

Outside Counsel

Just in Time: New Bankruptcy Relief For Small Businesses

The clock is ticking for small businesses (with debt of less than \$7.5 million) to take advantage of a new way to restructure under chapter 11 of the Bankruptcy Code. New sub-chapter V (“five”) – part of the Coronavirus Aid, Relief and Economic Security Act of 2020 (the “CARES Act”)—is set to expire in about six months.

The CARES Act special bankruptcy relief increased the debt limit under the Small Business Reorganization Act of 2019 (SBRA) from about \$2.7 million to \$7.5 million in light of the unprecedented financial distress being experienced by small businesses all across the county, including especially by small retailers and

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manufacturers, restaurants and services providers. The increased debt limit, which became effective Feb. 20, 2020, includes a one-year sunset.

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The SBRA itself was designed to fix much of what is “broken” about Chapter 11 for small businesses, including most importantly, the “absolute priority rule” that often

led to owners losing their companies. High costs and indeterminable delays also made Chapter 11 unworkable for many small businesses.

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Creditors will also benefit from the lower costs, quicker proceedings, and increased certainty about the outcome of the process, if at the expense of some leverage. Secured lenders, whose long-term secured loans typically flow through the restructuring, will also enjoy the additional benefit of more economically viable borrowers emerging from Subchapter V.

Lower Costs and Streamlined Process

Owners now have a way to keep their equity ownership even over

the objection of creditors. The baseline economic requirement for Subchapter V plan confirmation is that creditors receive at least the value of the business's projected "disposable income" over a period of three to five years, and not less than creditors would receive in a chapter 7 liquidation.

Key to the calculation of "disposable income" is the minimum payment is after subtracting all of the business's reasonable expenses, including the owner's salary, and also may potentially include a contingency reserve in appropriate circumstances. In this way, Subchapter V is similar to Chapter 13 cases for individual wage earners and Chapter 12 cases for family farmers, which allow confirmation without creditor consent, subject to what may be considered a business's "reasonable best efforts" to pay its creditors.

The costs of small-business Chapter 11 cases are dramatically reduced because Subchapter V eliminates: (i) the requirement that a separate disclosure statement be prepared and approved before voting on the Chapter 11 plan; (ii) the risk of a creditors' committee being appointed absent cause; (iii) the risk of a competing Chapter 11 plan being filed by creditors; and (iv) the obligation to pay quarterly fees to the United States Trustee, the federal watchdog that oversees bankruptcy cases.

Subchapter V speeds up the

restructuring process through a regimen of three important deadlines: (i) the debtor is required to file a status report by 14 days before the initial status conference, detailing its efforts to "attain a consensual" Chapter 11 plan; (ii) by day-60 after the bankruptcy filing, the Bankruptcy Court is to hold an initial status conference to consider the substance of the debtor's status report, the purposes of the bankruptcy filing, and the path forward for the restructuring; and (iii) by day-90 after the filing,

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the debtor is required to file its Chapter 11 plan, which may be consensual or nonconsensual. The Bankruptcy Court retains discretion to extend these deadlines for "circumstances for which the debtor should not justly be held accountable."

Companies are nevertheless still required to file first day motions, including, for example, motions to use cash collateral, to make "adequate protection" payments to secured creditors after the petition date and before the plan is confirmed (via the Subchapter V trustee), and to file applications to employ professionals.

Similarly, debtors must file financial reports required by Section 1116(1) on the petition date, periodic performance reports required by Section 308, and their schedules and statements. (All statutory references are to the Bankruptcy Code at 11 U.S.C. §§ 101 *et seq.*) Companies must also maintain insurance and pay taxes that become due during the case.

Criteria

Subchapter V is strictly voluntary and must be affirmatively elected. A company makes its election when the case is filed, or within 14 days after an involuntary case is filed.

To qualify, businesses must meet two criteria. First, the total amount of secured *plus* unsecured debt may not exceed \$7.5 million, counting only noncontingent, liquidated, and non-insider debt. Second, at least half of the debt that is counted must have arisen from the debtor's "commercial or business activities."

Importantly, the debt limit does not count any debts owing to the owners or other insiders, such as family members, nor does the debt cap count any contingent debts, such as potential environmental claims, or debts that have not been liquidated and remains unfixed in amount, such as commercial tort claims.

Regrettably perhaps, Subchapter V is not available to businesses whose only business is the operation of its owned real property, so-called "sin-

gle asset real estate” cases. Those cases have their own special rules and requirements under Chapter 11.

The Subchapter V Trustee

As in traditional Chapter 11 cases, the company’s owner/management remains in control of the company (absent cause for removal), and a new player is added: the Subchapter V trustee. Some describe this trustee as a “facilitating neutral” or a “consulting trustee,” because the trustee’s mandate is to “facilitate the development of a consensual plan of reorganization.” This trustee may even interface with creditors in negotiations. This is a novel and unique role for a bankruptcy trustee, and the extent to which the promise of this role is actualized remains to be seen.

Unlike a Chapter 7 trustee, who has a duty to investigate the debtor’s affairs, or a Chapter 13 trustee, who scrutinizes the debtor’s expenses and is the disbursing agent in every case, the Subchapter V trustee serves a unique role as a facilitator whose primary purpose is to assist the debtor in making its restructuring successful.

Other Significant Features

Only the company’s owner may file a plan in a Subchapter V case; there are no creditor plans permitted. The plan must be filed within 90 days of the petition date, unless the Bankruptcy Court in its discretion grants more time, and the company

is free to amend its plan any time before the plan is confirmed. There is no deadline by when the company’s plan must be confirmed. While the company’s plan must be filed in good faith, ownership’s control over the plan deprives creditors of the strategic leverage of potentially offering a “competing plan” or otherwise seeking to end the company’s exclusive right to file a plan.

Subchapter V plans may provide for a lump-sum payment to be funded on the plan’s effective date, from exit financing or other means, which further speeds the company’s reorganization.

Subchapter V also allows home mortgages to be restructured—which is unique under bankruptcy law—so long as the proceeds were used for the company’s “commercial or business activities.” This presents a pre-filing planning opportunity to refinance a purchase-money mortgage.

Subchapter V plans are also to include fallback provisions to take effect if the plan payments are not made. Companies have considerable flexibility in this regard, including, for example, to provide for the liquidation or a going-concern sale of the debtor’s nonexempt assets, the terms of which may be specified in the plan.

Cooperation toward a consensual Chapter 11 plan is encouraged by two unique features of Subchapter V as compared to traditional Chapter 11 cases. First, the facilitating trustee

is available to assist in laying the groundwork for negotiations with creditors. Second, while the company is not required to obtain creditor consent so long as the disposable income test is satisfied, the company stands to benefit from confirming a consensual plan—and thus has an incentive to negotiate with creditors—including the company’s ability to obtain its discharge upon plan confirmation rather than after the required payments have been made under a nonconsensual plan.

Conclusion: *Carpe Diem!*

In light of some analyses showing that as many as half of all Chapter 11 cases filed last year would have been eligible to use this new Subchapter V had it existed, and the economic wreckage of COVID-19, this new subchapter is likely to have a substantial positive impact on Chapter 11 proceedings in the near term. But companies better act quickly: the debt cap is scheduled to fall back to under \$3 million in early 2021 unless Congress acts to extend this opportunity for small businesses.