A Modest Proposal: Amend the Bankruptcy Code to Give Single Asset Real Estate Debtors a Chance to Survive the COVID Crisis

December 21, 2020

By: Warren Martin Jr.

Authored by John S. Mairo, Warren J. Martin Jr. and Kwame Akuffo[1]

Single asset real estate ("SARE") bankruptcy filings are on the rise. From January 2020 through October 2020, sixty-two (62) cases have been filed nationwide. Forty-four (44) of these cases have been filed since mid-March when COVID-19 triggered a wave of bankruptcy filings. With foot traffic down to a trickle, retail tenants are closing their doors without any ability to pay their rent, causing a direct impact on the SARE industry.

On August 23, 2019, the Small Business Reorganization Act of 2019 ("**SBRA**")[2] was enacted and went into effect on February 19, 2020. SBRA provides a modified process for small business debtors to successfully reorganize in bankruptcy. Section 101(51D) of the Bankruptcy Code defines a small business debtor for purposes of SBRA, but the definition excludes SARE debtors. Currently, a small business debtor holding no more than $7,500,000 of non-contingent, liquidated debts[3], at least 50 percent of which arose from commercial or business activities, is eligible for relief under SBRA.

As discussed below, given the legal challenges SARE debtors face in confirming any bankruptcy plan, coupled with the impact of COVID-19 on landlord rental income, Congress should consider amending the definition of "small business debtor" to include SARE debtors, in order to avoid a potentially historic loss of small business real estate assets to foreclosure.

A. SARE Debtor

A SARE debtor is defined as one with "real property constituting a single property or project," which generates a large part of its gross income from the real property. 11 U.S.C. § 101(51B). A checklist utilized by courts to determine a debtor's SARE status is whether: (i) the real property constitutes a single property or project; (ii) the real property substantially generates all the debtor's gross income; and (iii) the debtor is not involved in any substantial business other than the business of operating real property. *In re Kara Homes, Inc.*, 363 B.R. 399, 404 (Bankr. D.N.J. 2007).

Rightly or wrongly, historically the bankruptcy courts have been tough on the single asset real estate debtors. Indeed the concept of "bad faith filing," in which cases are dismissed as two party disputes, essentially not fit for reorganization, grew out of the single asset real estate cases.[4] Historically, courts have often looked at single asset real estate entities as "passive investments" unworthy of the bankruptcy court's time to reorganize, rather than as failed businesses.[5] The SARE provisions of the Bankruptcy Code continued these prejudices and in many ways made it more difficult, rather than easier, for a single asset real estate entity to successfully restructure in Chapter 11. We think that the new COVID-19 work-from-home world requires a new look at SARE cases through a different prism.

When a bankruptcy petition designates the debtor as a SARE, unlike in an ordinary chapter 11, the SARE debtor will be subject to extremely tight time frames. For example, a SARE debtor may lose the benefit of the automatic stay if it does not file a plan of reorganization or commence monthly payments to the secured mortgage lender at the loan's non-default contract interest rate within ninety (90) days of the petition date. *See* 11 U.S.C. § 362(d)(3)(A) and (B) (stay relief may be granted if payments do not commence within ninety (90) days after the petition date or within thirty (30) days after a court determines that the debtor is a SARE debtor).[6]

Thus, for SARE debtors who lack liquidity – common in the COVID world – filing a plan that has a reasonable chance of being confirmed in a reasonable time is the only legal way to avoid expiration of the automatic stay and the attendant loss of the property. Without the protection of the automatic stay, the lender, typically the only secured party in a SARE case, proceeds to foreclose and take the property.

B. Small Business Reorganization Act

The SBRA is designed to streamline reorganization of small businesses.[7] It achieves this goal by reducing the costs of protracted negotiations and the cumbersome process of small business cases under ordinary chapter 11 cases, thereby allowing small business debtors to retain control and negotiate a consensual plan. It improves small business reorganizations by utilizing tools usually applied in chapter 13 cases.

The SBRA implements these objectives by eliminating or modifying the use of certain sections applicable in a large chapter 11 cases. For instance: (i) disclosure statements and unsecured creditor committees are not necessary, (ii) administrative claims may be paid through the life of a plan, (iii) U.S. Trustee quarterly fees are inapplicable, (iv) there are no competing plans, (v) rules about new value and absolute priority have been vaporized, and (vi) a discharge is granted after completion of all plan payments, rather than upon confirmation of a plan. *See* 11 U.S.C. § 1181(a)-(c). Many small business debtors *and* even pre-existing chapter 11 debtors before the effective date of the SBRA have benefited from the new law.[8] And more SBRA cases are forthcoming, considering that the CARES Act temporarily increases the debt limit for relief under SBRA to $7,500,000 from $2,725,625.

SARE debtors, however, cannot toast to such benefits because they are *excluded* from the definition of "small business debtor" for purposes of subchapter V. *See* 11 U.S.C. § 101(51D)(A). That would change with an amendment to include SARE debtors under the definition of "small business debtor." As explained below, inclusion would allow SARE debtors to obtain many of the benefits provided under the SBRA and would expedite SARE cases that section 362(d)(3) is designed to achieve. Creditors would not be prejudiced by the proposed amendment because the SBRA retains many important provisions afforded to creditors under the Bankruptcy Code and expedites cases under subchapter V far better than in ordinary chapter 11 cases.

