PUBLICATION

The Small Business Reorganization Act of 2019

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Changes to Chapter 11 for Small Business Debtors

The vast majority of commercial bankruptcy cases concern debtors with less than $2.1 million in assets.[1] Yet, Chapter 11 of the Bankruptcy Code, in its existing form, contains very few provisions designed to deal with small businesses. Instead, while Chapter 11 can be effective for administering complex business reorganizations involving multimillion-dollar companies, it is seldom effective for smaller businesses due to "high costs, deficits and procedural roadblocks."[2] Indeed, most financially troubled small businesses avoid Chapter 11 altogether.[3] In 2018, "there were only 1,335 small business Chapter 11 cases filed nationwide. The number of cases filed under the current small business Chapter 11 has declined for eight consecutive years."[4]

The Small Business Reorganization Act of 2019 (SBRA) addresses these issues by adding a new subchapter V to Chapter 11 of the Bankruptcy Code. The SBRA will increase the small business debtor's ability to successfully reorganize, retain control of its business, and reduce the procedural costs and burdens ordinarily associated with Chapter 11 filings.[5] On August 23, 2019, President Donald Trump signed the SBRA into law. The law will take effect in February of 2020.

The small business debtor may not have more than $2,725,625 in noncontingent, liquidated, secured, and unsecured debts[6] as of the petition date excluding debts owed to affiliates or insiders. A debtor that qualifies as a small business debtor may elect to proceed under the new subchapter V or proceed with the existing provisions of Chapter 11 applicable to small businesses.[7]

Key Provisions of the SBRA

Standing Trustee. Now, in a Chapter 11 small business case, a trustee is appointed only if the debtor is abusing the bankruptcy system, a creditor or party in interest files a motion, and obtains a court order appointing a trustee. Under the SBRA, a standing bankruptcy trustee will be automatically appointed. The standing trustee's duties include, among other things:

- Receiving plan payments or other property from the debtor and then distributing the payments or other property to the creditors in accordance with the plan of reorganization (similar to cases under Chapter 12 and Chapter 13);
- Examining and objecting to proofs of claim;
- Investigating the acts, conduct, assets, liabilities, and financial condition of the debtor;
- Reporting any fraud or misconduct to the bankruptcy court;
- Appearing at the status conference under section 1188 and any other significant hearings;
- Filing a final report of the case;
- Assisting in the formulation of a plan of reorganization; and
- Confirming the debtor's adherence to the court-approved plan during the payment period.

Once the debtor has concluded making all of its necessary payments under the plan, the standing trustee's services will be terminated.

Property of the Estate. Property of the estate in a small business case includes all of the property owned by the debtor as of the petition date, and any property acquired by the debtor after the petition date but before the

case is closed, dismissed, or converted. Except as provided in section 1185 and the confirmed plan, the debtor shall remain in possession of all property of the estate.

No Creditors' Committee. Under the SBRA, an unsecured creditors' committee will not be appointed, unless the court orders otherwise.

Deadline Changes. Many of the deadlines contained in the SBRA are expedited to encourage a streamlined confirmation process. No later than 60 days after the petition date, the court shall hold a status conference. A debtor under subchapter V must file a report with the court outlining the debtor's efforts to confirm a plan. The report must be filed no later than 14 days before the first status conference.

No Disclosure Statement. No disclosure statement is required under the SBRA, unless the court orders otherwise. The SBRA allows the debtor to avoid the substantial costs and expenses associated with preparing and seeking court-approval of a disclosure statement before solicitation of a plan. If the court requires a disclosure statement, the existing disclosure requirements for small business cases in section 1125(f) the Bankruptcy Code will apply.

Who May File a Plan. Under current law, only debtors may file a plan during a limited time known as the exclusivity period. After the expiration of the exclusivity period, any creditor or party in interest may file a plan which, if confirmed, is binding on the debtor and all other parties. Under the SBRA, only the debtor may propose a plan for reorganization. No other party may file a plan.

The Plan. Unless the debtor requests an extension related to circumstances outside of its control, the plan of reorganization must be filed no later than 90 days after the petition date. The plan shall include (a) a brief history of the business operations of the debtor; (b) a liquidation analysis; and (c) projections with respect to the ability of the debtor to make the payments under the proposed plan. The debtor may modify a plan at any time prior to confirmation, and if a plan has been confirmed, at any time prior to substantial confirmation, after notice and hearing, if circumstances warrant such modification.

Confirmation. An impaired consenting class of non-insider creditors is not required for confirmation. Additionally, small business debtors may have a plan confirmed over the objection of unsecured creditors so long as their plan is "fair and equitable." Under subchapter V, a "fair and equitable" plan must pay all projected disposable income of the debtor for the first three- or five- years of the plan. This is a different definition of the term "fair and equitable" than under current law. It is very similar to a case under Chapter 13, where plans are limited to five-years at the maximum, and unlike existing Chapter 11 law, which has no maximum plan duration.

