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Charting a Course Through Troubled Waters: Protecting Your Business in an Economic Downturn

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Summary of the Small Business Reorganization Act of 2019 ("SBRA"), PL 116-54, August 23, 2019, 133 Stat 1079

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I. Introduction

Bankruptcy practitioners regularly confront the irony that those businesses most in need of reorganization under the Bankruptcy Code, 11 U.S.C. §§ 101 *et seq*., often find the process too expensive, too time-consuming and too complicated to navigate successfully. To address this problem, Congress in 2019 passed the Small Business Reorganization Act of 2019 ("SBRA") to provide small businesses with aggregate liabilities of $2,725,625 or less a more streamlined and less expensive alternative to a traditional chapter 11 case.[1] The bulk of the SBRA is located in a new subchapter V to chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 1181-1195 but the SBRA also amends other provisions of the Bankruptcy Code, *e.g.*, section 547 (preferences) and those provisions of the U.S. Judicial Code dealing with, for example, bankruptcy jurisdiction. The SBRA became effective on February 19, 2020.[2]

Coincidently, the effective date of the SBRA occurred almost simultaneously with the emergence of the COVID-19 pandemic in the United States. In response, Congress subsequently

[1] "Notwithstanding the 2005 Amendments [to the Bankruptcy Code], small business chapter 11 cases continue to encounter difficulty in successfully reorganizing. Based upon their respective reviews of this issue, the NBC and the ABI developed recommendations to improve the reorganization process for small business chapter 11 debtors. H.R. 3311 is largely derived from these recommendations. As the bill's sponsor, Representative Ben Cline (R-VA), explained at the hearing held by the Subcommittee on Antitrust, Commercial, and Administrative Law on June 25, 2019 at which H.R. 3311 was considered, the legislation allows these debtors "to file bankruptcy in a timely, cost-effective manner, and hopefully allows them to remain in business" which "not only benefits the owners, but employees, suppliers, customers, and others who rely on that business." *Quoted in* In re Progressive Sols., Inc., Debtor., No. 8:18-BK-14277-SC, 2020 WL 975464 (Bankr. C.D. Cal. Feb. 21, 2020).

[2] Public Law No. 116-54. "SEC. 5. EFFECTIVE DATE. This Act and the amendments made by this Act shall take effect 180 days after the date of enactment of this Act."

enacted the Coronavirus Aid, Relief and Economic Security Act of 2020 ("CARES Act").[3] Of relevance here, the CARES Act temporarily increased for a period of one year the debt limit for small businesses to be debtors under the SBRA to $7.5 million dollars.[4] As a result of this change, it is hoped that many more small businesses will now be eligible to take advantage of the SBRA to reorganize and remain viable companies during these challenging times.

As noted above, Congress's primary goal in enacting the SBRA was to increase the likelihood that a small business debtor in bankruptcy could confirm a plan of reorganization as opposed to merely liquidating its assets and terminating all of its employees—a theme reinforced by the SBRA's bipartisan Senate sponsors.[5] For example:

"*Our bankruptcy system is designed to help highly complex businesses reorganize after falling on hard times, but for many small businesses going through bankruptcy, these requirements can create unnecessary burdens that stall recovery. The Small Business Reorganization Act takes into account the unique needs of small businesses and streamlines existing reorganization processes. A well-functioning bankruptcy system, specifically for small businesses, allows businesses to reorganize, preserve jobs, maximize the value of assets and ensure the proper allocation of resources.*"

- Sen. Charles Grassley

"*The strength of Rhode Island's economy depends on the strength of the nearly one hundred thousand small businesses that have set up shop here. We need to improve the bankruptcy*

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[3] CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY ACT, PL 116-136, March 27, 2020, 134 Stat 281.

[4] *Id*. at § 1113. The term 'debtor'—

"(A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning single asset real estate) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $7,500,000 (excluding debts owed to 1 or more affiliates or insiders) not less than 50 percent of which arose from the commercial or business activities of the debtor. . . ."

[5] *See* https://www.grassley.senate.gov/news/news-releases/grassley-bipartisan-colleagues-introduce-legislation-help-small-businesses-0.

process to give smaller employers who are struggling better tools to get back on their feet and preserve jobs."

