

# *Congress Makes Small Business Bankruptcy Faster, Easier, And Hopefully Cheaper* ©



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The Small Business Reorganization Act of 2019 (the “Act”) was enacted into law on February 22, 2020. The Act is the latest effort on the part of Congress to streamline the chapter 11 process for smaller, middle market businesses that had insufficient assets to fund a typical chapter 11 bankruptcy reorganization. Under the Act, a small business debtor will be allowed reorganization under what is now called Subchapter V of chapter 11.

The Act is new and there are still open issues and Federal and Local Rules to be finalized to facilitate Subchapter V. The following is a general overview of the new law.

## **A. Who Can Be a Small Business Debtor?**

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 of \$2,725,625<sup>1</sup>. The only excluded activity for the small business debtor is operating “single

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<sup>1</sup>The Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”) signed into law on March 27, 2020, expanded the debt ceiling will be raised to \$7,500,000 from \$2,725,625 thus expanding for the next year the number of small businesses eligible for relief during the COVID-19 pandemic.

asset real estate,” another defined term in the Bankruptcy Code that describes a debtor who derives substantially all of its gross income from the operation of a single real property.<sup>2</sup>

There is no requirement that the Subchapter V debtor remain engaged in the commercial or business activity post petition, but the Subchapter V debtor must show that at least 50 of its pre petition debts arose from such activities. This is jurisdictional, and is part of the Courts gate keepers function. For example, an individual with \$100,000 in business related debt and \$90,000 in consumer related debt is eligible to file as a small business debtor and reorganize under Subchapter V.

## **B. Operating as a Subchapter V Debtor Under the Act.**

What is clear is that the Subchapter V debtor is still subject to a number of general requirements which control the actions of chapter 11 debtors. For example, after filing a Petition a Subchapter V debtor may operate in chapter 11 as a debtor in possession (the “DIP”) and is obligated to file the schedules and statements required of

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<sup>2</sup> Debtors who are primarily engaged in a single real estate enterprise are now covered by other provisions of the Code. See, § 101(51B).

all debtors by § 521 of the Bankruptcy Code. As with all chapter 11 debtors, the court can strip a small business debtor of its debtor in possession 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. See 11 U.S.C. See § 1185(a). If the DIP is removed from power the Small Business Trustee (defined below) takes over the operation of the debtor's business with the right to prosecute a Plan and close the case. However, the bankruptcy court and the U.S. Trustee may not appoint a traditional chapter 11 trustee or examiner in a Subchapter V case. See Id. §1181(a) (stating that §§ 1104, 1105, and 1106 do not apply in a Subchapter V case). On request of a party-in-interest (which presumably includes the debtor or its principals), the court may reinstate the debtor as the DIP. See Id. § 1185(b).

### **C. The Roles of the Committee and Professionals in Subchapter V Cases.**

A review of the Congressional record supporting the Act shows that the key issues addressed were (1) how to control the traditional costs of chapter 11 cases and (2) reduce the time spent before the courts. The Act addresses these points.

The default rule in chapter 11 cases is that the U.S. Trustee could appoint an official committee of unsecured creditors. See 11 U.S.C. § 1102(a)(3). If a committee is appointed, the committee has the right to retain its own

professionals at the cost of the DIP, thus increasing the overall cost of the chapter 11 case. The Act eliminated the appointment of committees in Subchapter V cases “unless the court orders otherwise.” See Id. § 1181(b). Hence under the Act, creditors’ committees will be the exception, not the rule, in Subchapter V cases.

Professionals are not disqualified from being employed by the estate under § 327, *et seq.* of the Code if they hold a claim against the debtor of less than \$10,000 that arose prior to the commencement of the case. See Id. § 1195. This flexibility in professional retention acknowledges the reality that a small business debtor may lack the cash flow to provide its bankruptcy counsel with a retainer prior to filing bankruptcy or that the small business may wish to employ existing general counsel to prosecute the Subchapter V case.

