NEW LAW | PUTS CHAPTER 11 BANKRUPTCY WITHIN REACH FOR SMALL BUSINESSES

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The Small Business Reorganization Act of 2019 (SBRA), known as Subchapter V (Public Law (PL) 116-54), presents a new opportunity for reorganizing small businesses under Chapter 11 of the U.S. Bankruptcy Code.

This new law became effective February 20, 2020, and was promptly expanded as of March 27, 2020, when the eligibility debt cap was increased almost threefold, to $7.5 million, from about $2.7 million. This increased debt cap comes with a one-year sunset, as it was approved as part of the Coronavirus Aid, Relief and Economic Security Act of 2020. Some anticipate, however, that this temporary increase ultimately will be made permanent, as was done with Chapter 12, which was introduced in the 1980s to provide emergency relief for family farmers.

This article provides an overview of new Subchapter V (five) of Chapter 11 of the Bankruptcy Code, which was designed to make Chapter 11 dramatically cheaper, quicker, and more effective for small businesses facing financial distress. All statutory references are to the Bankruptcy Code, 11 U.S.C. Sections 101 *et seq.*, unless otherwise indicated.

Subchapter V of Chapter 11 (Sections 1181-95) is the product of more than three years of effort by bankruptcy lawyers and judges working together under the auspices of the American Bankruptcy Institute (ABI), which created a special commission to study how Chapter 11 was working—or failing to work—for small businesses. The commission articulated what bankruptcy practitioners have advised their clients for years, namely that Chapter 11 was broken or otherwise did not work for many small businesses. The commission recommended a broad array of fixes, most if not all of which were adopted.

Cost alone put traditional Chapter 11 out of reach for many small businesses. Traditional Chapter 11 cases typically cost tens of thousands of dollars, if not hundreds of thousands of dollars or more, in legal fees, not only for the debtor's counsel but also for counsel for the creditors' committee. These sums were in addition to quarterly fees payable to the Office of the United States Trustee (OUST), which are based on disbursements. These fees and costs have been reduced, if not eliminated, under Subchapter V.

Perhaps even more odious, owners were likely to lose their businesses in traditional Chapter 11 cases because of the absolute priority rule, which prohibits debtors from retaining ownership unless all of the impaired classes of claims either are paid in full or give their consent, or the owners otherwise pay into the plan "new value" in cash or its equivalent. With new criteria for what constitutes "fair and equitable" under Chapter 11 plans, the absolute priority rule has been eliminated under Subchapter V.

Creditors will also benefit from the lower costs, quicker proceedings, and increased certainty about the outcome of the process, if at the expense of some leverage. Secured lenders, whose long-term secured loans typically flow through the restructuring, will also enjoy the additional benefit of more economically viable borrowers emerging from Subchapter V.

Lower Cost, Streamlined Process

The costs of small-business Chapter 11 cases are dramatically reduced because Subchapter V eliminates: (i) the requirement that a separate disclosure statement be prepared and approved before voting on the Chapter 11 plan; (ii) the risk of a creditors' committee being appointed absent cause; (iii) the risk of a competing Chapter 11 plan being filed by creditors; and (iv) the obligation to pay quarterly fees to the OUST.

Subchapter V speeds up the restructuring process through a regimen of three important deadlines: (i) by 14 days before the initial status conference, the debtor is required to file a status report detailing its efforts to "attain a consensual" Chapter 11 plan (Section 1188(c)); (ii) by day 60 after the petition date, the Bankruptcy Court is to hold an initial status conference to consider the substance of the debtor's status report, the purposes of the bankruptcy filing, and the path forward for the restructuring; and (iii) by day 90 after the petition date, the debtor is required to file its Chapter 11 plan, which may be consensual or nonconsensual. The Bankruptcy Court retains discretion to extend these deadlines for "circumstances for which the debtor should not justly be held accountable." Sections 1188(b), 1189(b).

Debtors are nevertheless still required to file first day motions, including, for example, motions to use cash

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collateral, to make "adequate protection" payments to secured creditors after the petition date and before the plan is confirmed (via the Subchapter V trustee), and to file applications to employ professionals. Similarly, debtors must file their most recent financial reports required by Section 1116(1) on the petition date, periodic performance reports required by Section 308, and their schedules and statements. They must also maintain insurance and pay taxes that become due during the case. The OUST will continue to conduct an initial informal interview about 10 days after the petition date, and debtors are required to open debtor-in-possession bank accounts.

