# Client Alert: The Small Business Reorganization Act

BY CESIRA NEWCOMB • FEBRUARY 18, 2020

In February 2020, the Small Business Reorganization Act became effective, adding a set of new reorganization provisions to the Bankruptcy Code. The following is a general summary of "Subchapter V" of chapter 11.

## WHO CAN BE A SMALL BUSINESS DEBTOR?

Subchapter V provides a streamlined version of chapter 11 bankruptcy for individuals and businesses that qualify as "small business debtors." Subchapter V is optional. To proceed Subchapter V, the debtor must make an election on its bankruptcy petition.

A "small business debtor" includes an individual or corporate entity engaged in commercial or business activity with aggregate debts of $2,725,625 or less. Individuals must show that at least 50 percent of their debt arose from commercial or business activity. An individual with $100,000 in business-related debt and $90,000 in consumer-related debt is eligible to reorganize under Subchapter V.

Excluded from the definition of "small business debtor" is an entity that derives substantially all income from the operation of a single real property. An LLC that owns and earns rental income from a commercial office building (what the Bankruptcy Code calls "single asset real estate") is ineligible for Subchapter V.

## THE REORGANIZATION PROCESS

Subchapter V was designed to move cases along quickly and foster consensual reorganization plans. The debtor must include certain financial disclosures in its bankruptcy filing that will allow interested parties to assess the viability of the business from day one. The bankruptcy court is required to hold a status conference within the first 60 days of the case to assess the debtor's progress towards an "expeditious and economical" resolution of the case. No later than 90 days from the petition date, the debtor must file a plan of reorganization.

Unless ousted for cause (discussed below), management remains in possession of the debtor's assets during the bankruptcy and continues to operate the business. Several of the Bankruptcy Code's key operating provisions apply in Subchapter V. The debtor can reject burdensome leases and executory contracts, sell assets, or compromise claims on terms that are in the best interest of the estate. Like general chapter 11, the debtor cannot use a lender's cash collateral absent a consensual agreement or court order that adequately protects the lender's security interest.

Subchapter V also gives the debtor some new restructuring tools:

- The debtor has the exclusive right to propose a plan and does not need to create a separate disclosure statement to solicit acceptances of its plan.

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- Individuals can modify a mortgage on their principal residence, provided the loan was used primarily in connection with the debtor's business. For example, an individual who borrows $1 million against her home to support her business could modify the loan by proposing a lower interest rate, extending maturity, or "cramming" the loan down to the value of the lien. The debtor might even attempt to "strip" the lien if it is junior to other liens.
- If the debtor is unable to achieve a consensual plan, it can confirm a "cram down" plan without the need to obtain the acceptance of an impaired class of creditors. In a cram down scenario under Subchapter V:
  - Secured claims will still enjoy the protections of section 1129(b)(2)(A) of the Bankruptcy Code: the secured creditor either (1) retains its lien on the collateral and receives cash payments equal to the value of the lien, (2) obtains a lien on the proceeds if the debtor sells the collateral, or (3) receives the "indubitable equivalent" of its secured claim (a "dirt for debt" exchange). Secured creditors can also elect to have their claim treated as "fully secured" under section 1111(b) of the Bankruptcy Code, although the stream of payments in a "cram down" will be marked to the present value of the collateral, resulting in a lower monthly P&I payment but capturing the upside if the property value increases over time.
  - With respect to general unsecured claims in a "cram down," the debtor's owner can retain its equity in the business without paying unsecured creditors in full, provided the debtor commits all of its "projected disposable income" to paying creditors for a minimum of three and a maximum of five years.
  - With respect to unsecured claims that have administrative priority, the debtor can pay the claims in full over the life of the plan. This provision is intended to help small businesses with limited cash reserves reorganize without making a significant cash outlay in the first month of the plan.

In consensual plans, the debtor receives a discharge of debts at plan confirmation. In non-consensual "cram down" plans, the debtor will not receive a discharge until it makes all plan payments. In both cases, debts on which the last payment is due after the end of the plan term (e.g., long-term mortgage loans) are excluded from discharge.

## THE SMALL BUSINESS TRUSTEE

In general chapter 11, the United States Trustee often forms a committee of unsecured creditors, represented by counsel, who look out for the interests of all unsecured creditors. Unless the court orders otherwise, Subchapter V cases will not have a creditors' committee. Instead, the United States Trustee will appoint a "Small Business Trustee" in each case. With an express mandate to "facilitate the development of a consensual plan of reorganization," the Trustee is expected to function like a court-appointed monitor or examiner. Among other duties, the Trustee will participate in various court hearings during the case, review and object to proofs of claim, and furnish information to creditors. In some instances, the Trustee will act as a conduit for adequate protection payments to the secured lender and disburse plan payments to creditors.

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. If that happens, the Small Business Trustee takes over the operation of the debtor's business.

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