### **D. The Role of the Small Business Trustee.**

Every case under Subchapter V will have a trustee appointed by the U.S. Trustee (the Small Business Trustee). Most courts have employed a panel of specific Subchapter V Small Business Trustees who are also on the chapter 7 or chapter 13 panel trustees. Given the unique structure of Subchapter V, it incorporates provisions of chapters 12 and 13 of the Code, thereby assigning the Small Business Trustee a role similar to the chapter 13 trustee in a consumer bankruptcy case. He or she will act as a conduit for plan payments and have the authority to investigate the financial affairs of the Subchapter V

debtor and object to the allowance of proofs of claim. See *Id.* §§ 1183, 1194.

Specifically, the Small Business Trustee is also expected to appear and be heard at plan confirmation and has a general obligation to “facilitate the development of a consensual plan of reorganization.” The actual role the Small Business Trustee plays is assisting the Subchapter V debtor in working out an acceptable deal with the creditor base is unclear and developing. As described above, the Small Business Trustee is also authorized to operate the debtor’s business if the debtor is removed as a DIP (for cause). To address the issue of cost in a Subchapter V case the Small Business Trustee’s role is terminated upon “substantial consummation” of the confirmed plan.

#### **E. The Structure of the Small Business Debtor Reorganization Plan.**

As previously mentioned, the Congressionally mandated goals of Subchapter V are to minimize the time and expense of small business reorganizations. Thus, the Act specifies that within 60-days of the filing, the bankruptcy court is expected to hold a status conference “to further the expeditious and economical resolution” of the case. The role judges may play in assisting the Subchapter V debtor is in working out an acceptable deal with the creditors. Although, this role is not defined and is still developing. To assist the Judge and the Small Business Trustee in understanding the issues in the case, at least 14-days prior to the conference, the Subchapter V debtor is required to file a report

detailing its efforts to attain a consensual plan of reorganization. The debtor must file a plan 90-days after the order for relief. The court can extend this deadline only under “circumstances for which the debtor should not justly be held accountable.” What might be circumstances for which the debtor should not justly be held accountable is not defined but it is presume to be different is mere “cause” as used in other provisions of the Code.

Consistent with the ideal that Subchapter V cases are to be consensual, one of the most significant changes under the Act, is that only the Subchapter V debtor is allowed to propose a plan in a Subchapter V case. See *Id.* § 1189(a). In this respect, small business debtors enjoy the same perpetual plan exclusivity as do family farmers and fishermen under chapter 12 and consumer debtors under chapter 13. The small business debtor does not need to solicit plan acceptances with a separate disclosure statement. Instead, the Subchapter V plan itself must include a brief history of the business operations of the debtor, a liquidation analysis, and projections with respect to the debtor’s ability to make payments under the proposed plan. To this extent, the provisions applicable to regular chapter 11 cases for solicitation and plan confirmation do not apply. See *Id.* § 1126, *et seq.*

Drawing from chapter 12, for individuals who file under Subchapter V the Act offers a unique restructuring tool to small business debtors. An individual who qualifies as a small business debtor can modify the mortgage on his or her principal residence, provided that

the mortgage loan was not used to acquire the real property but was used primarily in connection with the debtor's business. See Id. § 1190(3).

Modification of consensual liens on principal residences is not possible in chapter 13 or ordinary chapter 11.

Thus, it is possible for the Subchapter V debtor to modify a secured creditor's claim in a small business reorganization by proposing a lower interest rate, extending the maturity date, and/or cramming the loan down to the value of the secured claim (the debtor might even attempt to "strip" the lien if it is junior to other liens). In this respect, small business debtors will acquire a modification tool that is currently available only to family farmers and fishermen under chapter 12. See Id. § 1222(b)(2).

