

Small Business Reorganization Act 2019

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Small businesses in financial distress have, over the past several decades, found it increasingly difficult to avail themselves of chapter 11 to effect a financial restructuring. Why? Simply put, the cost and time. Chapter 11's "one-size fits all" approach² ultimately proved to be wrong.

The result: myriad failed chapter 11 cases, more businesses liquidating in Chapter 7, and the rise of the use of Chapter 11 alternatives, such as receiverships, assignments for the benefit of creditors (ABCs) and Article 9 sales.³

These alternatives, to be clear, are not bad from the perspective of the debtor and its principals but they do have limitations as compared to Chapter 11. Gee, whiz, if only there was a way to get all those advantages without the cost...

That's what this article is about because after waiting...waiting on the Code to change (apologies to John Mayer) for so long, the "little guy" finally has Subchapter V of Chapter 11- designed to deliver all the benefits of traditional Chapter 11 at a fraction of the cost, and without some of the onerous confirmation requirements that so often stand in the way of reorganization.

Drawing support from bipartisan legislators, and drafted in consultation with the American Bankruptcy Institute (ABI) and the National Conference of Bankruptcy Judges (NCBJ), the principal features of the SBRA are intended to: (i) further streamline and simplify existing bankruptcy procedures and provide new mechanisms to increase a small business' ability to achieve a successful restructuring; and (ii) mitigate some of the challenges currently faced by small business debtors in a traditional Chapter 11 bankruptcy.⁴

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While the Bankruptcy Code is not exactly a "one-size fits all" tool, little distinction existed between the rules and case law governing a small business debtor case and a mega business reorganization case involving multi-million-dollar companies. For further discussion, see generally Friedland, Bernstein, Kunej and Ayer, *Chapter 11 - 101 The Nuts and Bolts of Chapter 11 Practice: A Primer*, NACM Oregon, Issue 8.15 (May 2009), [https://www.nacmcommercialservices.org/files/8.15 Chapter 11 - Small Business Provisions.pdf](https://www.nacmcommercialservices.org/files/8.15%20Chapter%2011%20-%20Small%20Business%20Provisions.pdf).

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Rising costs, time, and extensive creditor involvement are only a few of the disadvantages that have pushed small distressed businesses away from Chapter 11 and into the arms of nonbankruptcy alternatives. For more discussion, see generally Friedland, *RISE OF THE ALTERNATIVES: the increasing use of alternatives to chapter 11 bankruptcy for selling an insolvent business in the United States*, June 3, 2019, <https://www.linkedin.com/pulse/rise-alternatives-jonathan-friedland/>.

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See generally <https://www.congress.gov/congressional-report/116th-congress/house-report/171/1>.

Subchapter V went into effect on February 19, 2020, and only a few court decisions interpreting some of its provisions have been rendered as of the publication of this article. Because Subchapter V is such a departure from prior law and because many of its provisions are subject to more than one interpretation, speculating on how it will work in practice is a dangerous task. But, hell, we've been known to [run with scissors](#), so here we go...

Who is Subchapter V meant for?

A week from now, Bob Businessowner calls you up and tells you his tale of woe. Bob and his wife started BobCo, Inc. (BobCo) five years ago. BobCo is in the business of making and selling widgets. Due to a combination of factors, BobCo is suffering financially (and Bob is suffering emotionally). BobCo is highly leveraged, its bank debt is too much to service given the economic realities facing the widget industry: rent is too high, a liquidation of its assets wouldn't pay the bank off in full (let alone BobCo's other creditors), and it's fallen behind in paying its trade vendors.

Without Subchapter V, a Chapter 11 reorganization may not be a practical option for BobCo simply because of the high costs. So, you begin thinking about Chapter 11 alternatives to get BobCo some financial breathing room. A year ago, your mind would (should) have gone to options like trying to buy the company back through an ABC or an Article 9 sale.

But, wait... now that Subchapter V is effect, you have another tool at your disposal. To see if BobCo is eligible for Subchapter V, you need Bob to give you some information. As a result of your skilled questioning, Bob tells you:

1. He and his wife are the sole shareholders of BobCo.
2. BobCo owes the Bank approximately \$1.2 million on a business loan. The Bank has a security interest in all of BobCo's assets.
3. BobCo has missed several payments on the Bank loan and it's in default.
4. BobCo owes trade vendors an aggregate of \$500,000 in debt. Some of its essential vendors are still shipping it goods.
5. Several of its trade vendors have stopped doing business with BobCo and have filed lawsuits to collect on the unpaid amounts. Bob expects other vendors will sue BobCo soon and continuing to operate will become increasingly difficult.
6. BobCo leases a warehouse for its widget operations. BobCo is late on rent payments.

After what you hear from Bob, you decide that BobCo is in fact a suitable candidate for Subchapter V bankruptcy. You proceed to tell Bob how Subchapter V works, contrasting it with traditional Chapter 11.

Is BobCo a "Small Business Debtor" under Subchapter V?

