

ALERTS

Considering the Small Business Reorganization Act

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The Small Business Reorganization Act of 2019 is a new streamlined bankruptcy process for businesses that qualify as a small business and took effect on February 22, 2020. The act is commonly known as "Subchapter V".

Summary for Small Business Debtors:

To qualify as a small business debtor, the debtor must be a person or entity engaged in commercial or business activity with aggregate secured and unsecured debts not exceeding \$2,725,625. As a result of the COVID-19 pandemic, Section 1113 of the CARES Act temporarily increases the debt limit to \$7,500,000. This increased debt limit only applies to cases filed on or after March 27, 2020 and is valid for one year. For cases filed from and after March 28, 2021, the debt limit will be reduced back to \$2,725,625.

Single asset real estate debtors are specifically ineligible for relief under Subchapter V. A single asset real estate debtor is a debtor who derives substantially all of its gross income from the operation of a single real property.

There is no requirement that a small business debtor remain engaged in the commercial or business activity after filing for bankruptcy, but the debtor must show that at least 50 percent of its pre-filing debts arose from such activities. Upon electing the Subchapter V bankruptcy, the debtor must file a copy of the business's most recent balance sheet, statement of operations, cash-flow statement, and federal income tax return, or a sworn statement that such documents do not exist, to prove eligibility.

Notable provisions of the Bankruptcy Code available to Subchapter V small businesses include:

- *Appointment of a Trustee* - Subchapter V provides for the appointment of a trustee to oversee the bankruptcy process. The trustee's duties are significantly more limited than those of a trustee in bankruptcy proceedings under other chapters of the Bankruptcy Code. The more limited scope of duties include facilitating the development of a consensual reorganization plan, appearing at major hearings in the case, and ensuring that a debtor commences making timely payments under a plan.
- However, the court can strip a small business debtor of its management powers for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the commencement of the bankruptcy case or for failure to perform its obligations under a confirmed plan. If that happens, then the trustee takes over the operation of the debtor's business.

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- *Streamlining Reorganization* - There is a set schedule that a debtor must file in a Subchapter V. Only the debtor can propose a plan of reorganization, which must be submitted within 90 days of the bankruptcy filing. Within 60 days of the filing, the bankruptcy court is expected to hold a status conference to assist with resolution of the case. At least 14 days prior to the conference, the debtor is required to file a report detailing its efforts to attain a consensual plan of reorganization. These deadlines are hard deadlines. The court can only extend these deadlines under "circumstances for which the debtor should not justly be held accountable." The court does not have to approve a separate disclosure statement, thereby reducing the time and expense necessary to confirm the debtor's plan.
- *No committee* - Absent an order from the court, there will not be a committee of unsecured creditors. This will further reduce costs of bankruptcy for small businesses. A committee will be an exception and not the rule.
- *Elimination of the Absolute Priority Rule* - In a typical reorganization, a small business debtor must pay all creditors, including unsecured creditors, in full if the business's owners wish to retain their ownership interests. This requirement is not applicable to Subchapter V. Rather than paying all creditors in full, owners can retain ownership by confirming a plan that does not discriminate unfairly among creditors, is fair and equitable, and provides that the small business will contribute its projected disposable income to the plan for three to five years.
- *Modification of Certain Residential Mortgages* - Subchapter V offers a unique restructuring tool to individual debtors. An individual who operates as an eligible small business may modify a mortgage secured by a residence if the underlying loan was for commercial purposes. This is a change from existing law that generally prohibits modification of mortgages secured by a principal residence.
- *Delayed Payment of Administrative Expense Claims* - Subchapter V does not require payment in full of priority or administrative claims on the day the small business emerges from bankruptcy. Such claims often includes taxes, goods and services provided to the small business during bankruptcy and attorneys' fees. A small business debtor may now stretch payment of these claims out over the term of the plan, which will last three to five years. This significantly reduces the working capital burden that a debtor would typically experience upon reorganization.
- *Discharge Limitations* - If the creditors confirm a consensual plan, then the debtor is entitled to a discharge of all debts and liabilities upon confirmation. If the court confirms a nonconsensual plan over creditor objections, then the debtor receives a discharge after completing all payments due within the first three years of the plan, unless otherwise ordered. If all such payments are made, then the debtor would be relieved of liability except for future payments due under the plan. As is usual, there are exceptions for fraud or criminal charges.
- *Preferences* - The Small Business Reorganization Act also includes changes, applicable to all bankruptcy cases, to the preference or "clawback" actions where a trustee or debtor seeks to recover money from creditors who received property, liens or payments in the 90-days before the bankruptcy filing. The debtor is now required to exercise reasonable due diligence under the circumstances "taking into account a party's known or reasonably knowable affirmative defenses" before filing a preference lawsuit. Previously, a debtor or trustee could file against creditors irrespective of defenses to obtain nuisance payments; the debtor may now file preferences only after taking stock of known or reasonably known defenses. Further, if the preference claim is less than \$25,000, then the preference suit must be brought in the federal district

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where the creditor resides. This is welcome news for any creditor who receives a small-dollar preference demand or lawsuit in connection with an out-of-state bankruptcy proceeding.

Summary for Creditors of a Small Business

While the Subchapter V provisions help small businesses emerge quickly and economically, they do remove many protections normally afforded creditors.

- In most business cases, a committee is appointed to advocate on behalf of unsecured creditors. In Subchapter V, a committee would be an exception, not the norm.
- A non-consensual plan can be confirmed by the court upon a finding that the plan does not discriminate, even if every creditor objects to its confirmation. In bankruptcy proceedings not under Subchapter V, a plan must be supported by at least one impaired class.
- There is no absolute priority rule, so an owner can retain its equity in the debtor without contributing new value so long as all disposable income is paid to creditors over a three to five-year period.

In light of the new law, creditors should consider the following when dealing with a small business that would qualify as a debtor under Subchapter V:

- When entering into new loans:
 - Insist on liens upon assets with equity, including a pledge of ownership interests; and
 - Require financial reporting to determine the eligibility of the borrower for relief under Subchapter V.
- When settling a default prior to bankruptcy and negotiating a settlement agreement:
 - Insist upon entry of a judgment - or, at the very least, an admission of liability - exceeding \$2,725,625 (or \$7,500,000 until March 2021) in order to disqualify the business from Subchapter V relief;
 - If applicable, obtain admissions of wrongdoing in the settlement agreement, because debts that are non-dischargeable under other chapters of the Bankruptcy Code remain so under Subchapter V; and
 - Focus on anything that may create a lien or property interest, such as a writ of attachment, lis pendens, or judgment lien, as these will increase the chance of a substantial payment.