Confirmation of a small business debtor plan of reorganization tracks the criteria of § 1129(a) of the Code, with the critical exception that the Subchapter V debtor does not need to obtain the acceptance of an impaired class of creditors. Drawing from chapter 13 practice, the small business debtor also has the flexibility to pay administrative claims of professionals and advisors over the life of the plan instead of in cash on the effective date. See Id. § 1191(e).

While the provisions of Subchapter V are designed to drive the parties in a Subchapter V case to be consensual, drawing both the judge and the Subchapter V Small Business Trustee into plan negotiations with creditors early in the case, cramdown is alive and well in Subchapter V. With respect to secured claims, cramdown is identical to

an ordinary chapter 11 case. The debtor must comply with § 1129(b)(2)(A) to cramdown a secured claim. See Id. § 1191(c)(1). To be clear, § 1129(b)(2)(B) and (C) do not apply in Subchapter V. This means that equity holders can retain their interests in the business even if the plan does not pay unsecured claims in full. As long as the plan "does not discriminate unfairly, and is fair and equitable" with respect to impaired unsecured creditors, the court shall confirm the plan. Section 1111(b) is unaddressed in the Act and may be available to secured creditors at the point of plan confirmation.

Using a hybrid of chapter 11 and chapter 13 concepts, "fair and equitable" under the Act means that the small business debtor must commit all of its "projected disposable income" or property of equivalent value to make payments under the plan for a minimum of three and a maximum of five years (the "Income Commitment Period"). See Id. § 1191(c). In any plan, the debtor must agree to turn over so much of its future income to the Small Business Trustee as is necessary to fund the plan. See Id. § 1186. "Disposable income" means income received by the debtor that is not reasonably necessary to (1) maintain and support the debtor or a dependent, (2) satisfy domestic support obligations that become first payable post petition, or (3) ensure the continuation, preservation, or operation of the business. See Id. § 1191(d).

As in chapter 11, the debtor must demonstrate a "reasonable likelihood" that it will be able to make all payments under the plan, and the plan must provide "appropriate remedies, which

may include the liquidation of nonexempt assets” to protect creditors if the debtor fails to make plan payments. If the Subchapter V plan is confirmed under the § 1191(b) “cram down” provision, then all property specified in § 541 that the Subchapter V debtor acquires post petition and before the case is closed, dismissed, or converted becomes property of the estate. See *Id.* § 1190(2). Presumably, this means that the Subchapter V debtor cannot use the property outside the ordinary course of business without court approval.

The debtor can modify the plan prior to confirmation, provided that the plan complies with § 1122 (classification of claims and interests) and § 1123. The debtor can modify a plan confirmed under § 1129(a) only if it has not been substantially consummated and the court finds, after notice and a hearing, that circumstances warrant modification. See *Id.* § 1193(b). If the plan was confirmed under § 1191(b), then modification is allowed only during the Income Commitment Period. Because § 1125 does not apply in Subchapter V, the debtor does not need to provide a disclosure statement for the modified plan.

#### **F. Discharge Under Subchapter V.**

If the plan is confirmed under § 1191(a), then the standard discharge provisions of § 1141(d) will apply to discharge debts at confirmation. If the debtor makes use of the § 1191(b) cramdown provisions, however, then a discharge enters “as soon as practicable” after the debtor completes all payments due within the Income Commitment Period. Discharge does not extend to debts on which the last payment is due after the Income Commitment Period (e.g., long term mortgage loans). See *Id.* § 1192.

#### **G. Conclusion**

At first sight, Subchapter V appears to have significantly reformed small business debtor reorganization under chapter 11. The elimination of creditors’ committees, perpetual plan exclusivity, and the support of a Small Business Trustee are measures intended to give more small businesses a chance at reorganizing instead of simply liquidating. Ultimately, Subchapter V’s success or failure may turn on whether enough “small” businesses qualify to utilize its debtor friendly provisions and how the judges and Small Business Trustee’s exercise new roles under the Act.