UNITED STATES' SMALL BUSINESS REORGANIZATION ACT:

TIMELY LEGISLATION MAKES CHAPTER 11 MORE ATTRACTIVE FOR SMALL BUSINESSES[1]

A new year has brought a new avenue of debt relief for small businesses in the United States. On February 22, 2020, the Small Business Reorganization Act of 2019 (the "SBRA")[2] became effective. In the past, businesses seeking the protection of the bankruptcy code had to choose between Chapter 7 (liquidation) and Chapter 11 (reorganization), and the potential of large fees and other costs in a Chapter 11 made many businesses shy away from seeking a reorganization in Chapter 11. The SBRA adds a new subchapter to Chapter 11 reorganizations specifically designed to provide relief to small businesses, and strike a balance between Chapter 7 and Chapter 11. This article will review the novel provisions of the SBRA that are designed to give small businesses access to Chapter 11 reorganizations, as well as note the recent updates to the SBRA in light of the current COVID-19 pandemic.

Generally, debtors seeking protection under Chapter 11 are allowed to retain control of their business while they propose and seek the court's approval of a plan of reorganization that will restructure its debts. During this process, the debtor is subject to oversight from a number of parties, including the court and the United States Trustee's Office, which is a component of the Department of Justice. The debtor in a Chapter 11 case must seek court approval of all expenditures not in the ordinary course of its business, as well as comply with the provisions of the Bankruptcy Code and the United States Trustee's reporting requirements. Any plan of reorganization must meet a number of rigorous requirements, including grouping similarly situated creditors into classes, with acceptance of the plan by 67% in dollar amount of creditor claims and 51% in number of claims of creditors that vote on the plan in each class. Additionally, during the initial "exclusivity period," only a debtor may propose a plan of reorganization; however, once that period (typically 120 days from the date of filing a bankruptcy petition, but extendable up to 18 months from the date of the petition) expires, other interested parties may file a plan of reorganization that may be less favorable to a debtor. Any proposed plan must provide for payment in full of administrative claims—claims that are entitled to priority over other unsecured claims—upon the effective date of the plan, and holders of equity in the debtor must provide "new value," usually in the form of cash payments, in order to retain any of their equity interests. Because the requirements to confirm a plan under Chapter 11 generally bring with them extensive negotiation and professional fees, small businesses are many times "priced out" to the point where it is not cost effective, and often fiscally impossible, to avail themselves of the benefits provided by Chapter 11 reorganizations.

The SBRA seeks to change this paradigm, and make it easier for small businesses to seek chapter 11 protection. At the outset, it must be noted what qualifies as "small businesses"

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[2]The SBRA was originally enacted on August 23, 2019, but did not go into effect until February 22, 2020. It is officially codified under subchapter V of title 11 of the United States Code.

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under the SBRA: a "small business" is any business debtor that has secured and unsecured debts aggregating less than $2,725,625 (USD).[3,4] Although the small business debtor may be permitted to remain in control of its business under the SBRA, every case has a Chapter 11 trustee appointed in addition to the United States Trustee.[5] The SBRA Trustee is a private trustee appointed on a case-by-case basis from pools created across the country; they are not appointed to operate the debtor's business unless so ordered by the court, and their primary goal is to facilitate the confirmation of a plan of reorganization.

Many costs typically associated with the Chapter 11 process are reduced or outright eliminated by the SBRA, resulting in a much more efficient process. For example, in a standard Chapter 11, it is commonplace for an official committee of unsecured creditors to be appointed, usually consisting of between three and seven of the debtor's larger unsecured creditors. Such a committee can retain its own professionals,[6] with the costs and expenses of such professionals being paid by the debtor. However, under the provisions of the SBRA, unsecured creditors' committees will generally not be appointed, unless ordered by the court for cause.

With regard to filing and confirming a plan, the SBRA may provide the most relief to small businesses. Most significantly, the debtor in a case under the SBRA is the only party that may file a plan; accordingly, the exclusivity period mentioned above is eliminated, and no competing plans may be filed by creditors. The caveat to this is that the debtor must file its plan of reorganization within 90 days of the petition date, further streamlining the process. In non-SBRA cases, a plan proponent is required to file, and have the court approve, a disclosure statement. The disclosure statement is usually a complex and thorough document that provides creditors with an overview of the plan's provisions, and details the effects the plan will have on creditors and other parties in interest. Under the SBRA, the debtor need not file a disclosure statement with the court. Likewise, the debtor's plan is not subject to voting by creditors, so the debtor does not need to solicit votes from creditors. Whereas in a non-SBRA case the debtor needs not only to solicit votes on a plan, but also must have an "impaired"[7] class of creditors accept the plan. The SBRA contains no such requirements, meaning all classes of creditors can reject the plan and it can still be approved by the bankruptcy court.