Elimination of Absolute Priority Rule. The SBRA removes the requirement that equity holders of the small business debtor provide "new value" in order to retain their interests in the debtor without paying senior creditors in full. Instead, for plan confirmation, the SBRA only requires that the plan does not discriminate unfairly and is "fair and equitable."

There are two ways for a debtor to comply with the "fair and equitable" requirement under the SBRA. The first option is for the debtor to identify its "disposable income," meaning income that is not used to maintain and support the debtor or pay the debtor's necessary expenses. Thereafter, the plan of reorganization must provide for distribution of disposable income by the standing trustee over the three- to five-year period. Alternatively, the second option is for the plan to require the debtor to distribute some or all of its property to the trustee for the benefit of its creditors. The plan must demonstrate that such property "is not less" than the projected disposable income during the debtor's next three- to five-years.

Modification of Certain Residential Mortgages. Currently, individual debtors may not modify the rights of a creditor whose claim is secured only by a mortgage on the individual debtor's principal residence. The SBRA provides an exception to this general rule: a small business debtor may modify the rights of creditor whose claim is secured only by a mortgage on the debtor's principal residence if the loan was not used to acquire the residence, and was used in connection with the debtor's business. Otherwise, secured lenders have the same protections as in other Chapter 11 cases.

Delayed Payment of Administrative Expense Claims. The SBRA removes the requirement that the debtor pay administrative expense claims, including those claims incurred by the debtor for post-petition goods and services, on the effective date of the plan. Hence, a small business debtor may stretch payment of administrative expense claims out over the term of the plan.

Discharge Limitations**.** The court must grant the debtor a discharge after completion of all payments due within the first three-years of the plan, or such longer period as the court may fix (not to exceed five-years). The discharge relieves the debtor of personal liability for all debts provided under the plan except any debt: (1) on which the last payment is due after the first three-years of the plan, or such other time as fixed by the court (not to exceed five-years); or (2) that is otherwise non-dischargeable. All exceptions to discharge in section 523(a) of the Bankruptcy Code apply to the small business debtor. This is a departure from a typical corporate Chapter 11 which has limited exceptions to discharge set forth in section 1141 of the Bankruptcy Code.

Debtor's Professionals. Under the SBRA, the disinterestedness requirement under section 327(a) of the Bankruptcy Code is relaxed so that a professional is not disqualified for employment solely because the professional holds a prepetition claim, as long as the claim is less than $10,000.

Changes to Preference Laws

Section 3. *Preferences; Venue of Certain Proceedings* of the SBRA makes changes to existing preference laws (applicable to all debtors, not just small business debtors). These changes are favorable to creditors. Currently, trustees and debtors in possession have broad authority to file lawsuits to recover preferential transfers which were made 90 days prior to the petition date, or in the case of insiders, one year.

Under existing law, if the amount of the transfer was less than $13,650, then the trustee or debtor in possession is required file the lawsuit to recover the transfer in the federal district where the defendant resides, not in the district where the bankruptcy case is pending. The SBRA raises the threshold for non-insider defendants from $13,650 to $25,000 so that claims of less than $25,000 must be filed in the district where the defendant resides.

Furthermore, the SBRA amends section 547(b) of the Bankruptcy Code by adding the requirement that any preference claims asserted by the trustee or debtor in possession must be "based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c)."

Because of costs and logistics, preference suits are rarely filed outside of the district where the bankruptcy case is pending. Consequently, raising the threshold to $25,000 effectively removes most transfers less than $25,000 from recovery. In addition, the SBRA's due diligence requirement should also result in a reduction of the number of preference lawsuits.

[1] Michael J. Kaczka and Maria G. Carr, *Passage of the Small Business Reorganization Act Could Dramatically Change a Majority of Chapter 11 Bankruptcies (For the Better)*, TMA Turnaround Times, Vol. 6, Issue 3, May/June 2019, at 3 (2019).

[2] ABI, Journal, *Small Business Reorganization Act*, Am. Bankr. Inst. J., Jan. 2019, at 8 (2019).

[3] Robert J. Leach, *Small Business Bankruptcy: Assessing a Broken System*, Am. Bankr. Inst. J., Apr. 2018, at 10 (2018).

[4] Robert J. Keach, *ABI Testifies on Family Farmers and Small Business Reorganizations,* Am. Bankr. Inst. J., Aug. 2019, at 9 (fn1) (2019).

[5] ABI Journal, *New Bipartisan Legislation to Help Small Businesses Restructure Debt*, Am. Bankr. Inst. J., May 2019, at 8 (2019).

[6] Note, some legal analysts believe that this debt limit to too low to be widely effective. ABI's independent study on chapter 11 reform recommended a $10 million debt threshold for small and medium businesses. *See* Robert J. Keach, *ABI Testifies on Family Farmers and Small Business Reorganizations,* Am. Bankr. Inst. J., Aug. 2019, at 9 (2019).

[7] Ken Hill, *The Small Business Reorganization Act of 2019: Conquering Obstacles and Cleaning Up Small Business Reorganizations*, Nat'l Ass'n. of Bankr. Tr. (NABT), Aug. 9, 2019.