C. Benefits to SARE Debtors

As a small business SARE debtor, SBRA would provide substantial cost savings considering U.S. Trustee quarterly fees are not required[9], and the lack of a disclosure statement and a creditors' committee means less professional fees. The SBRA would allow a small business SARE debtor to confirm a plan without the vote of impaired classes provided the plan does not discriminate unfairly and is fair and equitable. *See* 11 U.S.C. § 1191(b). Also, it would allow a small business SARE debtor to preserve cash by paying administrative expense claims through the life of a plan, rather than upon the effective date of a confirmed plan as is required in an ordinary chapter 11 case. *See* 11 U.S.C. §§ 1129(a)(9)(A), 1191(e).

Under the SBRA, a small business SARE debtor would also have the exclusive benefit of filing a plan, which must be filed within 90 days after the petition date. 11 U.S.C. § 1189(a) and (b). A court may extend filing of a plan if an "extension is attributable to circumstances for which the debtor should not be held accountable." 11 U.S.C. § 1189(b). This means an amendment would include the elimination of section 362(d)(3) entirely. Thus, the option of monthly payments to secured

creditors within 90 days after the petition date or 30 days after a court determines a debtor's SARE status would be eliminated. In cases where a SARE debtor is likely to provide monthly payments to preserve the automatic stay, elimination of monthly payments under section 362(d)(3) would allow a small business SARE debtor to retain cash desperately needed to continue operations and make payments under a confirmed plan.

Finally, the exclusion of new value and the absolute priority rule means that equity interests may be retained in a reorganized entity over the objection of unsecured creditors who receive less than full recovery of their claims. As noted, the SBRA abolishes the new value and absolute priority rule requirement pursuant to section 1181(a). The exclusion of the absolute priority rule and new value also means that the Supreme Court's decision in *Bank of America Nat. Trust and Sav. Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999) is inapplicable against small business debtors. In 203 *North LaSalle*, the Court held, among other things, that old equity holders could not contribute new capital and receive new ownership interests in a reorganized entity over the objection of a senior class of impaired creditors when such opportunity is given exclusively to the old equity holders under a plan. *Id.* at 458.

D. Minimal Prejudice to Creditors

While there are obvious benefits to debtors, an amendment would impose minimal, if any, prejudice upon creditors. As noted, the SBRA maintains certain provisions applicable in ordinary chapter 11 cases. For instance, the solicitation process under section 1122 is retained. So, artificial classification and artificial impairment issues that typically arise in SARE cases would remain objectionable in a small business SARE debtor case. Objections on the basis of lack of good faith or on other grounds under section 1112 is also retained. So are financial reporting requirements under section 308, a modified fair and equitable standard under section 1191(b), and the period to file a plan under section 1189(b), which must be filed within 90 days after the petition date.

Creditors may seek adequate protection payments even though the monthly payments option under section 362(d)(3) would be eliminated. They might also seek stay relief early on in a case for lack of adequate protection or because reorganization seems hopeless, § 362(d)(1) and (2), rather than wait 30 or 90 days after the expiration of the automatic stay (some courts have held that such "wait period" is required in a SBRA case prior to obtaining stay relief under section 362(d)(3)).[10] Partially secured creditors may still exercise their rights under section 1111(b) to waive their unsecured deficiency claim and treat the entire claim as fully secured, and any concerns about lack of information about the debtor is addressed through the "separate disclosure statement exemption" under section 1187(c), insofar as it is necessary.

Lastly, a small business SARE debtor would obtain a discharge of all pre-confirmation debts only *after completion of all payments* under a three (3) year confirmed plan, not to exceed five (5) years. 11 U.S.C. § 1192. Essentially, a small business SARE debtor would have to make all payments under a confirmed plan *or* risk losing essential benefits provided under the SBRA, including retention of equity interests in the reorganized entity and a discharge of debts. This risk, in effect, offsets the elimination of section 362(d)(3), which was designed to curb abuses by SARE debtors to "delay mortgage foreclosures even when there is little chance that they can reorganize successfully." *In re Triumph Inv. Grp., Inc.*, 2009 WL 2916986, at *2 (Bankr. E.D. Pa. 2009) (quoting 3 Collier on Bankruptcy, ¶ 362.07[5] [b]).

E. Conclusion

An amendment to the definition of "small business debtor" to include SARE would be a rather straight-forward and simple method to give SARE Debtors a fighting chance to reorganize in the highly distressed COVID environment. Creditors would not be greatly prejudiced by the proposed amendment because the SBRA retains many important creditor protections applied in ordinary chapter 11 cases, provides for quick reorganizations, and a subchapter V debtor must complete all payments under a confirmed plan or risk losing essential benefits provided under the SBRA. Without making these or similar changes to the Bankruptcy Code, the continued onslought of retail bankruptcies and the difficulty of confirming a SARE bankruptcy case could very well lead to historic changes in real property ownership, from SARE owners to banks.

