



EMORY
LAW

Emory Bankruptcy Developments Journal

Volume 36
Issue 2 *The Seventeenth Annual Emory
Bankruptcy Developments Journal Symposium*

Article 2

2020

The Pros and Cons of the Small Business Reorganization Act of 2019

William L. Norton III

James B. Bailey

Follow this and additional works at: <https://scholarlycommons.law.emory.edu/ebdj>

Recommended Citation

William L. Norton III & James B. Bailey, *The Pros and Cons of the Small Business Reorganization Act of 2019*, 36 Emory Bankr. Dev. J. 383 (2020).

Available at: <https://scholarlycommons.law.emory.edu/ebdj/vol36/iss2/2>

This Article is brought to you for free and open access by the Journals at Emory Law Scholarly Commons. It has been accepted for inclusion in Emory Bankruptcy Developments Journal by an authorized editor of Emory Law Scholarly Commons. For more information, please contact law-scholarly-commons@emory.edu.

THE PROS AND CONS OF THE SMALL BUSINESS REORGANIZATION ACT OF 2019

*William L. Norton III**

*James B. Bailey***

Effective February 19, 2020, Congress enacted new bankruptcy legislation granting debtors the option to elect a new subchapter V of chapter 11 of the bankruptcy code (Subchapter V). This was made possible by the bipartisan legislation known as the Small Business Reorganization Act of 2019 (SBRA).¹ The SBRA was enacted to provide small business debtors² the opportunity to reorganize in a cost-effective manner. This Article addresses certain pros and cons of these amendments to the Bankruptcy Code (Code), which will depend upon the eyes of the beholder.

I. THE ADVANTAGES TO A DEBTOR

A. *Reduced Expenses*

Reorganizing under Subchapter V should be less expensive for the debtor because certain administrative expenses that a small business would normally incur in a chapter 11 case have been eliminated. For example, the debtor in Subchapter V is no longer required to pay U.S. Trustee's fees.³ Additionally, the requirement for the appointment of an official committee of unsecured creditors has been eliminated in Subchapter V.⁴ Although appointment of a committee in a small business case may have been rare, at least there is no longer a need for the U.S. Trustee to solicit the formation of such a committee. Although a

* Partner, Bradley Arant Boult Cummings LLP.

** Partner, Bradley Arant Boult Cummings LLP.

¹ Small Business Reorganization Act (SBRA) of 2019, Pub. L. No. 11654, 133 Stat. 1079. Unless otherwise stated, all statutory references are to the Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.*

² Defined in § 101 (51D) as a person (1) engaged in a commercial business activity, excluding the ownership of single asset real estate as defined in 11 U.S.C. §101 (51B), (2) non-contingent liquidated secured and unsecured debt as of the date of the filing of the petition not more than \$2,725,625.00 (excluding debts owing to affiliates and insiders), and (3) the majority of such debts must have arisen from the commercial or business activities of the debtor. 11 U.S.C. § 101 (51D). The cap was increased to \$7,500,000 by the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020, Pub. L. No. 116-136, 134 Stat. 281 (effective March 27, 2020 for the period of one year).

³ 28 U.S.C. § 1930(a)(6)(A) (2019).

⁴ 11 U.S.C. §§ 1102(a)(3), 1181(b) (2019).

creditor's committee is not mandatory, the U.S. Trustee or a creditor may file a motion requesting the appointment of a committee.⁵

B. Easier Retention of Counsel

The requirements for retaining debtor's counsel have been modified to permit counsel to represent a debtor notwithstanding the existence of unpaid prepetition fees in an amount less than \$10,000.⁶ On the one hand, this is an advantage in cases where the debtor does not have the luxury to delay the bankruptcy filing while accumulating cash in order to pay accrued attorney's fees. On the other hand, the provision will be a negative to debtor's counsel who loses the leverage of the disinterestedness provision under § 327(a) to require fees to be paid in full before filing a bankruptcy petition.