A plan under the SBRA must contain 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. Such payments can be modified from the strictures of a typical Chapter 11 plan. As noted above, a non-SBRA plan must provide for payment in full of administrative claims upon the effective date of the plan. Not so under the SBRA, which allows the debtor to stretch out payment of administrative expense claims, including claims incurred by the debtor for post-petition services and goods, over the entire term of the plan. Small business debtors may now also modify residential mortgages if the underlying loan was not used to purchase the residence, and instead was used primarily in connection with the debtor's small business. Another important aspect of the SBRA is the elimination of the "absolute priority rule," under which a debtor cannot retain an ownership interest in its assets if creditor claims are not paid in full. In a non-SBRA case, an owner of a debtor faces the possibility that it could lose its equity in the reorganized entity if creditors are not paid in full and creditors object. For an owner to retain its equity in a non-SBRA case, an owner is required to pay "new value" for the reorganized entity's equity, which is a potentially large expense and serves as a barrier for any owner considering Chapter 11 since, typically, an owner of a small business wants to maintain ownership of its reorganized entity. The SBRA allows equity holders of the debtor to retain their equity interests in the debtor without paying creditors in full (or paying "new value" for the reorganized entity's equity), provided the plan does not "discriminate unfairly," is "fair and equitable," and provides that all of the debtor's projected disposable income for three to five years will be applied to

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[3]At least 50% of the prepetition debts must arise from commercial or business activity. For example, an individual that has $600,000 in business-related debt and $500,000 in consumer-related debt would be an eligible debtor under the SBRA, but not vice versa.
[4]This does not include debtors operating single asset real estate, e.g., debtors that derive substantially all of their income from the operation of a single piece of real estate.
[5]In non-SBRA cases, a Chapter 11 Trustee is only appointed upon motion by a party in interest or the United States Trustee, and operates the debtor's business.
[6]Normally, such professionals include counsel, financial advisors, investment bankers, and/or accountants.
[7]An "impaired class" of creditors is a class that is being asked under the plan to accept less than what the class is owed.

payments under the plan, or the value of property to be distributed under the plan is not less than the projected disposable income of the debtor.

In order to be confirmed, the plan must also meet the regular guidelines of section 1129 of the Bankruptcy Code, with the exceptions noted above such as not requiring an impaired class to accept the plan. Accordingly, it is possible that every creditor of the debtor objects to the plan, but the plan is still confirmed by the court, provided it meets the other requirements under the Bankruptcy Code and uses all projected disposable income over the next three to five years for payments under the plan. All of the above nuances to the SBRA will result in less contested hearings that prolong the Chapter 11 process and increase costs for the debtor, thus providing small businesses with more access to the protections afforded by the Bankruptcy Code without having to liquidate their companies.

The SBRA has expanded to meet challenges early on it its life. Within the first month of it going into effect, the world was changed by the onset of the current COVID-19 pandemic. Among the various responses by the United States government to the pandemic was the enactment of the Coronavirus Aid, Relief, and Economic Security ("CARES") Act. As it pertains to the SBRA, the most significant impact of the CARES Act was to increase the debt limit for SBRA debtors from the $2,725,625 mentioned above, to $7,500,000 for cases filed on or after March 27, 2020. Such an increase in the debt ceiling widens the SBRA's reach to include a much larger group of businesses, a particularly important modification based upon the projections of the vast number of businesses that will be affected, if not shuttered, by the COVID-19 pandemic. Finally, it should be noted that a growing number of bankruptcy judges are allowing traditional Chapter 11 debtors to convert their cases to ones under the SBRA in the face of the failure of their non-SBRA case. Although judges have noted that such a conversion should be modestly granted using judicial discretion because of the already near-failure of a bankruptcy case, transition to a case under the SBRA may be appropriate where it may increase the possibility of success for debtors struggling to confirm a plan under the general constrictions of Chapter 11.

In conclusion, time will tell what the overall effectiveness and usefulness of the SBRA is, but the initial consensus is that many more small business will now have access to the protections of Chapter 11 reorganizations, especially in light of the increased debt ceiling of $7,500,000. The looser requirements of the SBRA, as well as its ability to streamline a Chapter 11 case from over a year to just a few short months, drastically decreases the potential costs of a Chapter 11 on the debtor, and provides a welcomed new avenue of relief to struggling small businesses.