Apropos of cash collateral, a quirky new provision, Section 1186, makes post-petition earnings and assets property of the estate but only if the plan is confirmed on a nonconsensual basis. This may lead practitioners, especially in individuals' cases, to include in cash collateral agreements the authority to use post-petition earnings pending plan confirmation.

Qualifying Criteria

Subchapter V is strictly voluntary and must be affirmatively elected. A debtor makes its election either upon filing the case or within 14 days after an involuntary case is filed.

This subchapter is available to most small businesses so long as they meet two criteria. First, the aggregate amount of their secured *plus* unsecured debt may not exceed $7.5 million, counting only noncontingent, liquidated, and non-insider debt. Second, at least half of the debt that is counted must have arisen from the debtor's "commercial or business activities." PL Section 4(a)(1)(B)(i)(II).

Significantly, when calculating the debt cap, one does not count any debts owing to insiders, such as loans from owners, officers, directors, partners, or affiliates, nor does the debt cap count any contingent debts, such as potential environmental claims, or debts that have not been liquidated and thus remain unfixed in amount, such as commercial tort claims.

Though single asset real estate owners do not qualify for Subchapter V, the definition was modified to allow real estate businesses to qualify if their commercial activities include "operating real property or activities incidental thereto." PL Section 4(a)(1)(B)(i)(I). Publicly traded and public reporting companies also do not qualify for Subchapter V relief.

Management Retains Control, 'Facilitating' Trustee Appointed

Importantly, as in traditional Chapter 11 cases, the debtor's current management remains in control of the debtor throughout the pendency of the case, absent cause for removal.

Unique to Subchapter V, however, a trustee is appointed in every case. The Subchapter V trustee, who some describe as a "facilitating neutral" or a "consulting trustee," is invited to attend and provide input at the OUST's initial informal interview, the Bankruptcy Court's 60-day status conference, and other important hearings in the case, and is obligated by statute to "facilitate the development of a consensual plan of reorganization." Section 1183(b)(7). This trustee may even interface with creditors in negotiations. This is a novel and unique role for a bankruptcy trustee, and the extent to which the promise of this role is actualized remains to be seen.

The OUST is anticipated to appoint sophisticated business people to serve as Subchapter V trustees, most likely lawyers with expertise in financial projections and win-win mediations. The trustee's fees and costs will be payable by the debtor, but trustees will be discouraged from hiring their own professionals. Trustees' fees and costs may be paid over time under nonconsensual Subchapter V plans, and trustees have discretion to accept payment over time under consensual plans.

Unlike a Chapter 7 trustee, who has a duty to investigate the debtor's affairs, or a Chapter 13 trustee, who scrutinizes the debtor's expenses and is the disbursing agent in every case, the Subchapter V trustee serves a unique role as a facilitator whose primary purpose is to assist the debtor in making its restructuring successful.

Cramdown, Other Novel Features

A defining new feature of Subchapter V Chapter 11 plans is the cramdown opportunity, which allows owners to confirm a plan in which they retain their ownership of the business over the nonacceptance of the plan by an impaired class of claims that is not paid in full. In lieu of the absolute priority rule, the "fair and equitable" prerequisite is satisfied so long as creditors receive under the plan at least the value of the business's projected "disposable income" over a period of three to five years.

The calculation of this minimum payment, however, deducts from income all of the business's reasonable expenses, including the owner's salary, but which also may include a contingency reserve in appropriate circumstances. In this way, Subchapter V is akin to Chapter 13 cases for individual wage earners and Chapter 12 cases for family farmers, which allow confirmation without creditor consent, subject to what may be considered a business's "reasonable best efforts" to pay its creditors.

Subchapter V also allows the opportunity for a speedy consummation of the plan by permitting the disposable income minimum amount to be paid in a lump sum after confirmation. Subchapter V plans may provide, for example, for discharge of all dischargeable claims upon a lump-sum payment to be funded from exit financing or other means after plan confirmation, which further speeds the reorganization.

