SMALL BUSINESS DEBTOR REORGANIZATION: AN OVERVIEW OF CHAPTER 11'S NEW SUBCHAPTER V

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The term "small business debtor" originated in 1994 with Congress's first attempt at a streamlined chapter 11 process for businesses that had insufficient assets to fund a typical bankruptcy reorganization. A "small business case" allowed a small business debtor to combine the hearing on its disclosure statement with plan confirmation. In theory, a small business debtor could file chapter 11 and immediately begin soliciting votes on a plan, thereby ensuring a swift and less-costly exit from bankruptcy. In 2005, Congress added financial disclosure requirements for small business debtors and strengthened the role and oversight of the U.S. Trustee but balked on raising the debt limit from $2 million to $5 million, which would have made more debtors eligible to reorganize as small businesses.

The Small Business Reorganization Act of 2019 (the "Act") is far more ambitious than the legislation preceding it, which attempted to create small business reorganization within the strictures of standard chapter 11. Small business debtors will now reorganize under Subchapter V of chapter 11. The following is a general overview of the new law, which takes effect on February 22, 2020.

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. [1] The only excluded activity for the small business debtor is operating "single 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. There is no requirement that the debtor remain *engaged* in the commercial or business activity post-petition, but the debtor must show that at least 50 percent of its pre-petition debts arose from such activities. [2] 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.

After filing, a small business debtor may operate in chapter 11 as a debtor-in-possession and is obligated to file the schedules and statements required of all debtors by section 521 of the Bankruptcy Code. [3] 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. [4] If that happens, a Small Business Trustee (defined below) takes over the operation of the debtor's business. [5] The bankruptcy court may not appoint a traditional chapter 11 trustee or examiner in a small business debtor reorganization. [6] On

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request of a party in interest (which presumably includes the debtor or its principals), the court may reinstate the debtor as a debtor-in-possession. [7]

Upon "electing" that Subchapter V shall apply to the debtor's case, 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. [8] The Act does not specify when the debtor must elect to proceed as a small business debtor under Subchapter V. Currently, debtors are required to state in their petition whether they are small business debtors. [9] Bankruptcy Rule 1020 sets the procedure for a "small business case," and it is likely that Bankruptcy Rule 1020 will be amended to address the new legislation and to provide when and how a debtor elects to proceed under Subchapter V.

B. COMMITTEES AND PROFESSIONALS

Ever since the introduction of the small business bankruptcy case, Congress and the bankruptcy courts have struggled with accommodating a committee of unsecured creditors in these small cases. The default rule required the U.S. Trustee to appoint an official committee of unsecured creditors as it would in any other chapter 11 case. [10] If a committee is appointed, however, Bankruptcy Rule 1020 provides that the bankruptcy case can only proceed as a small business case if the court determines that the "committee has not been sufficiently active and representative to provide effective oversight of the debtor." This vague standard made it unclear when a chapter 11 case should proceed as a small business case because it required the bankruptcy court to find that the committee was not functioning properly.

The Act addresses the historic problems with lackluster creditors' committees in small business cases by eliminating them from Subchapter V "unless the court orders otherwise." [11] Going forward, creditors' committees will be the exception — not the rule — in small business debtor reorganizations. In addition to dispensing with committees, Subchapter V provides a welcome measure to debtor's counsel. Professionals are not disqualified from being employed by the estate under section 327 of the Bankruptcy Code if they hold a claim against the debtor of less than $10,000 that arose prior to the commencement of the case. [12] 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.

C. THE SMALL BUSINESS TRUSTEE

Every case under Subchapter V will have a trustee appointed by the U.S. Trustee (the "Small Business Trustee"). [13] The Small Business Trustee has 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 debtor and object to the allowance of proofs of claim. [14] 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." [15] As described above, the Small Business Trustee is also authorized to operate the debtor's business if the debtor is removed as a debtor-in-possession. [16] The Small Business Trustee's role is terminated upon "substantial consummation" of the confirmed plan. [17]

D. THE SMALL BUSINESS DEBTOR REORGANIZATION

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The goals of Subchapter V are to minimize the time and expense of small business reorganization. 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. [18] 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. [19] The debtor must file a plan 90 days after the order for relief. [20] The court can only extend this deadline under "circumstances for which the debtor should not justly be held accountable." [21]

One of the most significant changes to the small business debtor reorganization is that only the debtor is allowed to propose a plan. [22] 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 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. [23]

