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Major Ch. 11 Changes Set To Aid Distressed Small Businesses

By **Zach Shelomith** (February 21, 2020, 5:56 PM EST)

Small businesses are the backbone of the U.S. economy. According to recent statistics, 99% of all businesses in the U.S. are small businesses, and almost half of the entire workforce is employed by small businesses.

However, the majority of small businesses do not survive after 10 years. Chapter 11 bankruptcy was designed to allow businesses struggling with debt to restructure their finances and maximize the return to their creditors. Most importantly, Chapter 11 bankruptcy is meant to allow businesses to survive, rather than close down and liquidate.



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The Problem With Chapter 11 Bankruptcy for Small Businesses and Introduction of the Small Business Debtor Reorganization Act

However, the advantages of Chapter 11 have been largely unavailable for small businesses and their owners. For example, Chapter 11 bankruptcy is expensive, complicated, time consuming and generally provides creditors with superior leverage than debtors.

In response to these issues, Congress created the Small Business Reorganization Act of 2019, which took effect on Feb. 19. The act implements a new subchapter of Chapter 11 (Subchapter V), called a small business debtor reorganization, which addresses many of the difficulties experienced by small business debtors in Chapter 11 cases and makes a successful reorganization more of a possibility for a struggling business and its owners.

Only debtors that have no more than \$2,725,625 of aggregate noncontingent liquidated secured and unsecured debt are eligible to be a subchapter V debtor. The act is available to both companies and individuals whose debts primarily arose from commercial or business activities, with certain exceptions.

The core objectives of the act are to make a subchapter V case quicker, cheaper and more effective for debtors. The act provides for a streamlined reorganization process and contains numerous powerful tools for debtors that are not typically available in Chapter 11.

Significant Changes Under the Small Business Reorganization

Act Some of the sweeping changes include:

Time and Cost Associated With a Subchapter V Bankruptcy

- Under the act, only the debtor may file a plan. The plan must be filed within 90 days after the bankruptcy is filed, with limited exceptions.

- In general, there is no committee of unsecured creditors in a subchapter V case.
- In general, there is no disclosure statement required in a subchapter V case.
- A subchapter V debtor does not have to pay quarterly U.S. trustee fees.

These changes are intended to make a subchapter V bankruptcy proceed on a streamlined process, with significantly fewer expenses than a traditional Chapter 11 case.

Appointment of a Subchapter V Trustee

In addition, a trustee with limited duties and powers is appointed in every case. The trustee's role is to facilitate the development of a consensual plan, and in certain circumstances, make distributions under the plan. However, the debtor still remains a debtor in possession, unless the court, for cause, orders otherwise. That means that the debtor still runs the business and generally has the same rights as in a typical Chapter 11 case.

How a Small Business Debtor Can Successfully Confirm a Plan of Reorganization

Perhaps most significantly, the act changes the way that a subchapter V debtor can successfully confirm a plan of reorganization.

Among the more onerous provisions in Chapter 11 is the fact that a debtor must obtain votes from impaired classes of creditors in order to confirm a Chapter 11 plan. Furthermore, the "absolute priority rule" oftentimes either prevents a business owner from retaining his or her ownership interest in the company, or requires significant expense to the business owner to retain such ownership interest.

These burdensome provisions many times result in no Chapter 11 being filed at all by a small business. Many small businesses have only a handful of creditors and finding an impaired accepting class of creditors is particularly difficult. Furthermore, small businesses oftentimes do not have the financial wherewithal to withstand a contested and litigated confirmation process.

However, the act does away with these specific provisions that relate to confirmation of a plan.

In particular:

- Under the act, a subchapter V debtor now has the ability to confirm a plan without having any creditors vote to accept the plan. A subchapter V debtor must still meet all of the other requirements for confirmation of a plan under the act. This should actually lead to more consensual plans in the future, as creditors realize that the leverage has shifted more in the debtor's favor.
- The act does away with the absolute priority rule, allowing business owners a greater opportunity to retain their ownership interests.
- The act modifies cramdown rules. In a typical Chapter 11 case, if a certain number of accepting votes are not attained, then certain additional requirements apply to confirm a plan, called a Chapter 11 cramdown. The act modifies the cramdown rules relating to unsecured creditors by requiring that all of the projected disposable income of the debtor to be received in a period of time ranging from three to five years must be applied to payments under the plan (or the value of the property to be distributed must not be less than the projected disposable income). This is a much simpler and straightforward way to confirm a plan when there are insufficient accepting votes.

Essentially, as mentioned above, the act shifts a lot of the leverage back to the subchapter V debtor. Of course, many of the other provisions of Chapter 11 were unaffected, meaning that a debtor that files a Chapter 11 in bad faith is not entitled to an unfettered path to reorganization. However, under the act an honest small business debtor that wants to finally solve its financial issues is now given a much greater opportunity to do so.

Specific Benefits to Individual Debtors Under Subchapter V

Also significant are the considerable benefits to individual small business debtors, who are also now able to take advantage of these sweeping changes. Typically, a small business owner will personally guarantee much of the company's debt. A corporate Chapter 11 will generally, with few exceptions, only resolve the debt of the company, and not the personal guarantees of the business owner(s).

Small business owners who wanted to avail themselves of the benefits of a personal bankruptcy would have to choose between a Chapter 7 liquidation, a Chapter 13 reorganization or an individual Chapter 11 reorganization, which has many of the same harsh requirements as that of a corporate debtor.

Furthermore, there are stringent debt limitations involved with Chapter 13. Currently, only an individual debtor with aggregate noncontingent liquidated and unsecured debts of less than \$394,725 is eligible to file under Chapter 13. The act creates a new opportunity for business owners with unsecured debts greater than that amount, but who are within the subchapter V debt limitations, to reorganize.

As compared to Chapter 13, some of the benefits of subchapter V for an individual include:

- The ability to repay debt over a longer period of time than in a Chapter 13;
- Utilization of a more relaxed definition of disposable income;
- The ability to obtain a discharge before the completion of plan payments; and
- The ability to modify certain residential mortgages, if the underlying loan was not used to acquire the residence and was primarily used in connection with the small business.

Struggling businesses and their owners should strongly consider subchapter V as a potential remedy to their financial problems. It will be important for bankruptcy attorneys to advise their clients of this addition to their bankruptcy toolbox and navigate the act to bring about a successful reorganization.

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