Just What the Doctor Ordered?
The Small Business Reorganization Act in the Wake of COVID-19

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Agenda

• Historical developments and evolution
• Eligibility and exclusions
• Filing requirements
• Roles of other parties
• Deadlines, plans, modifications and discharge
• What comes next

Background

• 1978: Bankruptcy Code was first enacted, becoming generally effective October 1, 1979
• 1979-2005: Chapter 11 was unpopular with small and even medium-sized businesses
• Common criticisms of Chapter 11 for small businesses:
  – Too expensive
  – Too lengthy
  – Too complicated
• 2005: In response to these common criticisms, Congress added small business provisions to the Bankruptcy Code.
  The 2005 revisions were not enough to make Chapter 11 a feasible option for small businesses.
Background

- **2018**: Only 1335* small business Chapter 11 cases were filed out of a nationwide total of 5,962** Chapter 11 business filings

- **2019**: Congress enacted Subchapter V of Chapter 11 to:
  - Increase the number of successful reorganizations
  - Reduce liquidations
  - Preserve jobs
  - Increase creditor recoveries
  - Simplify the bankruptcy process and
  - Reduce costs for small business debtors

- **2020**: The CARES Act raised the debt ceiling for Subchapter V eligibility for one year.

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Small Business Reorganization Act (SBRA)

- **New Subchapter V of Chapter 11 of Title 11 of the United States Code (the Bankruptcy Code)**
- **Referred to simply as “Subchapter V”**
- **Effective February 2020**
- **Addsto existing small business provisions**
- **Provides an alternative procedure for small business debtors**

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Eligibility for Subchapter V

- Available to businesses and individuals engaged in commercial or business activity
- Excludes single-asset real estate cases

Debt Limits

- Initially, Subchapter V relief was limited to small business debtors with secured and unsecured debt totaling no more than $2,725,625.
- In calculating the debt limit:
  - Contingent and unliquidated debts are excluded
  - Debt owed to affiliates or insiders is excluded
  - At least 50% of the debt must arise from commercial or business activities
- Temporary increase as part of federal COVID-19 relief:
  - On March 27, 2020, Congress increased the debt limit to $7,500,000 as part of the CARES Act.
  - The increased limit is effective for one year.
Subchapter V Election

- It's not automatic. A debtor must elect to proceed under Subchapter V.
- The election typically will be made when the case is filed, but debtors may seek to re-designate a case after filing.
- The U.S. Trustee and others have a 30-day time period to object to a debtor’s Subchapter V election.

What Documents Must a Subchapter V Debtor File?

- Schedules and a statement of financial affairs
- Balance sheet
- Statement of operation
- Cash-flow statement
- Federal income tax return
- Sworn statement if those documents do not exist
Notable Aspects of Subchapter V Filings

- Repayment of debts over 3 to 5 years using projected disposable income
- Administrative expenses may be paid over the plan term—not required to be paid on the effective date
- No absolute priority rule—owners can retain their interest in the debtor without paying senior creditors in full
- Plan can be confirmed without the vote of any impaired consenting class
- Debtor must file a plan within 90 days, but the bankruptcy court can extend this timeline if the need is based on circumstances for which the debtor can’t be held accountable

Standing Trustee

- Automatic appointment of a standing trustee
- Duties:
  - Facilitates “the development of a consensual plan of reorganization” (11 U.S.C. § 1183(b)(7); emphasis added)
  - Where a plan is confirmed without the consent of all impaired classes, receives plan payments and makes distributions to creditors
  - Appears at the 60-day status conference and major hearings
  - Reviews (and may object to) proofs of claim and
  - Prepares a final report and files a final account
- Compensation is calculated as a percentage of plan payments
- Notwithstanding appointment of standing trustee, debtor retains control of its business and assets
- There are approximately 250 acting standing trustees nationwide
Role of Creditors’ Committees

- Very limited
- Only when ordered by the Bankruptcy Court for cause
- Benefits debtor by reducing administrative costs
- Detrimental to unsecured creditors because there’s no Committee to act as a watch dog