- Sen. Sheldon Whitehouse

"*We need to make sure that businesses on Main Street have the same opportunities as big businesses to utilize the protections offered by our bankruptcy laws. This legislation will help streamline bankruptcy procedures for small businesses, ensuring that when mom-and-pop businesses fall on hard times, they have a chance to recover and be successful.*"

- Sen. Amy Klobuchar

"*Iowa is home to more than 267,700 small businesses, making up just over 99% of the businesses in our state. While many of these businesses are thriving, those that experience financial distress face an overly burdensome and costly bankruptcy system. Our bipartisan bill would streamline the reorganization process, preserve jobs, and allow small business owners to maintain control and negotiate a successful reorganization.*"

- Sen. Joni Ernst

"*All too often, an outdated bankruptcy system forces small businesses to close their doors when they hit hard times. When a small business owner requires relief from overwhelming debt, bankruptcy should offer a path forward to preserve jobs - not an endless, money-draining process. Our bipartisan legislation implements thoughtful, commonsense reforms to make our bankruptcy system work for small businesses instead of against them.*"

- Senator Richard Blumenthal

II. SUBSTANCE OF THE SBRA

A. What is a "Small Business Debtor?"

Section 101(51D) of the Bankruptcy Code defines a "small business debtor" to mean:

(A) subject to subparagraph (B), means a person engaged in commercial or business activities[6] (including any affiliate of such person that is also a debtor under this title and

[6] In one of the first reported cases under the SBRA, Judge Grossman held in the context of a bed & breakfast that even though the owner of the business lived in the establishment and that the mortgage was styled as a residential one, such mortgage debt was nevertheless incurred in connection with "commercial or business

excluding a person whose primary activity is the business of owning single asset real estate)[7] that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $2,000,000[8] [as may be adjusted by section 104 of the Bankruptcy Code] (excluding debts owed to 1 or more affiliates or insiders) not less than 50 percent of which arose from the commercial or business activities of the debtor; and

(B) does not include--

(i) any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $2,000,000 (excluding debt owed to 1 or more affiliates or insiders);

(ii) any debtor that is a corporation subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78***o***(d)); or

(iii) any debtor that is an affiliate of an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)). (Emphasis supplied).

Originally, the American Bankruptcy Institute advocated that the debt limit for eligibility as a small business debtor be $10 million but Congress instead limited it to approximately $2.5

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activities." *In re Ventura*, No. 8-18-77193-REG, 2020 WL 1867898 (Bankr. E.D.N.Y. Apr. 10, 2020). Specifically, the court noted that "the fact that a debtor incurs mortgage debt to buy a residence does not automatically mean that the debt is consumer debt. 'The test for determining whether a debt should be classified as a business debt, rather than as a consumer debt, is whether it was incurred with an eye toward profit. [c]ourts must look at the substance of the transaction and the borrower's purpose in obtaining the loan, rather than merely looking at the form of the transaction.' citing *In re Martin*, No. 12-38024, 2013 WL 5423954, at *6 (S.D. Tex. Sept. 26, 2013).

[7] "Single asset realty" is generally regarded as a business that owns real estate for investment purposes only and does not conduct commercial or business activities on such real property. For example, an entity that owns a hotel but contracts with a management company for all of its operations is characterized as "single asset realty." Conversely, if that same entity owns and operates the hotel and files for bankruptcy, is not a "single asset realty" debtor.

[8] Raised to $7.5 million under the CARES Act for a period of one-year.

million. Significantly, the debt limits exclude debts owed to insiders or affiliates of the small business debtor (insider debt is a common feature of many small businesses) and not less than 50% percent of such debt must arise from the commercial or business activity of the debtor. This latter provision is to ensure that "small business debtors" are actively engaged in commercial activity and not just passive investment vehicles. Finally, the eligibility exclusions are designed to filter out more complex enterprises that have public debt or securities and are therefore subject to SEC reporting requirements.

B. Material Provisions of the SBRA

In accordance with Congress's stated goal of making chapter 11 a less onerous and expensive prospect for small businesses, the SBRA eliminates or modifies many of the substantive provisions of a traditional chapter 11 case. This subsection identifies and highlights some of the important distinctions between a traditional chapter 11 case and one conducted under the SBRA. To facilitate this goal, the SBRA, among other things, contains the following significant provisions:

1. Under the SBRA, only the debtor may propose a plan of reorganization. In a traditional chapter 11 case, the debtor maintains so-called "plan exclusivity" for 120 days from entry of the order of relief. 11 U.S.C. §1121. After expiration of this 120-day period, absent an extension by the Bankruptcy Court, any party-in-interest may file a proposed plan. *Id.* In this way, a traditional chapter 11 debtor not making progress towards confirmation of a plan, may see its chapter 11 case "taken over" by its creditors. Conversely, under section 1189 of the SBRA, only the debtor may file a plan and creditors lack any ability to do so.[9]

[9] In *In re Ventura*, the Bankruptcy Court held that a debtor could retroactively reclassify its chapter 11 case as one filed under the SBRA even where the secured creditor had already received the court's permission to file its own plan of reorganization effectively nullifying the court's previous order terminating the debtor's plan exclusivity. Judge Grossman reasoned as follows: "Given that subchapter V was not available to the Debtor on the Petition Date and the Debtor has made very clear from the outset the nature of Property as a business, the Court will not penalize the Debtor because after careful analysis by Congress the law has been amended to address the needs of debtors that engage in the type of business she operates. These types of debtors who are willing to risk everything to start and

2. The SBRA eliminates the requirement of a plan disclosure statement. Outside of subchapter V, a chapter 11 debtor cannot solicit votes on a plan of reorganization until the bankruptcy court approves its disclosure statement. 11 U.S.C. § 1125. Although intended by Congress to provide creditors and other parties-in-interest with "adequate information"[10] about a proposed plan of reorganization, the typical disclosure statement has ballooned into a voluminous, complex and costly document for a debtor to prepare and which at the end of the day has very little legal significance. In lieu of a disclosure statement, section 1190 of the SBRA requires that a plan of reorganization contain "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 of reorganization." *Id.*[11] Through the elimination of a court-approved disclosure statement as a prerequisite to solicitation on a plan of reorganization, the SBRA dramatically scales back both the time and expense faced by a debtor seeking to reorganize under chapter 11.
3. Initial status conference requirement. Unlike in a traditional chapter 11 case, under the SBRA the Bankruptcy Court must conduct an initial status conference within 60 days of

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maintain their own businesses should not be penalized, rather, they should be applauded. [secured creditor] will retain many of the rights it had at the inception of the case, any delay caused by this ruling is not sufficiently prejudicial to [secured creditor], given the current economic conditions. For these reasons, the Court finds that the SBRA applies to the Debtor's case in its totality." 2020 WL 1867898 at *11.

[10] Section 1125 defines "adequate information" as: "information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such a hypothetical investor of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan and in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information."

[11] In this regard, a plan of reorganization under the SBRA looks more like a consumer plan under chapter 13 of the Bankruptcy Code. For a sample form of SBRA Plan, *see* http://www.njb.uscourts.gov/sites/default/files/forms/Subchapter%20V%20Small%20Business%20Debtor%27s%20Plan%20of%20Reorganization%20or%20Liquidation%202-19-20%20final.pdf.

the petition date to assess the debtor's progress towards confirmation of a plan of reorganization. 11 U.S.C. §1188(a). In addition, that section also provides that "not later than 14 days before the date of the status conference under subsection (a), the debtor shall file with the court and serve on the trustee and all parties in interest a report that details the efforts the debtor has undertaken and will undertake to attain a consensual plan of reorganization." *Id*. at §1188(c). In this way, the Bankruptcy Court can monitor the debtor's progress towards the filing and confirmation of a plan and address any concerns from parties-in-interest earlier rather than later in the process.

4. Cases under the SBRA are assigned a standing trustee. Unlike in a traditional chapter 11 case, each case under the SBRA will be assigned a standing trustee to monitor the case and work with the debtor and its creditors on the formulation of a chapter 11 plan. 11 U.S.C. §1183.[12] Similar to the standing trustee appointed in all chapter 13 cases, the

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[12] That section provides: (a) In General.—

If the United States trustee has appointed an individual under section 586(b) of title 28 to serve as standing trustee in cases under this subchapter, and if such individual qualifies as a trustee under section 322 of this title, then that individual shall serve as trustee in any case under this subchapter. Otherwise, the United States trustee shall appoint one disinterested person to serve as trustee in the case or the United States trustee may serve as trustee in the case, as necessary.