You begin by explaining to Bob that BobCo needs to qualify as a "small business debtor" under the Bankruptcy Code. A "small business debtor" is a person or entity that is engaged or has

been engaged in commercial or business activities with aggregate secured and unsecured debts of no more than \$2,725,625⁵.

Under Subchapter V, BobCo is required to demonstrate that at least 50 percent of its debts arose from commercial or business activities. Meeting this new element isn't an issue for BobCo but if Bob needs to also consider filing bankruptcy (not uncommon given that small business owners often personally guaranty the debt of their businesses), then he also needs to pass this test.

How does BobCo obtain Subchapter V treatment?

A debtor, like BobCo, must affirmatively elect⁶ to be treated under Subchapter V at the time⁷ it files its Chapter 11 petition. If it does not so elect, and also doesn't elect to be administered under the non-Subchapter V small business provisions⁸ under the Code, then the case will proceed to be administered as a standard Chapter 11.⁹ In sum, Chapter 11 can now be administered in three possible ways: "regular" Chapter 11, small business provisions, and Subchapter V.

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The Coronavirus Aid, Relief and Economic Security Act ("CARES Act"), enacted into law on March 27, 2020, expanded the eligibility threshold for debtors filing under Subchapter V from \$2,725,625 to \$7,500,000. The debt threshold will revert to \$2,725,625 within *one year* of the CARES Act being enacted into law.

Note, the Bankruptcy Code's definition of "small business debtor" was not amended by the CARES Act, troubled businesses who are electing to have their estate administrated by the small business provisions of the Bankruptcy Code are still limited by the \$2,725,625 debt cap referenced in the "small business debtor" definition. The CARES Act amends §1182(1) of the Code to expand the debt threshold for debtors electing Subchapter V administration of their case.

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The statute doesn't explicitly discuss how the debtor can make the Subchapter V election. Proposed changes to the voluntary petition forms require the debtor to check a box indicating it seeks Subchapter V treatment.

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At least one bankruptcy court has held a pending Chapter 11 case may be re-designated to a Subchapter V case after the SBRA took effect.

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Congress has previously attempted to address challenges faced by small business debtors in Chapter 11. First, in 1994, it attempted to reduce costs and streamline cases by providing for a combined hearing on plans and disclosure statements for debtor with up to \$2MM in debt. In 2005, through BAPCPA, Congress tried again by reducing costs of a case by decreasing the role of creditors' committees in small business Chapter 11 cases, but increasing the required financial disclosures from the debtor, and increasing the role of the UST in the case. These prior changes are still part of the Code and will apply when a debtor elects to be treated under Subchapter V. The rules governing confirmation of a Chapter 11 plan were still the same for all business entities – big or small. Congress gives it another shot in 2019 with the SBRA.

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See FRBP 1020.

Where will BobCo’s duties end & the Subchapter V trustee’s begin?

Once BobCo files Chapter 11, it becomes a debtor-in-possession (DIP), just like in a regular Chapter 11 case. Akin to a regular Chapter 11, a Subchapter V debtor has certain rights and duties delineated in both §§1108 and 1184 of the Code.

BobCo must comply with the Bankruptcy Code’s regular reporting requirements, plus some. Stated differently, BobCo, as a debtor-in-possession under Subchapter V is obligated to “check in” with the court about its financial operations more than other Chapter 11 debtors.

Another new obligation under Subchapter V is the requirement that the debtor work with a Subchapter V trustee, appointed by the United States Trustee (UST).¹⁰ The role of a Subchapter V trustee may be generally described as combination of a “financial guru” and a “mediator” – she exits to supervise and monitor the Chapter 11 case, and help facilitate a plan of reorganization.¹¹ The SBRA lays out certain duties unique to a Subchapter V trustee¹² while eliminating others that Chapter 11 trustees would normally have.¹³ Nonetheless, it leaves much to be interpreted by case law that has yet to be decided.

No Creditors’ Committee & No UST Quarterly Fees

The SBRA eliminates the automatic appointment of an official committee of unsecured creditors (which applies in both small debtor cases administered under Subchapter V and non-Subchapter V), unless a court orders otherwise *for cause*. While committees are important parties in interest in Chapter 11 bankruptcies, the cost of hiring counsel to represent the committee and actively participate in Chapter 11 is costly and onerous on small business debtor estates, particularly since legal fees are borne by the estate. This is another win (and another dollar) for the BobCo estate to help with facilitating a successful reorganization.

Also absent in a Subchapter V case is the UST quarterly fee. There simply is none.

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Subchapter V gives the UST wide latitude in who it selects as trustee, the UST can appoint an individual under §586 to serve as standing trustee, a disinterested person on a case-by-case basis, or can serve as trustee in the case, if necessary.

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See §1183(b)(7).

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See generally §1183.

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See generally §1106 – generally requiring a trustee to investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor’s business, and the desirability of the continuance of the business, and any other matter relevant to the case or to the formulation of a plan – is not applicable in a Subchapter V case.