Assuming that this is not a desired policy goal, Congress should consider an amendment to the Bankruptcy Code to allow SARE debtors a better chance at successfully reorganizing through use of the SBRA.

_____

[1] John S. Mairo and Warren J. Martin, Jr. are co-chairs of the Bankruptcy and Financial Restructuring Group of Porzio, Bromberg & Newman, P.C., and Kwame Akuffo is a former associate of the firm.

[2] The SBRA is codified under subchapter V of title 11 of the United States Code. For a fuller analysis of the SBRA, see John S. Mairo & Chris P. Mazza, *Timely Legislation Makes Chapter 11 More Attractive For Small Businesses*, INSOL Quarterly, 2020.

[3] The debt cap had been set at $2,725,605. The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") temporarily increased it to $7,500,000.

[4] *See In re American Prop. Corp.*, 44 B.R. 180 (Bankr. M.D. Fla. 1984) ("An important factor to consider is whether the debtor's reorganization effort is one which 'involves essentially a two-party dispute which can be resolved outside the Bankruptcy court's jurisdiction, where the purpose of the filing is to frustrate a creditor's sale'. . . . Clearly, bad faith is shown if the purpose of a Chapter 11 debtor is to hold a single asset 'hostage' in order to speculate that such asset may increase in value in order to recover its original investment at the creditor's risk." [citations omitted]); *See also In re Alison Corp.*, 9 B.R. 827 (Bankr. S.D. Cal. 1981) (case dismissed on grounds of bad faith because there was "no prospect of a fresh start being promoted, since the corporate Debtor has only this single asset. The only reason to continue the stay in effect and keep the case going is so that the principals of the Debtor, at the creditors' risk, can retrieve their investment and obtain the appreciation in value of the property.").

[5] *See In re Scotia Pac. Co.*, 508 F.3d 214, 223 n.7 (5th Cir. 2007) ("The legislative history of the 1994 inclusion of SARE in the Bankruptcy Code indicates that SARE refers to property held for passive investment—not property used in an active business enterprise. 'We commonly think of a single asset case as one of a debtor with a single apartment house or condo complex or a single piece of real estate. However, this could include a debtor ... such as a real estate investment trust . . . .'" (quoting 138 Cong. Rec. S8241–01, *S8264 (daily ed. June 16, 1992) (statement of Sen. Reid).")).

[6] Ordinary chapter 11 debtors benefit from the automatic stay throughout a case until a party obtains stay relief. They also benefit from the 120-day exclusivity period to file a plan. *See* 11 U.S.C. § 1121. Unlike a SARE debtor, an ordinary chapter 11 debtor may request to extend the 120-day period for cause, but only for 18 months after the petition date for the 120-day period. 11 U.S.C. § 1121(d)(2)(A) and (B).

[7] *See, e.g., In re Sustainable Restaurant Holdings, Inc.*, Case No. 20-11087 [Dkt. No. 212], (Bankr. D. Del. July 16, 2020) (bankruptcy court confirmed subchapter V plan in *two months*) (emphasis added).

[8] *In re Progressive Solutions, Inc.*, 615 B.R. 894 (Bankr. C.D. Cal. 2020) and *In re Moore Props. of Person Cty.*, LLC, 2020 WL 995544, at *1 (Bankr. M.D.N.C. 2020) were the first two cases to permit a chapter 11 debtor to re-designate a pending chapter 11 case to one under subchapter V. Most courts have followed suit and ruled that re-designation is permitted pursuant to Bankruptcy Rule 1009. *See, e.g., In re Body Transit, Inc.*, 613 B.R. 400 (Bankr. E.D. Pa. 2020); *In re Ventura*, 615 B.R. 1 (Bankr. E.D.N.Y. 2020); *In re Bello*, 613 B.R. 894 (Bankr. E.D. Mich. 2020); *In re Bonert*, 2020 WL 3635869, at *3 (Bankr. C.D. Cal. 2020). But *see In Re Double H Trans. LLC*, 614 B.R. 553 (Bankr. W.D. Tex. 2020) (denying request to re-designate pending chapter 11 case to subchapter V because SBRA has no retroactive effect).

[9] U.S. Trustee quarterly fees apply in chapter 11 cases "*other than under subchapter V.*" 28 U.S.C. § 1930(a)(6)(A) (emphasis added).

[10] *In re SSK Partners LLC*, 2012 WL 4929019, at *5 (Bankr. N.D. Ill. 2012); *In re Salem Logistics Distribution Services, LLC*, 2009 WL 1783547, at *1 (Bankr. M.D.N.C. 2009) (creditor must wait 30 days after determination of a debtor's SARE status to seek

stay relief); *In re ACA Real Estate LLC*, 2008 WL 4899024, at *1 (Bankr. M.D.N.C. 2008) (same); *In re Hope Plantation Group*, 393 B.R. 98, 102-103 (Bankr. D.S.C. 2007); *In re National/Northway Ltd. Partnership*, 279 B.R. 17, 22 (Bankr. D. Mass. 2002).