C. Only the Debtor Can File a Plan

Subchapter V does not authorize creditors or other interested parties to submit plans of reorganization.⁷ Another advantage is that the debtor does not have to prepare and file a separate disclosure statement along with the plan.⁸ Instead, new § 1190 requires the debtor to include in the plan a brief history of the business operations of the debtor, a liquidation analysis, and projections with respect to the ability of the debtor to make payments under the proposed plan.⁹

D. Absolute Priority Rule Is Not a Barrier to Confirmation

The most significant advantage for debtors in Subchapter V is the elimination of the absolute priority rule. Typically, § 1129(b)(2)(B)(ii) mandates that a dissenting class of unsecured creditors must be paid in full before any junior class can receive or retain property under a plan of reorganization.¹⁰ Hence, if the unsecured creditor class votes to reject a chapter 11 plan, equity holders cannot receive anything unless the dissenting class is paid in full. Rather, the equity holders would have their shares in the company cancelled.¹¹ Courts recognize a new value exception to the absolute priority rule, but there are strict

⁵ §§ 1102(a)(3) and 1181(b).

⁶ 11 U.S.C. § 1195 (2019).

⁷ 11 U.S.C. § 1189(a) (2019).

⁸ § 1181(b).

⁹ 11 U.S.C. § 1190(1) (2019).

¹⁰ *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988).

¹¹ *See, e.g., Bank of Am. Nat'l Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 437 (1999).

limitations on the exception. Equity's new value contribution to retain their ownership interest must be money or money's worth. Simply contributing future labor, management, or expertise is not sufficient to qualify as new value supporting retention of equity ownership.¹²

New Subchapter V does not include these limitations on equity retaining ownership. Now the court may confirm a plan over the objection of unsecured creditors as long as all projected disposable income of the debtor, to be received in a three-year period or such longer period as the court may approve but not to exceed five years, will be applied to the plan.¹³ Removing the absolute priority rule in Subchapter V should encourage more successful small business reorganizations by allowing owners to continue managing their businesses and enjoying the benefits of ownership.

E. Voting Is Not Necessary to Confirm a Plan

The requirements under § 1129(a)(10) that the debtor receive the acceptance of at least one impaired class has been eliminated.¹⁴ The debtor in Subchapter V may confirm a cramdown plan without the approval of any class of creditors.¹⁵

F. Modification of Certain Mortgages on the Debtor's Principal Residence

Although the fair and equitable requirements for the treatment of secured claims pursuant to § 1129(a)(2)(A) have not changed, Subchapter V does modify § 1123(b)(5) to enable the debtor to modify the rights of certain holders of claims secured only by a security interest in the debtor's principal residence when the proceeds of the relevant mortgage were used primarily in connection with the debtor's business.¹⁶ Thus, if the mortgage is not a purchase money mortgage, then the debtor will be able to modify that debt through a confirmed plan.

G. Post-Confirmation Plan Modifications

After confirmation, only the debtor may modify the plan.¹⁷ This is a distinct advantage when the debtor is an individual because § 1127(e) permits the

¹² See *Norwest Bank Worthington*, 485 U.S. at 202–06.

¹³ 11 U.S.C. § 1191(b) (2019).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ 11 U.S.C. § 1190(3) (2019).

¹⁷ 11 U.S.C. § 1193 (2019).

trustee, U.S. Trustee, or the holder of an allowed unsecured claim to seek a modification to (i) increase or reduce the amount of payments, (ii) extend or reduce the time-period for such payments, or (iii) alter the amount of distribution to a creditor at any time before the completion of payments under the plan. § 1127 is not applicable in a Subchapter V case.¹⁸ Thus, in a Subchapter V case, if the debtor's business improves significantly during the course of the plan, there is no provision permitting a creditor to request modification of the plan to increase payments. However, if the business declines, the debtor may still request a modification of the plan under Subchapter V even though the plan has been substantially consummated.¹⁹ The debtor's right to modify a substantially consummated plan is limited to plans confirmed under § 1191(b), which is the cramdown option available when all voting classes do not approve of the plan.²⁰