No Disclosure Statement

In other good news, BobCo is not required to file a disclosure statement unless the court orders otherwise *for cause*.¹⁴ If the court does so order, the existing disclosure statement requirements for small business cases in Bankruptcy Code §1125(f) will apply to BobCo.¹⁵

BobCo's Plan of Reorganization

Unlike regular Chapter 11 where parties, other than the debtor, are allowed to file a plan, Subchapter V is reserved for the debtor – only the debtor can file a plan.¹⁶ The debtor, however, *must* file a plan within 90 days of the bankruptcy filing – although the court may extend the deadline if the debtor shows that it should not be held accountable for any delay.¹⁷ Moreover, and in stark contrast to a regular Chapter 11, the Subchapter V debtor faces no hard deadline to get its plan confirmed.

Subchapter V does not require that the plan contain “adequate information” and, ironically, no judicial oversight exists to confirm the requisite information in the plan is indeed accurate.

Game Day: Confirming BobCo's Plan

Whether a small business debtor elects Subchapter V treatment or not, there are only two pathways to getting a plan confirmed: consensual and “cramdown.” Generally, §1129(b) will not apply in a Subchapter V case. Instead, §1191(b) revises the cramdown rules to allow cramdown confirmation even if all impaired classes do not accept the plan.¹⁸ If a plan is confirmed under the cramdown provisions of §1191(b), it allows administrative expenses to be paid over a period of time through the plan, rather than having to be paid in full on the effective date. The cramdown requirements for treatment of secured claims under §1129(b)(2)(A) will, however, still apply.¹⁹

Under Subchapter V, Bob and his wife can retain their equity in BobCo even if non-accepting creditors are not paid in full, so long as the plan does not discriminate unfairly, and is

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See §1190(1). In exchange for eliminating the disclosure statement requirement, the plan must at least include history of the debtor's business, projections, and liquidation analysis.

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See §1187(c).

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See §1189(a).

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See §1189(b).

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See generally §1191(e).

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See §1191(c)(1).

fair and equitable with respect to each class of claims or interests.²⁰ *This is groundbreaking* and is a critical distinction from a regular Chapter 11 in which a debtor must comply with the “absolute priority rule,” which requires that any equity holder seeking to reorganize under Chapter 11 to contribute to the plan to maintain their equity interest.

In exchange for this increased flexibility, the SBRA does impose other constraints not found in regular Chapter 11. If a trustee or holder of an unsecured claim objects to the plan, the court cannot approve the plan unless the plan provides that all of the small business debtor’s projected “disposable income” received during the period of the plan will be applied to make payments under the plan for three to five years.²¹

The SBRA modifies the definition of “property of the estate” to include the debtor’s post-petition assets and earnings. Pre-SBRA, the debtor’s acquired assets and earnings postpetition were not included in the bankruptcy estate, except when the debtor is an individual.²² This definition, which is almost identical to §1306, assures that the debtor’s postpetition assets are allocated to funding a plan of reorganization and that they are protected by the automatic stay.

If a consensual plan is confirmed under Subchapter V, the property of the estate includes the debtor’s earnings and property acquired post-petition but before the confirmation date.²³ If, however, the plan is confirmed through a cramdown, property of the estate includes property acquired post-petition *and post-confirmation*.

If the court confirms a consensual plan under §1191(a), the Subchapter V debtor receives a discharge under §1141(d) *upon confirmation*.²⁴ The Subchapter V trustee will remain a key player in the case until the plan is substantially consummated, which would usually mean when distributions under the plan begin. She may be reappointed for cause if her duties were terminated earlier because the plan was substantially consummated.

If a plan is confirmed pursuant to a cramdown under §1191(b), in contrast, a discharge will not be granted until the debtor completes payments under the plan, and the Subchapter V trustee’s

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See §1191(b) and (c).

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See §1191(c)(2)(A). For further discussion, see Friedland and Jouglaf, *Some Financial Help for the Little Guy: President Trump Does Something Uncontroversial for a Change and Signs Four New Bankruptcy Bills into Law*, DailyDAC (August 27, 2019), <https://www.dailydac.com/bankruptcy-code-revised-a-review-of-the-sbra-and-other-reforms/>.

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See §1181(a) noting that §1115 is inapplicable to a Subchapter V case.

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See generally §1186(a).

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The effect of the discharge will be termination of automatic stay under §362(c)(2)(C) of the Code.

services will not end at confirmation. Instead, she must continue to serve until the case is converted, discharged, or dismissed.

Conclusion

Now that Bob somewhat understands how Subchapter V works, he is probably hopeful that Subchapter V can give BobCo a chance at reorganizing instead of simply liquidating. However, there are a lot of questions that the SBRA doesn't answer, which means that there will be a level of uncertainty surrounding a Subchapter V case that can be avoided by proceeding down an alternative (i.e. non-bankruptcy) path. Moreover, depending on a debtor's (and its owner's) goals, a bankruptcy alternative may be a better path than Subchapter V, even without regard to its yet-to-be resolved ambiguities. Regardless, however, Subchapter V certainly presents a new and promising option for smaller businesses in financial distress.

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