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The Small Business Reorganization Act and Other Recent Changes to Bankruptcy Law

Steve Roach, Ron Spinner, and Marc Swanson

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Small Business Reorganization Act–Overview

- Belief that chapter 11 is too expensive, restrictive for small businesses
- Act adds “subchapter V” to chapter 11
  - Debtors can still choose a traditional chapter 11 if they wish
  - Must “elect” to proceed under this new subchapter
- Subchapter V designed to be more affordable
  - Presumption that there will be no unsecured creditors committee
  - No United States Trustee fees
  - Debtor needs to file plan within 90 days

Small Business Reorganization Act–Overview

- Limited creditor leverage, though
  - Debtor need not pay unsecured creditors in full for owner to retain interest
    - *I.e.*, no "absolute priority rule"
  - No impaired accepting class needed to cram down a plan
  - Creditors cannot file a competing plan
  - Can modify the security interest in an individual debtor's primary residence
    - Value received for the security interest must have been primarily used in connection with the debtor's business, not to acquire the property

The Small Business Reorganization Act

- On August 23, 2019, Small Business Reorganization Act was enacted
  - Its provisions become effective February 19, 2020
  - Main change—create a new "subchapter V" to chapter 11 for small business debtors
- The Small Business Reorganization Act does not cover everyone
  - Total debt limit of $2,725,623 to qualify*
    - Seems low, but should cover up to 40% of current chapter 11 filings
    - There is already talk of raising this number to $10,000,000 – may try to do in conjunction with a pending venue reform bill**
  - Single Asset Real Estate (SARE) debtors are not eligible for this process
  - At least 50% of the debt must have arisen from commercial or business activities to qualify
- If a small business files, the SBRA allows the business owner to file under the SBRA as well

* Raised to $7,500,000 for one year as a result of passage of the CARES Act.

** If passed, the venue reform bill (H.R. 4421 "Bankruptcy Venue Reform Act of 2019"), would make it difficult to file bankruptcy cases other than in the district of a business's principal place of business. The current bill would apply to all chapters of the Bankruptcy Code, including SBRA.

The Subchapter V Trustee

- United States Trustee will appoint a trustee to act in each case
- US Trustees have set up panels of pre-qualified trustees, just like for chapter 7 and chapter 13 cases
  - Other individuals can be appointed as trustee, though it is not as clear on how such individuals get compensated
- Subchapter V trustees intended to be financial advisors, not lawyers
- Duties similar to a chapter 13 trustee

The Subchapter V Trustee (continued)

- Trustee also makes sure that debtor commences timely payments under a confirmed plan or, if the plan is confirmed by cramdown, to make those payments
- If debtor is removed as debtor in possession, trustee is to operate the small business
- Termination of trustee's services
  - Terminated if case converts to another chapter
  - If a consensual plan is confirmed, trustee's services end when plan is substantially consummated (usually at first distribution under plan)
  - If plan is crammed down, trustee makes the plan payments except as plan or court order provides otherwise
    - Thus, trustee serves while plan is in effect

Plan and Confirmation

- Plan must contain the debtor's history, liquidation analysis, and projections to show plan payments can be made
  - This replaces traditional "disclosure statement"
  - If insufficient, or if cause exists, court can require a disclosure statement
- If plan meets all current applicable chapter 11 requirements (including consent by all classes of claims), then court must confirm it
  - Note – like now, consent by all classes does not mean consent by all claimants
    - A class accepts the plan if enough creditors with claims in that class accept the plan such that, not counting insiders,
      - More than one-half of allowed claims in the class accept the plan, and
      - At least two-thirds of the amount of allowed claims in the class accept the plan
  - Still, every dissenting unsecured creditor must receive as much as it would in a hypothetical chapter 7 liquidation

Cramdown

- If an impaired class of claims does not accept the plan, the plan must be "crammed down" to be confirmed
- Court will cram down a plan if, for each impaired class that does not accept the plan, the plan
  - Does not discriminate unfairly
  - Is fair and equitable
- The first test is unchanged as to all claims, though it is still somewhat of a vague standard
- Fair and equitable rules for secured claims are unchanged
  - Claimant must retain liens and receive payment in full over life of plan,
  - Claimant must receive the indubitable equivalent of its claim, or
  - Debtor may sell claimant's collateral and transfer claimant's liens to the proceeds, and then apply either of the above two rules
- Fair and equitable rules do not define how unsecured claims should be treated, but instead apply to the plan overall