H. *The Discharge*

Subchapter V allows a small business debtor to obtain a discharge on the effective date of the plan, provided the plan was consensual and approved under the new § 1191(a), which requires compliance with all of the consensual confirmation provisions in a typical chapter 11 case.²¹ Additionally, a corporate debtor may be able to obtain a discharge under Subchapter V even if the plan is a nonconsensual liquidating plan.²² One negative for small business debtors is that Subchapter V makes applicable the nondischargeability provisions of § 523(a),²³ thus preventing a corporate debtor from discharging fraud, tax, and other nondischargeable claims. Although the exceptions to discharge for a corporate debtor are much more limited in a typical chapter 11 case,²⁴ the existence of the absolute priority rule under § 1129(b)(2)(B) would generally require these claims to be paid in full for equity holders to retain their interests without the approval of a voting class of unsecured creditors.²⁵

¹⁸ 11 U.S.C. § 1181(a) (2019).

¹⁹ § 1193(c).

²⁰ *Id.*

²¹ See §§ 1191(a), 1129(a), and 1141(d)(1)(A) (2019). *But see* 11 U.S.C. § 1181(c) (2019) (special rule for discharge in Subchapter V); 11 U.S.C. § 1192 (2019) (providing for discharge after plan payments are completed in a nonconsensual plan).

²² See 11 U.S.C. § 1181(c) (2019) (special rule for discharge in Subchapter V); 11 U.S.C. § 1192 (2019) (providing for discharge after plan payments are completed in a nonconsensual plan). *But see* § 1141(d)(3) (prohibiting discharge of liquidating corporate debtor in typical chapter 11).

²³ § 1192(2).

²⁴ See § 1141(d)(6).

²⁵ New § 1192(2) states without qualification that debts "of the kind specified" in § 523(a) are excepted from the discharge in a Subchapter V cramdown plan. Substantially similar language is used in

I. Stretching Payments on Administrative Expenses

Subchapter V permits the debtor to pay administrative expenses over the life of the plan. This advantage, which is standard in chapter 12 and 13 cases, is limited in a Subchapter V case to a plan that is approved pursuant to the cramdown provisions of new § 1191(b).²⁶ Thus, the debtor is in the unusual position of potentially preferring a contested plan in order to take advantage of stretching out administrative payments over the life of the plan. The ability to stretch out some payments can be a tremendous advantage to debtors, but it is not available in a consensual plan probably because the drafters did not want the trustee appointed in the case to be removed until after the administrative expenses, including trustee fees, have been paid.

J. Serial “Small Business Case” Filing Exception to Automatic Stay Does Not Apply

Section 362(n) provides an exception to the automatic stay in certain instances where a “small business case” is filed within two years after confirmation or dismissal of a prior “small business case.”²⁷ However, an eligible debtor that elects to proceed under Subchapter V is not a debtor in a “small business case”²⁸ as that term is applied in § 362(n) because the exceptions to the automatic stay in § 362(n) do not apply to a serial filer under the new Subchapter V. Nonetheless, creditors may still raise the debtor’s serial bankruptcy filing as cause of relief from stay under § 362(d).

K. Debtor Is Not Limited in Modifying Motor Vehicle Loans

Debtors who may be eligible for chapter 13 or new Subchapter V should consider whether they desire to cramdown a motor vehicle loan. In a chapter 13 case, the debtor typically may not use bankruptcy to cramdown a secured

chapter 12, which governs family farmer or fisherman cases. Courts have held that the exceptions to discharge in § 523(a) apply to non-individual debtors in chapter 12 cases. *See* Sw. Ga. Farm Credit, ACA v. Breezy Ridge Farms, Inc. (*In re* Breezy Ridge Farms, Inc.), No. 08-12038, Adv. Nos. 08-12038-JDW, 09-1011, 2009 LEXIS 1396 (Bankr. M.D. Ga. May 29, 2009); *New Venture P’ship v. JRB Consol.* (*In re* JRB Consol., Inc.), 188 B.R. 373 (Bankr. W.D. Tex. 1995).

²⁶ § 1191(e).

²⁷ 11 U.S.C. § 362(n)(1) (2019).

