

IS THE NEWLY ENACTED SECTION OF THE BANKRUPTCY CODE "SMALL BUSINESS REORGANIZATION" A LIFELINE OR CURSE FOR DEBTORS AND CREDITORS?

The Small Business Reorganization Act of 2019 provides Main Street business debtors with a more streamlined path for restructuring their debts.

In light of the COVID-19 virus, a newly enacted section of the Bankruptcy Code, Subchapter V of Chapter 11 (“Small Business Reorganization”) may suddenly become, depending on your perspective, a lifeline for many small businesses or a curse for creditors.

The Small Business Reorganization Act of 2019 took effect February 19, 2020. It creates a less expensive, more streamlined, and more expedited way for “small businesses” to reorganize without many of the more legally challenging, and more expensive, obstacles of a traditional Chapter 11 reorganization.

A “small business debtor” can be (a) an individual or an entity, (b) engaged in commercial or business activities, (c) whose total aggregate, non-contingent and liquidated, debts, both secured and unsecured, are not more than \$2,725,625, (d) not less than 50% of which arose from commercial or business activities.

Importantly, the recent CARES Act increases this debt threshold, for a period of one year, to \$7.5 million. This increase in the debt threshold will increase the number of businesses that can take advantage of the Small Business Reorganization provisions.

Among the benefits of the Small Business Reorganization Act are:

- The small business debtor remains in possession of its assets and operates its business, as a debtor-in-possession, during the pendency of the case (just as in a traditional Chapter 11).
- Only the small business debtor may file a plan of reorganization, but it has to be filed within 90 days of the bankruptcy filing. There is no ability of creditors to file a competing plan of reorganization or liquidation.
- The Bankruptcy Court may confirm a plan of reorganization even if no class of creditors votes in favor of it and all classes reject it.
- The Court may confirm a plan over unsecured creditors’ objections, and allow the small business debtor’s owners to retain their ownership interests, even if the unsecured creditors are not paid in full, so long as the small business debtor commits all of its “projected disposable income” for a period of three to five years to payments to

creditors. There is no need for a small business debtor's owners to contribute "new value" in order to retain their ownership interests. This change abolishes the prior "absolute priority rule," which proved very challenging for small businesses to overcome in traditional Chapter 11 reorganizations.

- A disclosure statement is not required, so long as the plan of reorganization provides (i) a brief history of the debtor, (ii) a liquidation analysis, and (iii) projections demonstrating the small business debtor's ability to make payments under the plan.
- No creditors committee will be appointed, unless otherwise ordered by the Court.
- The small business debtor does not have to pay fees to the United States Trustee's Office.

These provisions will make it much easier and less expensive for small business debtors to reorganize.

In exchange for these benefits, there are some requirements imposed on the small business debtors that do not apply in a traditional Chapter 11 case, such as:

- The small business debtor's bankruptcy estate includes all property acquired by the debtor pre- and post-bankruptcy filing until the bankruptcy case is closed, dismissed, or converted, including earnings for services performed post-bankruptcy filing.
- The small business debtor's earnings must be included in the plan of reorganization and used to pay debts.
- Small business debtors must attach to their bankruptcy petition their most recent balance sheet, statement of operations, cash-flow statement, and federal income tax return, or declare under penalty of perjury no such documents have been prepared.
- A mandatory status conference is held not less than 60 days after the small business debtor's bankruptcy filing to discuss the expenditures and an economical resolution of the case. Fourteen days before the status conference, a report must be submitted detailing the small business debtor's efforts undertaken to achieve a consensual plan of reorganization.
- A standing trustee is appointed in the bankruptcy case who supervises the case, helps the small business debtor formulate a plan, reports fraud/misconduct, and monitors distributions to creditors under the small business debtor's plan of reorganization until substantial consummation of the plan is achieved.

These primarily administrative burdens are relatively insignificant compared to the significant benefits to small business debtors afforded by the Small Business Reorganization Act.

It is likely that many small businesses will now meet the debt limitations, and potential debtors and creditors should familiarize themselves with the Act's provisions as part of addressing creditor/debtor issues arising from the COVID-19 pandemic.

ETHICAL CONSIDERATIONS IN SMALL BUSINESS BANKRUPTCIES

One of the consequences of whenever a major rule change is implemented is the probability that unwary bankruptcy practitioners will either unwittingly or unintentionally commit ethical violations or malpractice while proceeding under those rules. Subchapter V provides small businesses an inexpensive and expedited vehicle to reorganize, but bankruptcy lawyers cannot rely upon their past experience while operating under that Chapter since it is brand new. Conscientious attorneys therefore need to devote attention to all the intricacies and idiosyncrasies of that act to ensure that their clients receive the full benefit of it while not finding themselves subject to disciplinary proceedings or a malpractice claim.

IS YOUR CLIENT ELIGIBLE FOR SUBCHAPTER V?

As a general proposition, you probably want your client to be eligible for Subchapter V because that Chapter normally streamlines the process. Those benefits include no Absolute Priority Rule, no creditor consent necessarily needed, no Disclosure Statement to be approved, and the Debtor can file a plan. As a preliminary matter, you need to understand the eligibility requirements so you do not inadvertently file a debtor under the Chapter accidentally. Originally the cap was \$2.7 million but on March 27th, Congress increased the cap to \$7.5 million for 12 months in response to the pandemic. You will be able to take remedial steps if you do mistakenly file a Subchapter V, but then you have to deal with the politics and practicalities of explaining to a client what went wrong. If by chance your client knew from the onset that eligibility may be an issue and your client was knowingly willing to take a chance, confirming this understanding in writing should be automatic.

