New bankruptcy law for small businesses provides welcome changes

Chapter 11's new Subchapter V helps achieve successful restructuring

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Small businesses entering Chapter 11 with the hope of re-emerging are often unsuccessful because the rules are complicated, challenging, and not traditionally well-designed for their needs.

In 2019, Congress' introduction of the Small Business Reorganization Act ("SBRA") added a new "Subchapter V" to Chapter 11, streamlining bankruptcy procedures for small businesses and providing new tools designed to achieve more successful restructuring. It was signed into law and took effect earlier this year. A closer look at the changes included in Subchapter V should be welcome news for small businesses facing financial difficulties and their attorneys.

Eligibility

In order to obtain the benefits of Subchapter V, a business must first meet the definition of a "small business debtor."

A small business debtor is a person or entity engaged in commercial or business activity with an aggregate liability below $2,725,625. At least half of the debt must have arisen from the business, but business owners facing both commercial and consumer debt can find relief. The CARES Act provides for a temporary increase of this threshold to $7.5 million that is scheduled to roll off in 2021.

The SBRA also modified the definition of small business debtor to include debtors who own and operate real property. However, owners of single-asset real estate are still excluded.

Note: the provisions of Subchapter V do not apply automatically when meeting the definition of small business debtor; the debtor must elect the treatment. This is as simple as checking a box on the Chapter 11 petition indicating the choice to proceed under Subchapter V. Currently, the Act does not specify when the debtor must elect to proceed as a small business debtor.

Creditors' committee

In Chapter 11 cases, a creditors' committee is appointed to provide oversight and help ensure proper management and operation of the business during reorganization. While committees can be beneficial in large cases with lots of competing interests, they can be a huge cost for small business debtors to bear in less complicated cases. In Subchapter V, no creditors' committee is appointed unless a court orders otherwise, making it the exception and not the rule.

Appointment of trustees

The SBRA created a new type of trustee, a Subchapter V trustee, to be appointed in every case. In the absence of a creditors' committee, the trustee serves in an administrative capacity to keep the reorganization on course. The trustee's duties include appearing at the first status conference and hearings that concern major case milestones, facilitating the development of a consensual reorganization plan, and making payments to creditors under the plan.

In preparation to implement the SBRA, the U.S. Trustees conducted a nationwide search for qualified candidates to serve as Subchapter V trustees. Of the more than 3,000 applications, 250 candidates, including two of the authors of this article, were selected.

Disclosure statement

In a Chapter 11 case, the debtor must file a disclosure statement with the court. SBRA eliminates this requirement for small businesses. No disclosure statement is required unless a court orders otherwise, which removes a common source of protracted battles among the parties involved. The expectation is that by eliminating the disclosure statement and the potential for competing plans (as explained below), the reorganization process will be streamlined and expedited.

Reorganization plan

Only the small business debtor may file a plan of reorganization under Subchapter V, in contrast to Chapter 11 rules that allow creditors to submit their own plans in certain circumstances. Small business debtors must submit plans within 90 days of the order for relief. This shortens the timeframe from 300 days unless the court provides an extension based on very limited circumstances beyond the debtor's control.

The rules for the contents of a Subchapter V plan of reorganization are more debtor-friendly, and should detail:

Information that would otherwise typically have been in the disclosure statement, such as:

A brief history of the business operations of the debtor.

A liquidation analysis.

Projections showing the ability of the debtor to make payments under the proposed plan.

Provision for all future income necessary for execution of plan.

Notably, a loan secured by a principal residence can now be modified if the proceeds of the loan were used for the business. This modification tool had previously only been available to family farmers and fishermen under Chapter 12.

Plan confirmation

There are two ways to have a plan confirmed:

Consensual. Subchapter V strives to help the debtor and creditors reach a consensual plan, and its facilitation is a key role of the trustee. If the plan meets all applicable requirements and all classes of creditors have accepted it, it is considered a consensual plan and the court may confirm it. Confirmation of a consensual plan terminates the trustee and the debtor receives a discharge upon confirmation, two important incentives for debtors.

Cramdown. A plan can still be confirmed if some or even all classes of creditors don't accept it, so long as the plan doesn't discriminate unfairly, and is "fair and equitable" to impaired unsecured creditors.

"Fair and equitable" is defined by a new rule stipulating that the small business debtor must commit all "projected disposable income" to make payments under the plan during a period of three to five years.

"Disposable income" has been redefined as income received by the business that is not reasonably necessary to support the debtor or dependent, satisfy domestic support obligations, or ensure the continuation, preservation, or operation of the business.

A "reasonable likelihood" of repayment must be demonstrated, and the plan must provide remedies to protect creditors if payments are not made. A discharge is not received upon confirmation, but "as soon as practicable."

Voting

Prior to the SBRA, at least one class of impaired creditors needed to vote for plan acceptance, often a serious sticking point in Chapter 11 cases. Voting rules change significantly under Subchapter V. As mentioned above, a debtor can now confirm a plan with no votes from creditors.

Though there are no voting requirements for confirmation, creditors can still object to a plan. Creditors can seek to block confirmation if they do not believe the plan provides for all disposable income to be used for repayment during the specified plan term.

Absolute priority rule

Previously, if a small business could not pay unsecured creditors in full to confirm a plan over the objection of creditors, the owners could not retain their interests in the business. In Subchapter V there is no absolute priority rule, allowing debtors to retain ownership without adding new value – provided the reorganization plan does not discriminate unfairly and funds the repayment of creditors in three to five years by committing all projected disposable income.

Small business debtors can also pay for the cost of administrative expenses over the life of the plan instead of in-full at confirmation.

What's next

It's difficult to know yet how the SBRA will impact the number of small business bankruptcy filings. Those small businesses that take advantage of Subchapter V may find themselves better able to access reorganization tools that previously proved elusive to them.

An attorney knowledgeable in Subchapter V can offer small businesses greater success in the bankruptcy process.

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