(b) Duties.—The trustee shall—

(1) perform the duties specified in paragraphs (2), (5), (6), (7), and (9) of section 704(a) of this title;

(2) perform the duties specified in paragraphs (3), (4), and (7) of section 1106(a) of this title, if the court, for cause and on request of a party in interest, the trustee, or the United States trustee, so orders;

(3) appear and be heard at the status conference under section 1188 of this title and any hearing that concerns— (A) the value of property subject to a lien;

(B) confirmation of a plan filed under this subchapter;

(C) modification of the plan after confirmation; or

(D) the sale of property of the estate;

(4) ensure that the debtor commences making timely payments required by a plan confirmed under this subchapter;

(5) if the debtor ceases to be a debtor in possession, perform the duties specified in section 704(a)(8) and paragraphs (1), (2), and (6) of section 1106(a) of this title, including operating the business of the debtor;

(6) if there is a claim for a domestic support obligation with respect to the debtor, perform the duties specified in section 704(c) of this title; and

(7) facilitate the development of a consensual plan of reorganization.

SBRA Trustee's primary function is to help the debtor formulate a confirmable plan that will garner the support of its creditors. Importantly, the SBRA trustee does not have any operational or management role with respect to the debtor's business. Finally, the SBRA trustee is charged with collecting and distributing all proceeds to be paid to creditors under a confirmed SBRA plan of reorganization, freeing the reorganized debtor from the administrative burden of making and monitoring plan payments to multiple creditors.

5. The SBRA eliminates the appointment of an official creditors' committee. Unless ordered by the Bankruptcy Court, the SBRA eliminates the appointment of an official creditors' committee in cases under subchapter V. This amendment to traditional chapter 11 practice eliminates a significant estate expense and is consistent with Congress's intent that promulgation of a plan of reorganization under the SBRA be a debtor-driven process.

6. The SBRA relaxes many of the more onerous plan confirmation requirements found in a traditional chapter 11 case. As noted by proponents of the SBRA inside and outside of Congress, more often than not traditional chapter 11 cases result in the debtor's liquidation or sale of the business as opposed to reorganization. Many times, this sub-optimal outcome is driven by the many "creditor-friendly" provisions of the Bankruptcy Code, particularly when a chapter 11 plan does not have the universal support of the

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(c) Termination of Trustee Service.—

(1) In general.—

If the plan of the debtor is confirmed under section 1191(a) of this title, the service of the trustee in the case shall terminate when the plan has been substantially consummated, except that the United States trustee may reappoint a trustee as needed for performance of duties under subsection (b)(3)(C) of this section and section 1185(a) of this title.

(2) Service of notice of substantial consummation.—

Not later than 14 days after the plan of the debtor is substantially consummated, the debtor shall file with the court and serve on the trustee, the United States trustee, and all parties in interest notice of such substantial consummation.

debtor's creditors. Here, we would highlight the following aspects of the SBRA with respect to confirmation of a plan:

a. The SBRA permits a debtor to modify the rights of a mortgagee with a security interest in the debtor's *personal residence* under certain circumstances.

Oftentimes in the small business context, owners will have to pledge personal property as collateral to induce lenders to extend financing to their businesses. And in those instances where the business files for bankruptcy, there is no mechanism in a traditional chapter 11 case for the owner to modify the rights of the lender in her personal property absent her filing for bankruptcy too. As a result, many owners who have pledged personal property to a lender might be resultant to file a traditional chapter 11 case for fear of the lender foreclosing on his residence or other pledged property. Under section 1190(3) of the SBRA, however, a small business debtor can modify the rights of a mortgagee with a lien on the debtor's personal residence if the proceeds of the loan were "not primarily used to acquire the property" and "used primarily in connection with the small business of the debtor." *Id.* In other words, if a small business debtor borrows money secured by her personal residence for the benefit of her business, she can modify the terms of that mortgage under an SBRA plan of reorganization.

b. The SBRA permits a debtor to confirm a plan without the requirement that at least one class of impaired creditors votes to accept it.

In a traditional chapter 11 case, confirmation of a plan requires, *inter alia*, that at least one class of creditors eligible to vote on the plan votes to accept it. 11 U.S.C. §1129(a)(8). This requirement obviously poses a substantial barrier to confirmation of a plan that does not enjoy creditor support even if all of the other confirmation requirements are met. Under the SBRA, however, so long as the Bankruptcy Court determines that the chapter 11 plan does not "discriminate unfairly" and is deemed to be "fair and equitable" with respect to each class of creditor claims, a chapter 11 plan can be confirmed without the support of any class of creditor claims. 11 U.S.C. §1191(b). Additionally, section 1191(c) provides the small business debtor with "rules of construction" that set out a non-exclusive list of requirements that satisfy the "fair and

equitable"[13] prong of the statute. In this way, the SBRA provides the small business debtor with a clear road map as to what the plan must provide so as to meet the Bankruptcy Code's confirmation requirements even in those instances where the plan otherwise lacks creditor support.

c. The SBRA eliminates the "absolute priority rule," making it more likely that a small business debtor's equity holders may retain their interests in the reorganized business.