Significantly, only the debtor may file a plan in a Subchapter V case. The plan must be filed within 90 days of the petition date, unless the Bankruptcy Court in its discretion grants more time, and the debtor is free to amend its plan any time before the plan is confirmed. There is no deadline by when the debtor's plan must be confirmed. While the debtor's plan must be filed in good faith, the debtor's control over the plan deprives creditors of the strategic leverage of potentially offering a competing plan or otherwise seeking to end the debtor's exclusive right to file a plan.

While most secured debt is treated the same as in traditional Chapter 11 cases, Subchapter V allows the restructuring of mortgages that are secured by the debtor's primary residence so long as the proceeds were used for the debtor's business purposes. This presents a prefiling planning opportunity to refinance a purchase-money mortgage secured by the business owner's residence, if possible, provided the proceeds are used for "commercial or business activities."

Another novel feature of Subchapter V is that the debtor's counsel may be owed up to $10,000 on the petition date, which may be paid off under the Subchapter V plan. Such prepetition debt will no longer disqualify counsel for not being disinterested.

Because there is no separate disclosure statement, Subchapter V plans are required to include certain factual information. This includes the debtor's relevant history, a description of the purposes and workings of the plan, the liquidation analysis, and, most importantly, the financial projections showing how the plan payments are to be made.

Subchapter V plans are also to include fallback provisions to take effect if the plan payments are not made. Debtors have lots of flexibility in this regard, including, for example, to provide for the liquidation or a going-concern sale of the debtor's nonexempt assets, the terms of which may be specified in the plan (*e.g.*, in a sale, the bidding procedures, stalking horse protections, and closing particulars). This allows the contingency plan to be implemented after a default of plan payments without the need to return to the Bankruptcy Court for approval of the liquidation, going-concern sale, or other consequences for which the plan provides.

Cooperation toward a consensual Chapter 11 plan is encouraged by two unique features of Subchapter V as compared to traditional Chapter 11 cases. First, the facilitating trustee is available to assist in laying the groundwork for negotiations with creditors. Second, while the debtor is not required to obtain creditor consent so long as the disposable income test is satisfied, the debtor stands to benefit from confirming a consensual plan—and thus has an incentive to negotiate with creditors—including the debtor's ability to obtain its discharge upon plan confirmation rather than after the required payments have been made under a nonconsensual plan.

Moreover, the Subchapter V trustee's role will be terminated upon substantial consummation of a consensual plan, whereas the trustee is to be the disbursing agent under a nonconsensual plan, creating more trustee's fees, unless the plan provides otherwise.

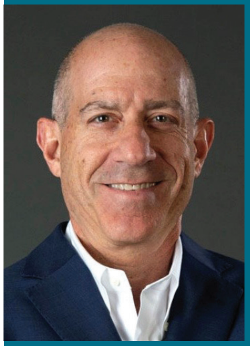
Open Questions

New Subchapter V provides eligible small businesses the welcome opportunity to maximize value for equity owners and creditors alike through financial restructuring in a Bankruptcy Court-supervised process. At the same time, this new law provides lawyers and judges the chance to shape Subchapter V in ways the drafters and Congress were unable or unwilling to address.

One open question, for example, is whether the effective shutdown of the economy and delayed return to normal business activity in the wake of the COVID-19 pandemic will justify extending the 90-day deadline for debtors to file plans. Questions pertaining to qualifications for Subchapter V relief include the extent to which certain personally incurred debt may qualify as arising from "commercial or business activities," and the nature and extent of operating activities sufficient for real estate owners to qualify for Subchapter V. Other unknowns include whether the calculation of a business's disposable income permits payments to individuals for taxes generated by pass-through entities, and the extent to which Subchapter V trustees will positively impact restructuring success rates.

In light of analyses showing that as many as half of all Chapter 11 cases filed last year would have been eligible to use this new Subchapter V had it existed, and the economic wreckage of COVID-19, this new subchapter is likely to have a substantial positive impact on Chapter 11 proceedings in the near and intermediate terms, if not for many years to come.

The opinions and statements made herein are for scholarship purposes only and do not necessarily reflect the opinions of the author or his law firm.



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