Cramdown – Fair and Equitable

- A plan is fair and equitable if
  - It generally provides that all projected disposable income of the debtor for at least the first three years of the plan (up to five years, if the court so requires) will be applied to make payments under the plan
    - Disposable income is income received by the debtor and not "reasonably necessary to be expended" for
      - Maintenance or support of the debtor or a dependent of the debtor
      - Domestic support obligations first payable after the petition is filed
      - Continuation, preservation, or operation of the debtor's business
  - The court finds that
    - The debtor will be able to make all plan payments or there is a reasonable likelihood the debtor will be able to do so, and
    - The plan provides appropriate remedies, which may include liquidation of nonexempt assets, to protect holders of claims and interests in case payments are not made

Original Chapter 11 Versus New Subchapter V

- Hypothetical facts
  - Bank has all asset lien and is owed $2 million
  - Debtor's assets worth $1.5 million
  - Bank thus has
    - $1.5 million secured claim
    - $500,000 unsecured claim
  - Debtor has additional $200,000 in unsecured claims
    - No other claims against the Debtor
- Debtor's Plan:
  - Bank's Secured Claim
    - Plan provides for a 30-year amortization; a balloon due in 5 years
    - Class is impaired
  - Unsecured Claims (Bank's $500,000 claim plus $200,000 other unsecured)
    - Plan provides for less than payment in full
    - Class is impaired
  - Equity
    - Debtor's owners retain their equity interests

Original Chapter 11 Versus New Subchapter V

- Original chapter 11 (no SBRA)
  - Bank votes “no” on both its secured and unsecured claims
  - Plan fails
    - No impaired accepting class (required)
    - Debtor’s owners retain equity interests (prohibited by absolute priority rule)
- New subchapter V (SBRA)
  - Bank votes “no” on both its secured and unsecured claims
    - Impaired accepting class requirement gone – plan does not fail on this ground
  - Bank objects to owners’ retention of equity in Debtor
    - Absolute priority rule gone - plan does not fail on this ground
  - But, “no” vote in either class sufficient to force contested confirmation
    - Cannot prevent confirmation, but can ensure that added protections of contested confirmation are in place
- Bank has other possible objections under SBRA
  - Treatment of secured claim (interest rate, etc.)
  - Feasibility
  - “Fair and equitable”

Cramdown – Other Effects

- A crammed down plan need not pay all administrative expenses as of the effective date—it can spread them over the life of the plan
- Payments under a crammed down plan are made by the trustee, not the debtor
- The discharge under a crammed down plan is more limited, in that
  - Certain debts may be found nondischargeable due to fraud, etc.
  - Debts on which the last payment is due after the first three years of the plan (extendable to the court to five years) are not discharged
    - This is a significant change to bankruptcy practices!

Important Notes

- Other rules in traditional chapter 11 cases do not go away!
  - Still need permission to use cash collateral
  - First day motions still necessary for
    - Payment of prepetition wages
    - Securing utility service
    - Debtor in possession loans
    - Continued use of existing accounts

Questions and Concerns

- How “hands on” will (or should) the trustee be?
- Will trustee try to surcharge secured creditor collateral for its fees?
- Will this subchapter prop up businesses that really should close?
- These are smaller cases – will they attract the best counsel?
  - Will they attract counsel familiar with chapter 13 cases, but not small businesses?
- How much projected income must be committed for a crammed down plan to be “fair and equitable?”
  - Expenditures for “continuation, preservation, or operation” of the business are allowed, but how much will be allowed for future investment?
  - Three to five years without investment is a long time for a business
- How will SBA loans be affected?
  - Usually need to show all options have been exhausted
  - Will fewer creditor options mean the SBA will be satisfied with less litigation?
  - Or, must every plan be opposed (especially where the last debt payment is due far enough out that discharge of the debt can be avoided)?

Additional Bankruptcy Law Changes

- Additionally, two other acts were enacted
  - The HAVEN (Honoring American Veterans in Extreme Need) Act: Excludes certain combat and disability income from the chapter 7 "means" test, making inexpensive chapter 7 bankruptcy relief more readily available to veterans
  - The Family Farmer Relief Act: increased the qualifying debt limit to $10,000,000, making chapter 12 available to larger farms
    - Change is to bring chapter 12 up to date
  - Both acts took effect August 23, 2019
- SBRA also made some changes to preference defense
  - In theory, limited venue for small cases to "defendant's home court" and required plaintiff to consider knowable defenses
  - In practice, effect of these changes likely limited at best
- The CARES Act brings additional changes
  - SBRA debt limit raised to $7,500,000 for one year for additional COVID-19 relief
  - Chapter 7 and 13 debtors need not count most COVID-19 payments as income
  - Chapter 13 debtors can modify and lengthen their plans if needed

Steve Roach
Ron Spinner
Marc Swanson

roach@millercanfield.com
spinner@millercanfield.com
swansonm@millercanfield.com

Thank you for joining us today!