In a traditional chapter 11 case, the only way for the debtor's equity interests to survive plan confirmation is with creditor consent or if the plan satisfies the so-called "absolute priority rule." In a nutshell, the "absolute priority rule" states that no junior class of claims or interests can receive a distribution under a plan unless each class of senior claims is first paid in full. 11 U.S.C. §1129(b)(1). In other words, the "absolute priority rule" means that unless a debtor's plan provides for payment in full of all creditor claims, the holders of the debtor's equity will have their interests extinguished. The SBRA's elimination of the absolute priority rule in favor of the "fair and equitable" requirement allows the debtor's principals to retain an interest in the reorganized business even though creditors will not be paid in full. Instead, those interest may be retained so

[13] Section 1191(c) provides as follows: (c) Rule of construction.--For purposes of this section, the condition that a plan be fair and equitable with respect to each class of claims or interests includes the following requirements:

(1) With respect to a class of secured claims, the plan meets the requirements of section 1129(b)(2)(A) of this title.

(2) As of the effective date of the plan--

(A) the plan provides that all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date that the first payment is due under the plan will be applied to make payments under the plan; or

(B) the value of the property to be distributed under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date on which the first distribution is due under the plan is not less than the projected disposable income of the debtor.

(3)(A)(i) The debtor will be able to make all payments under the plan; or

(ii) there is a reasonable likelihood that the debtor will be able to make all payments under the plan; and

(B) the plan provides appropriate remedies, which may include the liquidation of nonexempt assets, to protect the holders of claims or interests in the event that the payments are not made.11 U.S.C. § 1191

long as the plan provides that all of the debtor's projected disposable income to be received during the length of the chapter 11 plan will be applied to make payments under the chapter 11 plan for a period of 3 to 5 years.

7. The SBRA is intended to lead to less litigation over preferential payments. The SBRA makes several changes to the manner in which preference litigation is conducted. Specifically, the SBRA amended section 547(b) of the Bankruptcy Code to require the trustee or a debtor in a preference case to conduct "reasonable due diligence regarding the defendant's known or reasonably knowable affirmative defenses" before filing a preference action. *Id*. Further, Congress amended the United States Code to increase the dollar threshold from $13,650 to $25,000 for certain "covered actions" like preference and fraudulent transfer suits against non-insider defendants brought in the district where the defendant resides. 28 U.S.C. § 1409(b).

III. CASE LAW DEVELOPMENTS

1. The majority of courts that have considered the issue have held that the SBRA may be applied retroactively. Because the SBRA has only been in effect since February, 2020, there is scant case law construing it. However, there have been reported decisions considering whether a debtor which filed its chapter 11 case before enactment of the SBRA could convert its case to one under the SBRA (assuming all SBRA eligibility requirements are otherwise met). Of those courts considering this issue, the vast majority have held that because the SBRA does not alter "fundamental rights," it can be applied retroactively to chapter 11 cases filed before the law went effective. *See* In Re: Charles Christopher Wright, Debtor(s)., No. CA 20-01035-HB, 2020 WL 2193240 (Bankr. D.S.C. Apr. 27, 2020); In re Ventura, No. 8-18-77193-REG, 2020 WL 1867898 (Bankr. E.D.N.Y. Apr. 10, 2020); In re Bello, No. 19-46824, 2020 WL 1503460 (Bankr. E.D. Mich. Mar. 27, 2020) (holding that chapter 13 debtor could convert case to one under the SBRA); In re: Moore Properties of Pers. Cty., LLC, Debtor., No. 20-80081, 2020 WL 995544 (Bankr. M.D.N.C. Feb. 28, 2020). *But see*, In re Double H Transportation LLC, No. 19-31830-HCM, 2020 WL 2549850 (Bankr. W.D. Tex. Mar. 5, 2020) (declining debtor's request to convert case to one under the SBRA on the grounds that to permit "the

Debtor to now elect ‘Subchapter V’ status at this stage of the bankruptcy case would create a procedural quagmire and likely create ‘cause’ to dismiss or convert the Debtor's case.).

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