A case may come along in which you do not want your client to pursue a Subchapter V. This will probably be rare, but make sure this possibility is at least given some thought. For example, Subchapter V does not grant a discharge until the plan payments are completed with such payments based on at least 3 to 5 years of disposable income. Or, be prepared to file a plan within 90 days of the petition being filed unlike in a Chapter 11.

If Subchapter V is a far superior option for your client and by engaging in proper gerrymandering, your client could be rendered eligible, you may need to engage in planning to achieve that goal. Sophisticated lawyers routinely utilize proper pre-bankruptcy planning. If by slightly reducing the debt, you can substantially simplify your client's life by allowing the client

to proceed in Subchapter V, consider this option. At the same time, make sure that any planning your client engages in does not lead to concerns about preferential or fraudulent transfers or similar concerns.

This raises another related issue of the risk of dabbling in bankruptcy and, in particular, this new Chapter of the Code.

IF YOU ARE DABBLING WITH SUBCHAPTER V, GET HELP

An attorney with extensive experience in Chapter 11 and in Chapter 13 will have an advantage from the onset practicing under Subchapter V since it is a hybrid of different bankruptcy Chapters. Especially because of current economic travails and the anticipated downturn in other types of legal work, many practitioners may be tempted to utilize Subchapter V as an excuse to enter into the bankruptcy practice.

Ironically, if such a lawyer is conscientious and hard-working, Subchapter V provides that individual with equal footing with bankruptcy lawyers with 30 and 40 years of experience. It is hard to develop experience practicing in an area of the law that did not exist until a few months ago.

However, a lawyer delving into bankruptcy for the first time should not assume that the newness of Subchapter V means that lack of bankruptcy experience is not a handicap. The vast array of legal issues that arise in other forms of bankruptcy may be present in Subchapter V and a lawyer not used to dealing with them may simply be overwhelmed or may adopt positions that are simply not practical though technically correct. For all of those reasons, if an ambitious attorney has decided to use the advent of Subchapter V as a perfect excuse to jump into the bankruptcy arena, co-counseling with a bankruptcy lawyer for the first one or two cases is probably a prudent step. An experienced lawyer will tell you that oftentimes complex and challenging disputes can be quickly and inexpensively settled when that lawyer is negotiating with a lawyer of similar background and experience. Most successful bankruptcy lawyers have learned that it is not crucial to win every battle, but rather it is of utmost importance to ultimately win the war.

I now will discuss the client's role in all of this.

CLIENT'S ROLE

Oftentimes, lawyers wandering into the bankruptcy arena confuse the obligations and responsibilities of a Chapter 7 client with one trying to reorganize. Both the lawyer and the client have different responsibilities and obligations when a client is pursuing either a Chapter 11 or Subchapter V.

In a Subchapter V, the lawyer and the client have an absolute responsibility to treat creditors in a fair and equitable manner. If a Plan is drafted which does not do so, the client and the lawyer may have breached their duties to the Court and the system. This concept can be confusing, disconcerting and frustrating to an inexperienced lawyer.

Your client needs to understand from the onset its reporting requirements and specific obligations under Subchapter V. This is in dramatic contrast to a Chapter 7 in which after the case is filed, a client's obligations are fairly minimal and normally cease fairly quickly. The opposite is true in a Subchapter V.

ATTORNEY'S ROLE – SUBCHAPTER V VERSUS CHAPTER 11

Experienced Chapter 11 attorneys will need to divorce themselves of many Chapter 11 practices which are inapplicable in Subchapter V. An attorney who has handled a large number of complex Chapter 11s needs to be careful to differentiate between how to handle a Subchapter V versus a Chapter 11 for a number of reasons, including:

- a. A Subchapter V is designed to be far quicker with more immediate deadlines.
- b. You can circumvent many of the normal steps of a Chapter 11 in a Subchapter V.
- c. If handled properly, a Subchapter V should be far less expensive than a Chapter 11.
- d. In many instances, you really should not rely on the forms you have become used to in Chapter 11.
- e. No Absolute Priority Rule in a Subchapter V.
- f. Creditor consent is not needed to confirm a plan.
- g. No Disclosure Statement is needed.
- h. Only the Debtor can file a plan.

What about dealing with that new animal, the Subchapter V Trustee?

DEALING WITH THE SUBCHAPTER V TRUSTEE

You need to be intimately familiar with the role of a Subchapter V Trustee. A Subchapter V Trustee is a hybrid of a Chapter 11 and Chapter 13 Trustee, but also has unique attributes unrelated to both. You quickly need to learn the idiosyncrasies and predilections of the local Subchapter V Trustee similar to the Chapter 13 Trustees who have held those positions in Arizona for many years. They possess extraordinary powers in a small business bankruptcy and you do not

want to view them as an adversary, but rather a proponent of what you are trying to accomplish. Not doing so could be disastrous for your client.

Lawyers filing Subchapter Vs have to familiarize themselves with the specifics of what the local Subchapter V Trustee expects, demands and may not be overly concerned about for whatever reason. Initially, lawyers have to assume that the Subchapter V Trustee will carefully abide by each and every Subchapter V Trustee guideline, but as is always the case over time, keep tabs on areas which are especially sensitive to that individual.

CONCLUSION

As you are navigating the Subchapter V waters, always remember the reasons why this Chapter was enacted. The Bankruptcy Commission involved in its drafting determined that most Chapter 11s were too expensive and unwieldy and a different option needed to be available for a large number of cases which did not need all of the restrictions and controls of Chapter 11. If utilized as intended, you can provide your struggling client with a perfect vehicle to turn around its financial affairs. However, an incautious attorney utilizing that Chapter can create a variety of problems and complications, which could lead to a displeased client, ethical concerns and a potential malpractice claim.