²⁸ *See* SBRA of 2019, Pub. L. No. 11654, 133 Stat. 1079, 1085 (amending § 101(51C) to provide that a “small business case” is defined as one where the debtor “has not elected that [S]ubchapter V of chapter 11 of this title shall apply”).

personal motor vehicle loan incurred within 910 days prior to the filing of the bankruptcy.²⁹ These limitations do not apply in new Subchapter V.³⁰

II. LIMITATIONS TO THE DEBTOR

The SBRA is not simply a windfall for debtors. There are several limitations that a debtor should consider before pursuing reorganization under new Subchapter V.

A. *Eligibility Is Limited*

As originally enacted, the eligibility for Subchapter V is restricted to a narrow group of debtors. The amount of noncontingent, liquidated, secured, and unsecured debt for a small business debtor was limited to \$2,725,625.00.³¹ In response to the Coronavirus (COVID-19) pandemic, and only for the limited period of one year beginning March 27, 2020, Congress increased the debt limit for eligibility to \$7,500,000.³² This debt limit only applies when the majority of the debts arose from the commercial or business activities of the debtor. Thus, individuals will not qualify unless they were involved in a business and the majority of their debts relate to that business. For individual debtors, business debts will typically not include a mortgage on a principal residence.

B. *Limitations on Use of Cash Collateral*

The SBRA does not amend any provisions of the Code that limit the debtor's right to use a creditor's cash collateral. Debtors filing cases under the new Subchapter V will still have to obtain an agreement on the use of a creditor's cash collateral or otherwise be able to provide adequate protection of the creditor's interest in cash collateral.³³

C. *Mandatory Appointment of a Trustee*

Subchapter V requires appointment of a trustee in every case.³⁴ The good news for the debtor is that the trustee generally will not operate the debtor's business. Rather, the trustee's duties are intended to assist the debtor in

²⁹ See 11 U.S.C. § 1325(a) (2019) (hanging paragraph).

³⁰ See 11 U.S.C. §§ 1190, 1191, 1123 (2019).

³¹ See 11 U.S.C. § 101(51D) (2019).

³² CARES Act of 2020, Pub. L. No. 116-136, 134 Stat. 281.

³³ See 11 U.S.C. §§ 363, 361 (2019).

³⁴ 11 U.S.C. § 1183 (2019).

proposing and confirming a plan, as well as making distributions under the plan. The trustee will be accountable for all funds received from the debtor and should examine proofs of claims and object to the allowance of claims that are improper.³⁵ Additionally, the trustee should furnish information concerning the estate as requested by a party in interest and may oppose the discharge of the debtor if appropriate.

The term of the trustee's appointment will depend upon whether the plan is consensual or contested. Pursuant to new § 1183(c)(1) in a consensual plan, the trustee's services terminate when the plan has been substantially consummated. In this instance, the debtor is obligated to provide notice of substantial consummation to the trustee, the U.S. Trustee, and all parties in interest. The debtor must send the notice no later than fourteen days after substantial consummation of the plan.³⁶ In a nonconsensual plan, unless the plan or the court provides otherwise, the trustee is responsible for making distributions to creditors until the plan is complete.³⁷ At that time, the trustee is obligated to file a final accounting and a final report.³⁸

D. Mandatory Status Conference

The debtor will have to be prepared to move the case along under Subchapter V. The court is required to hold a status conference within sixty days of the order of relief.³⁹ Within fourteen days prior to the status conference, the debtor must file a notice with the court explaining the debtor's progress in confirming a consensual plan.⁴⁰

E. Accelerated Confirmation Schedule

Subchapter V accelerates the timeframe for a small business debtor to file a plan from 180 days—as provided under § 1121(e)—to ninety days under new § 1189.⁴¹ The debtor can obtain an extension of this ninety day deadline, provided it can show that the need for the extension is attributable to

³⁵ § 1183(b).

³⁶ § 1183(c)(2).

³⁷ 11 U.S.C. § 1194(b) (2019).

³⁸ 11 U.S.C. §§ 1106(a)(1), 704(a)(9) (2019).

³⁹ See 11 U.S.C. §§ 1188(a) (providing for initial status conference), 1189(b) (“[D]ebtor shall file a plan not later than [ninety] days after the order for relief . . .”), 1121(e) (providing limit of exclusivity for 180 days in small business case) (2019).