Deadlines

- 60-day mandatory status conference
- Debtor’s pre-status conference report is due 14 days before the status conference
- Debtor must file plan within 90 days
- Deadlines can be extended if the need is based on circumstances for which the debtor can’t be held accountable
Plan Requirements in Subchapter V Cases

- Separate disclosure statement not required
- The plan must include:
  - brief history of the debtor’s business operations
  - liquidation analysis and
  - projections concerning the debtor’s ability to make plan payments
- Administrative claims may be paid over the plan term
- Creditors may not file competing plans
- Debtor may modify the plan at any time before confirmation OR after confirmation but before substantial consummation

Confirmation of the Consensual Plan

- A plan may be confirmed if all classes of creditors vote to accept and all requirements of Section 1129(a)—other than Section 1129(a)(15)—are met:
  - (a)(1)-(3): Plan and plan proponent comply with the Bankruptcy Code, and the plan is proposed in good faith and not by means forbidden by law
  - (a)(4), (6): Debtor has obtained court approval for payment of costs and expenses and received regulatory approval of rate changes
  - (a)(5): Insider disclosures have been made
  - (a)(7): Best interests of creditors test
  - (a)(8), (10): All classes accept the plan, including at least one impaired class
  - (a)(9), (12), (13), (14): Payment of administrative claims [*but may be paid over course of the plan*], U.S. Trustee fees*, certain retiree benefits and domestic support obligations
  - (a)(11): Feasibility
  - (a)(16): Restrictions on transfers of property of nonprofit entities

* Subchapter V cases are exempt from paying U.S. Trustee fees.
Confirmation of the Non-Consensual Plan

- Section 1191(b) contains the cramdown criteria for Subchapter V plans
- Eliminates the requirement that an impaired class of creditors vote to accept the plan
- Plan must be “fair and equitable” as to each class of creditors:
  - No absolute priority rule (and no new value exception)
  - Secured claims: plan must comply with Section 1129(b)(2)(A)
  - All of debtor’s projected disposable income must be applied to plan payments or value to be distributed must equal all of debtor’s projected disposable income
  - Plan must be feasible but must also provide remedies to protect holders of claims or interests in event that payments are not made

Disposable Income

- Disposable income = any income received by the Subchapter V debtor that isn’t reasonably necessary to:
  - Maintain and support the Subchapter V debtor or dependents
  - Satisfy domestic support obligations that first become payable after the bankruptcy case was filed
  - Ensure the continuation, preservation, or operation of the business
Residential Mortgages

- **Lien stripping:**
  - Debtor may modify the rights of a creditor whose claim is secured by a mortgage on the debtor’s principal residence
  - New value received in connection with loan:
    - Must not have been used primarily to acquire the real property
    - Must have been used primarily in connection with the debtor’s small business

Discharge

- Consensual plan → the debtor will receive a discharge at the time of confirmation
- Non-consensual plan → the debtor will receive a discharge after the first three years of plan payments are completed
- Debts for which the last payment is due after the plan period (e.g., long-term mortgages) will not be discharged
Creditor-Friendly Provisions

- Preferential transfers:
  - Plaintiffs must perform “reasonable due diligence” and take into account “known or reasonably knowable affirmative defenses.”
  - Preference actions for amounts less than $25,000 must be filed in the district where the defendant resides.

Concerning Provisions
(...from a Creditor’s Perspective)

- Elimination of requirement that administrative claims be paid on the effective date
- Lien stripping of certain mortgages
- Shocking erosion of unsecured creditors’ leverage
What’s Next?

- Expect to see many more Subchapter V filings in the coming year
- There are many issues to be worked out, so look for new case law as Subchapter V cases wind their way through the courts
- Lenders should review small business loan underwriting in light of the Subchapter V changes
- Vendors should be mindful that they will not have the same protections in Subchapter V that they have in a typical Chapter 11 case
- Creditors should contact experienced bankruptcy counsel when doing business with companies in financial distress

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Questions

If you have questions, you are welcome to follow-up directly with the presenters or call on your trusted Dorsey contact.
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