Subchapter V offers a unique restructuring tool to individual 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. [24] Modification of consensual liens on principal residences is not possible in chapter 13 or ordinary chapter 11. For example, under Subchapter V, an individual who incurs debts of $1 million investing in a commercial activity by borrowing against the equity in his or her home could modify the claim in a small business reorganization by proposing a lower interest rate, extending maturity, 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. [25]

Confirmation of a small business debtor plan of reorganization tracks the criteria of section 1129(a) of the Bankruptcy Code, with the critical exception that the debtor *does not* need to obtain the acceptance of an impaired class of creditors. [26] The small business debtor also has the flexibility to pay administrative claims over the life of the plan instead of in cash on the effective date. [27]

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 section 1129(b)(2)(A) to cramdown a secured claim. [28] Section 1129(b)(2)(B) and (C) do not apply in Subchapter V, however. 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. [29]

Using a hybrid of chapter 11 and chapter 13 concepts, "fair and equitable" 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"). [30] 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. [31] "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

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obligations that become first payable post-petition, or (3) ensure the continuation, preservation, or operation of the business. [32]

If the plan is confirmed under the section 1191(b) "cram down" provision, then all property specified in section 541 that the debtor acquires post-petition and before the case is closed, dismissed, or converted becomes property of the estate. [33] Presumably, this means that the debtor cannot use the property outside the ordinary course of business without court approval. [34]

The debtor can modify the plan prior to confirmation, provided that the plan complies with section 1122 (classification of claims and interests) and section 1123. [35] The debtor can modify a plan confirmed under section 1129(a) only if it has not been substantially consummated and the court finds, after notice and a hearing, that circumstances warrant modification. [36] If the plan was confirmed under section 1191(b), then modification is allowed only during the Income Commitment Period. [37] Because section 1125 does not apply in Subchapter V, the debtor does not need to provide a disclosure statement for the modified plan.

E. DISCHARGE

If the plan is confirmed under section 1191(a), then the standard discharge provisions of section 1141(d) will apply to discharge debts at confirmation. [38] If the debtor makes use of the section 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). [39]

F. CONCLUSION

At first blush, 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. However, the debt limit to qualify as a small business debtor remains unchanged from the 1994 amendments, increasing only with the Consumer Price Index by virtue of the automatic three-year dollar adjustments required by section 104 of the Bankruptcy Code. Fifteen years ago, Congress rejected the recommendation to raise the debt limit to $5 million, and the debt limit currently remains at $2,725,625. Ultimately, Subchapter V's success or failure may turn on whether enough "small" businesses qualify to utilize its debtor-friendly provisions.

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[1] *See* 11 U.S.C. § 101(51D)(A).

[2] *See* Act § 4(a)(1)(B) (describing conforming amendments to the definition of "small business debtor" in section 101 of the Bankruptcy Code).

[3] *See* 11 U.S.C. § 1184.

[4] *See* id. § 1185(a).

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[5] *See* id. § 1183(b).

[6] *See* id. § 1181(a) (stating that sections 1104, 1105, and 1106 do not apply).

[7] *See* id. § 1185(b).

[8] *See* id. § 1187(a) (incorporating Section 1116(1)).

[9] *See* Fed. R. Bankr. P. 1020(a).

[10] *See* 11 U.S.C. § 1102(a)(3).

[11] *See* id. § 1181(b).

[12] *See* id. § 1195.

[13] *See* id. § 1183.

[14] *See* id. §§ 1183, 1194.

[15] *See* id. § 1183(b)(7).

[16] *See* id. § 1183(b)(5).

[17] *See* id. § 1183(c).

[18] *See* id. § 1188(a).

[19] *See* id. § 1188(c).

[20] *See* id. § 1189(b).

[21] *See* id.

[22] *See* id. § 1189(a).

[23] *See* id. § 1190(1).

[24] *See* id. § 1190(3).

[25] *See* id. § 1222(b)(2).

[26] *See* id. § 1191(b).

[27] *See* id. § 1191(e).

[28] *See* id. § 1191(c)(1).

[29] *See* id. § 1191(b).

[30] *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.

[31] *See* 11 U.S.C. § 1191(c)(3)(B).

[32] *See* id. § 1191(d).

[33] *See* id. § 1190(2).

[34] *See* id. § 363(b).

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[35] *See* id. § 1193.

[36] *See* id. § 1193(b).

[37] *See* id. § 1193(c).

[38] *See* id. § 1181(c).

[39] *See* id. § 1192.

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