⁴⁰ 11 U.S.C. § 1188(c) (2019).

⁴¹ Compare 11 U.S.C. § 1121(e) (2019), with 11 U.S.C. § 1189 (2019).

circumstances for which the debtor “should not justly be held accountable.”⁴² It remains to be seen how stringent the courts will hold debtors to the ninety day requirement, but under the statute, the grounds for an extension are limited to circumstances beyond the debtor’s control.⁴³

F. Projected Disposable Income or its Value Must Go Towards Plan

Although the debtor does not have to satisfy the absolute priority rule, new § 1191 does require the debtor to devote projected disposable income or its value to pay creditors. Similar to a chapter 13, the debtor may apply towards the plan all “projected disposable income” to be received in a three-year period beginning on the day that the first payment is due under the plan. In the alternative, and similar to an individual debtor under § 1129(a)(15), the debtor may distribute property under the plan that is not less than the debtor’s projected disposable income over the three year plan period.⁴⁴ The court may require a longer period for payments or distributions, not to exceed five years. It remains to be seen as to what standards the courts will apply in determining whether plan payments should be based on a three-year period or up to five years. In either case, determining the debtor’s “projected disposable income” during a plan period is likely to be difficult since small business debtors may be more susceptible to business fluctuations. It is difficult for debtors to make projections for one year, much less three to five years.

G. Plan Must Have Remedy for Defaults

New § 1191(c) also requires the plan to provide appropriate remedies to protect the holders of claims and interest in the event that plan payments are not made. The debtor can avoid this requirement by showing the court with certainty that the debtor will be able to make all payments under the plan. Such certainty is not easy to prove. In order to confirm a plan, it is anticipated that the debtor will have to include a remedy for nonpayment, such as liquidation of non-exempt assets.⁴⁵ The advantage to creditors with this provision is that when the plan includes a remedy, the creditor may have good grounds to dismiss any subsequent chapter 11 petition (chapter 22) that the debtor may file because the existing plan already provides for the liquidation of the debtor’s assets upon a plan default.

⁴² § 1189(b).

⁴³ § 1188(b).

⁴⁴ 11 U.S.C § 1191(c)(2)(B) (2019).

⁴⁵ § 1191(c)(3).

III. THE UNCERTAINTY OF NEW SUBCHAPTER V

Of course, potential debtors are not the only parties who must be prepared for new Subchapter V. There are uncertain issues that other parties in interest will have to confront.

A. *Trustee Fees*

It is not clear how a trustee will be compensated under Subchapter V, and if such compensation will be adequate enough to encourage qualified professionals to serve as a Subchapter V trustee. In most federal districts, the U.S. Trustee has designated a pool of trustees in lieu of appointing a “standing trustee” even though a “standing trustee” was contemplated under the SBRA.⁴⁶ What is clear is that the non-standing trustee must meet the qualifications of a trustee under section § 322 and be disinterested,⁴⁷ and the compensation will not be based on the percentages normally used for compensation of chapter 7 or 11 trustees under § 326(a).⁴⁸ Instead, § 326(b) appears to link the compensation to a trustee under Subchapter V in the same manner as a chapter 12 or 13 trustee, which is determined by § 330 (reasonable compensation for professionals based on an hourly rate, subject to a limit of five percent of all payments under a plan).⁴⁹ This interpretation is based on the fact that § 326(b) refers to “subchapter V” along with “chapter 12 or 13” in the beginning of that subsection. However, there is no reference to § 1183(a) and Subchapter V trustees regarding compensation to a trustee in the second part of § 326(b) even though there is a reference to similar sections in chapter 12 or 13, thus leading one to question how a compensation to the non-standing trustee is determined. This ambiguity should be resolved in favor of applying § 326(b) to trustee compensation in Subchapter V cases.⁵⁰

If § 326(b) is interpreted to apply to trustees in Subchapter V cases and there is a limit of five percent on the compensation of a Subchapter V trustee, the

⁴⁶ 11 U.S.C. § 1183(a) (2019).

