The Changing World of Small Business Bankruptcies

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For many years bankruptcy practitioners and scholars alike have known that the filing of a chapter 11 proceeding by a small business is often the nail in the coffin of that small business. Over the years, there have been attempts to create relief for these small businesses, but most attempts have been futile. The Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") (effective October 17, 2005) first formalized a set of small business provisions, but those provisions did not sufficiently protect small businesses and enable them to emerge from chapter 11 successfully. Most small businesses did not elect the "small business" designation because the benefits just were not there. On August 23, 2019, the Small Business Reorganization Act of 2019 ("SBRA") was signed into law, creating Subchapter V in Chapter 11 of the Bankruptcy Act which became effective on February 19, 2020.

The primary purpose of the SBRA was to reduce costs for a small business in bankruptcy and increase efficiency to enable that small business to succeed. If a small business meets the eligibility requirements for a small business debtor under the SBRA, the small business debtor may elect, but is not required, to be treated as a small business under the SBRA. A "small business debtor" is defined under the SBRA as one engaged in commercial or business activities where the aggregate noncontingent, liquidated secured and unsecured debts is no more than $2,725,625.

While the SBRA granted more chapter 11 protections to a small business, faster deadlines compel that debtor to move through its chapter 11 proceeding quickly. This was one of the original goals as it was often said that the longer a small business remained in chapter 11, the likelihood of its success diminished**.**

Timelines

A status conference must be conducted by the court within sixty (60) days of the chapter 11 filing. At least fourteen (14) days prior to that status conference, the small business debtor is required to file a status report informing the court, among other things, that all tax returns and financial reports have been filed, all insurance is up to date, and what has been done to attain a consensual plan of reorganization.

The small business debtor must file a Plan within ninety (90) days of the chapter 11 filing date and this time period is exclusive to the debtor. No one else can file a Plan in a small business case. The court may extend the 90-day period if the need for the extension is attributable to circumstances beyond the control of the Small Business Debtor. It remains to be seen how the courts will interpret which circumstances qualify as those for which the small business should not be held accountable.

Elimination of Impediments to Successful Reorganization

The payment of quarterly fees to the Office of the United States Trustee has been eliminated with a cost savings to the small business.

There is no creditors' committee in a small business chapter 11 unless the court, for cause, orders otherwise. While this may not seem palatable to trade credit grantors, the debtor will save money by not having to pay for the committee professionals.

A small business debtor does not have to file a separate disclosure statement to accompany its plan. The information generally required by a disclosure statement can be inserted directly into the Plan of Reorganization.

Plan & Confirmation Process

The Plan of Reorganization submitted by a small business debtor must contain a brief history of the business operations of the debtor. The financial information must include a liquidation analysis which shows creditors what they will receive under the Plan as opposed to what they would receive if the business were to be liquidated. Financial projections must show the ability of the debtor to make the payments as promised under the Plan.

The Plan shall provide for the submission of all or such portion of future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan. This is commonly referred to as "current monthly income" or "disposable monthly income". This trustee is more akin to a chapter 13 trustee. The trustee does not operate the debtor's business but will be put into place in each small business chapter 11 to assist the debtor and to facilitate the successful reorganization. All Plan payments will be sent to the trustee who will make the distributions to the creditors.

Unlike a standard chapter 11 proceeding, there is no statutory deadline for acceptances of a Plan in a small business chapter 11 as the deadlines in section 1121 of the Bankruptcy Code are no longer applicable to small business debtor reorganizations.

It is not necessary for creditors to accept a small business Plan. The Plan can be confirmed even if all classes of impaired claims reject the plan. Payments due to administrative expense claimants can be stretched out over the term of the Plan.

Unlike a traditional chapter 11 proceeding, equity (i.e. the owners of the small business) can retain the ownership interest even if the unsecured creditor class is not paid in full and rejects the plan as long as all of the debtor's projected disposable monthly income over three (3) to five (5) years is used to make Plan payments.

Upon confirmation of a consensual Plan, the debtor will receive its discharge. Where there is a non-consensual Plan the discharge will be granted upon completion of all Plan payments.

