within a reasonable time" or interest payments are commenced.[13] When the reorganization of one debtor is intertwined with the success of the other, the SARE stay provisions invite early disputes about confirmation and give creditors leverage that does not exist in the SBRA, all of which add costs and can quickly sidetrack cases in a way that would not exist under subchapter V alone.

11 S. 256, 109th Cong. (2005).
12 11 U.S.C. § 1189.
13 11 U.S.C. § 362(d)(3).

As another example, § 1125 of the Code is made inapplicable to SBRA debtors, meaning that they need not file separate disclosure statements (unless ordered by the court).[14] Instead, SBRA debtors are only required to incorporate certain disclosures into the reorganization plan itself.[15] This change abbreviates the confirmation timeline by eliminating the two-staged, disclosure statement-then-plan-confirmation process, while also reducing the amount of ink (and costs) required to push through confirmation. But this change also causes simultaneous SBRA and SARE cases to fall out of sync during confirmation and defeats some of the intended savings under the SBRA — unless a motion is filed in the SARE case to consolidate the plan and disclosure statement, which itself adds time and costs to the process.

Finally, and perhaps most importantly regarding substantive rights, a SARE debtor will not benefit from the full cramdown powers in subchapter V, making confirmation more difficult and less effective for these debtors. Specifically, § 1129(b), which otherwise governs confirmation of a cramdown plan in chapter 11, is largely inapplicable in subchapter V.[16] Instead, § 1191(b) modifies the standards for confirming nonconsensual plans, including by discarding the requirement that at least one impaired class must accept the plan, which is significant in cases with few creditors likely to return ballots.[17] Further, § 1191(c) modifies the absolute-priority rule through the "projected disposable income" requirement for paying unsecured claims.[18] Thus, while the SBRA debtor can achieve cramdown (and preserve equity) by contributing three to five years of projected disposable income to pay unsecured claims, many of those same claims must be paid in full to satisfy the absolute-priority rule if they also exist in the SARE case, which lacks an equivalent of § 1191(b) and (c).

The overall result of these differences is to undermine, and perhaps even eliminate, the confirmation powers of an SBRA debtor that files with a SARE affiliate, making confirmation less likely and less effective overall.

Excluding All SARE Debtors with an SBRA Affiliate Is Not Necessary

Although the different treatment of SARE debtors is well justified in some contexts, the forces that originally animated Congress and courts to single out SARE debtors likely are less prevalent when the SARE entity's affiliate is an SBRA-eligible debtor. With an operating small business affiliate, the SARE is not a standalone investment vehicle, nor does it lack for consistent cash-flow opportunities. Rather, the SARE entity exists hand-in-glove with the operating affiliate, with the success of each intertwined.

14 11 U.S.C. §§ 1125, 1181(b).
15 11 U.S.C. § 1190.
16 11 U.S.C. § 1181(a).
17 *Id.*
18 *Id.*

continued on page 52

from page 51

Thus, not only are bad-faith filing concerns less likely, but the SARE debtor — in partnership with the operating affiliate — has a clearer path to successfully reorganize in chapter 11 because of its affiliate and the related cash flow. As a result, creditors at risk from abusive SARE filings are in an improved position with an operating affiliate, while those creditors also would continue to benefit from the same protections under subchapter V (and elsewhere in the Bankruptcy Code) that they normally have.

Existing Options for Managing SBRA-SARE Cases Are Insufficient

Under the existing setup, some solutions are available to help manage SARE-SBRA cases. None, however, is a perfect cure.

As to current options, the operating and real estate entities could merge or transfer the real estate prior to the bankruptcy to avoid a multidebtor filing. In addition to the costs and potential logistical hurdles for this strategy, it also requires time that might not be available if an urgent filing is needed, and may open up the entities to fraudulent transfer claims (though the success of such claims is dubious). Alternatively, the debtors could seek to substantively consolidate within the bankruptcy cases, but doing so requires meeting a high standard that likely will invite challenges and might not be approved.[19] If all else fails, there are ways to manage the cases procedurally through motions practice, but that, too, is costly and not always effective.

However, most importantly, coordinating timing and procedures between the cases simply will not restore the substantive benefits of the SBRA that are lost when an affiliated debtor is shoehorned into a SARE case and must proceed under those rules. Thus, a bigger change is needed.

Legislative Change Is the Favored Solution

The most effective solution to the SBRA-SARE dilemma is for Congress to amend the Code to make (at least certain) SARE debtors eligible for subchapter V when an affiliate also is eligible. This change could occur in several different ways.

First, Congress could amend the SBRA to make all SARE entities with an affiliated SBRA debtor eligible for the SBRA. This change, however, might be too sweeping by encompassing more SARE debtors than is necessary to maximize the goals of the SBRA. It also is likely to encounter resistance from certain creditor groups concerned about expanding the reach of the SBRA.

Second, Congress could provide that SARE affiliates are eligible for the SBRA when operations between the SARE debtor and the SBRA debtor are "significantly intertwined" or when the SBRA entity could not operate "but for" the SARE debtor. While narrower than the first proposal, this option is likely too subjective and could lead to factual disputes that increase costs and undermine the benefits of the rule. Thus, although an option, it is not a favored approach.

Third — and the option preferred by the authors — is for Congress to amend the SBRA such that a SARE debtor is eligible for the SBRA when it is the lessor to an affiliated SBRA debtor-lessee. This amendment would provide an objective, easy-to-apply standard that also ensures that only a SARE debtor that is effectively operating as the same business as the SBRA entity is eligible. This narrower option also should invite less opposition in Congress, making passage more likely, because only those SARE debtors whose reorganizations are indivisible from the operating entity would become eligible, thus limiting eligibility while still lessening the risk of abuse of the SBRA by ill-fated SARE entities.

Conclusion

Juggling simultaneous SBRA and SARE chapter 11 cases increases costs, limits the effectiveness of the SBRA and, ultimately, could dissuade eligible small businesses and individuals from taking advantage of subchapter V. If the goal of the SBRA is to provider faster, more effective reorganizations, then the categorical exclusion of SARE affiliates is an impediment to that goal. Accordingly, to achieve the goals of the SBRA to the fullest extent possible, a fix is needed that affords greater access to the SBRA for certain well-qualified SARE entities. abi

19 *See, e.g., In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005) (discussing Third Circuit's heightened substantive consolidation standard).

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