⁴⁷ § 1183(a).

⁴⁸ Subchapter V is specifically excluded in 11 U.S.C. § 326(a) (2019).

⁴⁹ § 326(b).

⁵⁰ Another reference to compensation of a trustee exists in 28 U.S.C. § 586(e)(5) (2019). That subsection was added along with the Subchapter V amendments and states that when a trustee is terminated by dismissal, conversion or substantial consummation of a plan, the trustee’s compensation should be determined in the same manner as a standing trustee under subsection (1) of § 586. Although subsection (5) does not specifically refer to a “standing” trustee, since § 586(e) sets compensation limits for standing trustees, § 586(e)(5) will not likely be interpreted to apply the compensation limits of standing trustees to non-standing trustees.

compensation to Subchapter V trustees may be very little because the only distributions made by the debtor will be operating expenses during the case. Five percent of these distributions will likely be nominal. Regardless, Subchapter V trustees should not expect any payments until a plan is confirmed and as discussed above in the case of a contested Subchapter V plan, the fees and other administrative expense claims may be paid over the term of a plan.

B. Non Incentives for a Consensual Plan

The SBRA does not provide many incentives for creditors to consent to a plan. A consensual plan enables the debtor to get a discharge on the effective date of the plan⁵¹ and also compels the termination of the trustee when the plan is substantially consummated.⁵² In chapter 11 cases, substantial consummation, defined in § 1101(2), occurs shortly after the effective date of the plan when the initial distributions have been commenced to unsecured creditors.⁵³ Even the debtor has an incentive for the plan to be contested in order to stretch out administrative expenses over the life of the plan. Nevertheless, it is likely that the ability to terminate the trustee on the effective date of the plan will be incentive enough for the debtor to seek a consensual plan.

C. Non-Debtor Releases

The SBRA does not expand the scope of the automatic stay or discharge to cover non-debtor guarantors of the debtor's business obligations. In most instances, guarantors will still have to file their own petitions to obtain all benefits of a bankruptcy. Nonetheless, there may be unique circumstances where a court grants a release of non-debtor parties or temporary injunction barring collection efforts against non-debtor parties.⁵⁴

⁵¹ 11 U.S.C. § 1181(c) (2019).

⁵² 11 U.S.C. § 1183(c)(1) (2019).

⁵³ See 11 U.S.C. § 1101(2) (2019).

⁵⁴ See, e.g., *Deutsche Bank AG, London Branch v. Metromedia Fiber Network, Inc.* (*In re Metromedia Fiber Network, Inc.*), 416 F.3d 136, 142 (2d Cir. 2005) ("No case has tolerated [non-debtor] releases absent the finding of circumstances that may be characterized as unique."). *But see Resorts Int'l v. Lowenschuss* (*In re Lowenschuss*), 67 F.3d 1394, 1401 (9th Cir. 1995) ("This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors.").

D. Deferment of Administrative Claims

Trade creditors that have experience working with a debtor in chapter 11 are likely familiar with the fact that administrative expense claims are typically paid in full on the effective date of a plan.⁵⁵ As discussed above, a small business debtor in Subchapter V can confirm a plan that stretches payment of administrative expense claims over the term of a plan.⁵⁶ As a result, trade creditors may be less willing to offer pre-petition credit terms to a small business debtor, and may even demand payment in advance or cash on delivery.

IV. CONCLUSION

While there are many advantages for debtors in new Subchapter V, small businesses must consider the burdens that are tied to any relief under the Code. The SBRA's amendments to chapter 11 were intended to encourage quicker and more cost-effective reorganizations for small business debtors. But there is no guarantee that Congress's desire to streamline small business reorganizations will come to fruition in practice. As with any changes to complex statutory regimes, there will be some uncertainty going forward. Restructuring professionals are well advised to monitor closely the development of practice and case law under new Subchapter V.

⁵⁵ See 11 U.S.C. § 1129(a)(9)(A) (2019).

⁵⁶ See 11 U.S.C. §§ 1191(e) (Debtors in chapter 12 cases may similarly defer payment of administrative expense claims), § 1222(a)(2) (2019).