After Confirmation of the Plan, that Plan can be modified either before substantial consummation but only if the Plan still meets the requirements for confirmation, or after substantial consummation at any time within three (3) years, or such longer time not to exceed five (5) years. The court must hold a hearing upon notice to all creditors in order to approve a modified Plan.

Changes to preferences under the SBRA

This change to the Bankruptcy Code does not impact just small business bankruptcies, yet it was inserted into the SBRA, perhaps, to insure its passage. Trade credit grantors have always grumbled that a trustee or debtor-in-possession or committee should do its homework before commencing a lawsuit to recover alleged preference payments. Now, that homework is mandatory!

Described as a change to avoid abusive practices, section 547(b) of the Bankruptcy Code has been amended by the SBRA to add a due diligence requirement prior to the commencement of preference litigation. Section 547(b) now reads, in pertinent part, "except as provided in subsections (c) and (i) of this section, the trustee may, *based on reasonable due diligence in the circumstances of the case taking into account a party's known or reasonably knowable affirmative defenses under subsection* (c), avoid any transfer of an interest of the debtor in property…."

Creditors who are sued for the return of a preference still retain the burden of proving defenses to those preference actions.

In addition, the venue provision that forces a trustee or debtor-in-possession to commence litigation on smaller claims in the district court where the defendant resides has been increased from $13,650 to $25,000. It is hoped that trustees will be less likely to commence suit on preferences and other claims seeking recovery of less than $25,000 because of this change. This change does nothing to resolve the conflicting court decisions as to whether this venue limit applies to preference and other avoidance actions.

Along came COVID-19

Just as the SBRA was becoming effective in February, 2020, the United States (and the world) became enmeshed by the COVID-19 pandemic. In speed not often seen at the legislative level, the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") was enacted on March 27, 2020. The purpose of the CARES Act was to provide emergency assistance and health care response for individuals, families and businesses affected by the 2020 coronavirus pandemic. This article will only address those portions of the CARES Act which relate to small businesses.

The maximum aggregate debt limit for a business (excluding affiliates and insiders) to qualify as a small business debtor under chapter 11 has been increased to $7,500,000 from $2,725,625. Not less than fifty (50%) percent of that debt must be derived from the operation of the business. The intent is to enable small businesses to use chapter 11 to survive the pandemic and repay their debts without hardship.

Payments made under federal law relating to the national emergency declared by the president under the National Emergencies Act (50 U.S.C. 1601 *et seq.*) with respect to the coronavirus disease 2019 (COVID-19) (commonly referred to as "Stimulus Payments") are excluded from the definition of "current monthly income" which a small business is required to use for its Plan payments. This exclusion is a relief granted not only to small business chapter 11 debtors but also to chapter 13 debtors who may be small businesses, as well. In particular, these payments are excluded from the "disposal income" which is required to be paid by chapter 13 debtors.

These changes are not permanent, however. The relief granted to small business chapter 11 debtors and chapter 13 debtors by the CARES Act are due to expire ("Sunset") one year from the date of Enactment; i.e. March 27, 2021. It remains to be seen whether the CARES Act sunset date will be extended.

Unique treatment of personal guarantors

In the six months since the SBRA has been effective there have already been decisions written by various courts on whether or not guarantors of business debt are eligible to file small business chapter 11's and whether or not the businesses from which the debts were derived must still be in operation.

In the case of In re Wright, 20-01035, 2020 WL 2193240 (Bankr. D.S.C. April 27, 2020), the debtor had guaranteed business debts for two businesses which were defunct at the time of Wright's chapter 11 filing. Wright filed as a small business debtor, produced evidence that more than fifty (50%) of his debts were derived from the operation of those businesses and met the monetary criteria. Judge Helen B. Burris held that the personal guarantor of business debts (even when the business itself was defunct) qualified to file as a Small Business Debtor since he met the criteria and in this instance he was "engaged in commercial or business activities" by addressing residual business debt.

In the case of In re Blanchard, 19-12440 (Bankr. E.D. La. July 16, 2020), relying in part on the Wright case, Judge Meredith S. Grabill held that two individuals who owned several businesses and owed substantial debt as a result of personally guarantying those business debts qualified as small business debtors under the SBRA.

Trade creditors should be watching their guarantors since these courts have opened the door for personal guarantors to file as small business debtors whether they are currently or formerly engaged in business.

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