CLIENT ALERTS

Revisions to Chapter 11 Create New Opportunities for Small Business Reorganization

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On February 19, 2020, the Small Business Reorganization Act of 2019 (the "SBRA") becomes effective. A small business debtor under the US Bankruptcy Code is a person or entity, other than the owner of a single asset real estate, that is engaged in commercial or business activities that has aggregate noncontingent liquidated secured and unsecured debt of not more than $2,725,625 (subject to periodic adjustment). The objective of the SBRA is to make it easier and less expensive for small businesses, considered by Congress to be the backbone of the American economy, to reorganize and remain in business under Chapter 11. The SBRA makes a number of changes to the Bankruptcy Code that will decrease the costs of reorganizations and enable small business owners to retain control over their businesses.

Background:

Chapter 11 is the Bankruptcy Code's centerpiece for reorganization for corporate businesses and individuals with complex financial affairs. In broad strokes, and subject to many exceptions, Chapter 11 permits existing management to retain control of the debtor's assets and operations during the course of a case. Generally, the objective of Chapter 11 is either to reorganize a business's financial affairs or sell a business's operating assets as a going concern under Section 363 of the Bankruptcy Code, in either case, under a confirmed Chapter 11 Plan of Reorganization. To confirm a Plan, a debtor must provide creditors with a Disclosure Statement (similar to a securities prospectus) that provides creditors with sufficient information to make an informed decision in connection with their vote to accept or reject the Plan. The Plan must be accepted by all impaired classes of creditor (determined both by number and dollar amount of claims). If any impaired class of creditors rejects the Plan, the Plan may still be confirmed through a

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process known as "cram down" in accordance with certain legal standards that ensure that the Plan is fair and equitable and does not discriminate against creditors in favor of existing equity. The plan confirmation process can be onerous and expensive.

Development of Small Business Reorganizations

Since the Bankruptcy Code's enactment in 1978, courts and practitioners have struggled with the "one size fits all" nature of the Bankruptcy Code. As originally enacted, the rules governing a Chapter 11 case were the same, whether the debtor was General Motors Corporation or Mom and Pop's Pizza Stand.

In 1994, Congress first introduced the concept of small business reorganizations into the Bankruptcy Code, creating a somewhat streamlined process to confirm Chapter 11 Plans for businesses with less than $2,000,000 in secured and unsecured debt. This first step attempted to reduce costs and streamline cases by providing for a combined hearing on Plans and Disclosure Statements. In 2005, Congress tried again, reducing costs of a case by decreasing the role of Creditors' Committees in small business Chapter 11 Cases, but increasing the required financial disclosures from the Debtor, and increasing the role of the United States Trustee's Office, a government agency with supervisory functions over Chapter 11 Cases. However, the rules governing confirmation of a Chapter 11 Plan were still the same for all business entities, big or small.

Real Change – the SBRA

In contrast, the SBRA makes significant amendments to the Bankruptcy Code in favor of Small Business Chapter 11 cases. While a small business debtor may still elect to be governed by traditional Chapter 11 provisions, by electing to proceed under the provisions of the SBRA, among the most significant changes it will enjoy are:

1. The debtor can remain in possession and control of its assets and business affairs during the case but can lose that status if the court finds, after notice and a hearing, that the debtor engaged in fraudulent, dishonest or incompetent behavior or grossly mismanaged its financial affairs.
2. An unsecured creditors committee will not be appointed unless ordered by the bankruptcy court for cause.
3. The debtor will no longer be required to provide creditors with a Disclosure Statement (although significant disclosures, including some traditionally required in a disclosure statement such as a brief history of the business operations, a liquidation analysis and projection of the debtor's operations during the 3-5 years after bankruptcy, must be included in the Plan).
4. A Plan must be filed within 90 days of the commencement of the case (unless the court finds circumstances exist for which the debtor should not be held accountable).
5. Only the Debtor may file a Plan.
6. A Plan can be confirmed even if it is not supported by any class of creditors.
7. A trustee shall be appointed with specific duties such as (i) accounting for all estate property; (ii) monitoring the debtor's progress toward confirmation of a reorganization plan; (iii) ensuring the

debtor commences making timely payments under a confirmed chapter 11 plan; and (iv) making distributions to creditors under the plan. The trustee will not operate the business.

8. The Plan must provide for the application of all or a significant portion of the future earnings or other future income of the Debtor to the supervision and control of the trustee as is necessary for the execution of the Plan. If impaired creditors do not vote to accept the plan, the Plan must provide that all of the debtor's projected disposable income for not less than 3 but no more than 5 years after the date of confirmation of the Plan (or payments from another source that at least equals the total disposable income) will be applied to make payments under the Plan. For purposes of a business, disposable income means income above that reasonably necessary for the payment of expenses for the continuation, preservation, or operation of the business of the debtor.
9. The owner's equity can be maintained without any new value payment, even if unsecured creditors reject the plan and are not paid in full.

Mindful that the SBRA is intended to reduce the cost of Chapter 11 for small businesses, questions will initially remain as to the cost a trustee, other than a standing trustee, will create (particularly if it seeks to employ one or more professionals, such as an attorney, a financial advisor or accountant, to assist the trustee in the performance of its pre-confirmation duties). All of these costs will be the responsibility of the debtor. In addition, at no small cost to the debtor, the most likely fertile ground for litigation will be what constitutes projected disposable income and what expenses are reasonably necessary for the continuation, preservation, or operation of the debtor's business (bringing into play owner compensation among other things). That said, we believe the SBRA still will present a cheaper and better alternative for some small businesses.

Provided a small business has sufficient cash flow to stay above water if given the time to pay its creditors, with a further streamlining of the bankruptcy process, the elimination of unnecessary procedural burdens and the opportunity for owners to retain their ownership interest in their company without further consideration or having to pay creditors in full, reorganization should now be quicker, more affordable and hopefully more successful for the long term.

The above summary is not intended to represent a comprehensive review of the SBRA. As always, Butzel Long will continue to monitor the situation and will report on any significant changes or developments on this front.

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