LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

2 Years Of Small Biz Bankruptcy Law: Winners And Losers

By **Brian Shaw** (April 4, 2022, 2:53 PM EDT)

Brian Shaw

Since 2009, Chapter 11 filings across the country have precipitously dropped from 13,683 in 2009 to just 4,336 in 2021.[1] Many factors have been cited for the decline, including low interest rates, a strong economy and, most recently, so-called free money available through pandemic relief.[2]

However, while correct, these are reasons why fewer businesses need bankruptcy relief. They do not address why entities that need bankruptcy relief sometimes shun bankruptcy for other options such as receiverships, assignments for the benefit of creditors or composition agreements.

What causes putative debtors to choose other forms of relief over bankruptcy? Two principal answers to that question relate to the cost of Chapter 11: the administrative costs of the bankruptcy — the majority of which are professional fees — and the probability that equity holders will lose their interests in the debtor, or have to incur additional material cost to retain it.

Just over two years ago, on Feb. 19, 2020, the Small Business Reorganization Act, or SBRA,[3] proposed and passed in part to address the issues noted above, became effective.[4]

Subchapter V of the Bankruptcy Code was then available for use by "a person engaged in commercial or business activities" with "aggregate noncontingent liquidated secured and unsecured debts as of the date of filing ... [of] not more than $2,725,625," half or more of which must have arisen from commercial activities.[5]

And with the onset of the COVID-19 pandemic just weeks later, the Subchapter V debt threshold was temporarily raised to $7.5 million with the enactment of the Coronavirus Aid, Relief, and Economic Security Act on March 27, 2020.[6]

The debt threshold was initially set to return to $2,725,625 after one year, but was subsequently extended another year — until March 27, 2022 — by the COVID-19 Bankruptcy Relief Extension Act.[7] However, as noted below, Congress has failed to timely propose or pass a law that either further extends or makes permanent the increased debt threshold initially passed through the CARES Act in 2020.[8]

Undoubtedly, the SBRA has provided a less burdensome path to reorganization for qualified small businesses.[9] To its early supporters, the SBRA's enactment meant that small businesses and importantly, their owners, that had effectively been priced out of Chapter 11 over the past two decades, would again be able to utilize the premier restructuring process.[10]

Moreover, because of the abolition of the absolute priority rule, small business owners may retain their equity interests too.[11] In contrast, others, primarily creditors, predicted doom, gloom and the higher cost of credit in light of the perceived debtor/equity-oriented slant of the SBRA.[12]

Two (really long) years later, the results of the SBRA are generally positive. Some unofficial winners, losers, and undecideds are set forth below.[13]

The Numbers

But first, some Subchapter V numbers.

During its first two years, 2,977 Chapter 11 cases were commenced under Subchapter V, which is a material number when compared to the 12,152 Chapter 11 cases that were filed under all of Chapter 11 during calendar year 2020 and 2021. [14]

States that have had the most Subchapter V filings during its first two years are Florida, with 432; California, with 339; Texas, with 331; New York, with 181; Illinois, with 120; and New Jersey, with 113.[15]

Further, while bankruptcy petitions do not delineate between the Subchapter V debtor whose debts fall under the SBRA's original debt threshold from those debtors only eligible for Subchapter V as a result of the CARES Act debt threshold increase, the American Bankruptcy Institute estimates that approximately 30% of the Subchapter V cases filed within six months of the CARES Act enactment were only able to utilize Subchapter V because of the CARES Act increase in the debt threshold.[16]

So, while there is no practical way to assess how many of these Subchapter V debtors would have forgone Chapter 11 altogether if they had not qualified for Subchapter V, it is notable that the increase in the debt threshold materially increased the number of debtors and their owners taking advantage of Subchapter V's friendlier confines.

Accordingly, and not coincidentally, small business owners lead the list of SBRA winners.

Winners

Historically, equity holders have only been able to retain their ownership interests in a bankrupt company seeking relief under Chapter 11 by either (1) paying all holders of senior claims and interests in full, (2) obtaining the consent, or lack of objection, from any senior claims and interests holders if they are not being paid in full, or (3) utilizing the new value exception to the absolute priority rule.[17]

Each option comes at a material cost and risk, both of which were prohibitive to small business owners. The SBRA rectified this issue by abrogating the absolute priority rule in Subchapter V and enabling small business owners to use Chapter 11 to restructure and retain their businesses. Within the context of small businesses, many of which are part and parcel with the life of their owners, this single change was monumental financially and psychologically and makes equity holders winners under the SBRA.

Not surprisingly, small business debtors are also winners under the act meant to better their Chapter 11 experience.

While, as explained below, Subchapter V is not the panacea that somehow makes Chapter 11 as straightforward and inexpensive as a Chapter 7, it does materially lower the overall cost to small business debtors and their estates by removing a creditors committee — and the administrative costs of its professionals — from the equation and enabling plan confirmation in the absence of any consenting class.[18]

In addition, by shortening the time within which a debtor must file its plan, Subchapter V shortens the time period most debtors are in bankruptcy, further reducing the administrative costs of Chapter 11 — as long as the debtor diligently prosecutes its plan to confirmation.[19] Finally, it also allows a debtor to extend the time in which it pays the administrative costs of its bankruptcy over the plan's entire three-to-five-year payment period.[20]

Most creditors, especially those that are unsecured, are also winners. While the SBRA removes certain hurdles from the debtor's path to confirmation, those benefits come with a corresponding cost.

The cost is the creditor's protective backstop that is imposed if the debtor confirms a nonconsensual plan, which requires that all disposable income of the debtor during the plan payment period of three to five years be distributed to creditors through the Subchapter V trustee.[21]

While not perfect for creditors who would rather be paid sooner, it does an effective job of extracting blood from the proverbial stone in a case where the debtor has not come to consensus with its creditors. Moreover, it certainly provides a higher return to unsecured creditors than if the small business simply shut down and liquidated, or was handed over to its secured creditor.

The bankruptcy system wins too.

First, a statutory scheme that is meant to help rehabilitate the economically vulnerable must not be so burdensome as to prevent the smallest entities in that group from being able to utilize it. The SBRA, for a business that qualifies as a "small business debtor"[22] under Subchapter V, is a significant step towards affordability.

Second, it is important to know that on occasion Congress can enact laws that help the bankruptcy system as a whole, rather than just special interest constituents.

And finally, the SBRA promotes compromise. The SBRA provides debtors and creditors with certain handcuffs that temper the desire to partake in zero-sum litigation rather than compromise.

For example, a debtor may cramdown a nonconsensual plan on its creditors, but the cost of doing so is three-to-five years of increased oversight and no discretion in the debtor's use of its otherwise disposable income, even under circumstances where a debtor outperforms its projections on which the plan is based.

In contrast, because only the debtor can file a plan of reorganization under Subchapter V,[23] a creditor may be completely disgusted by the terms of the debtor's proposed plan, but the creditor will have to choose between the debtor's less than satisfactory proposal or the self-harm brought on by a successful motion to convert or dismiss.

Losers

Despite the benefits that the SBRA brought to the bankruptcy system, as a whole, there was some unintended harm too.

Professionals and putative debtors that bought into the early hype that Subchapter V was "Chapter 11 lite" or a cheap and easy alternative to Chapter 11 grossly underestimated the complexity of the Subchapter V process and were not prepared or able to succeed under it, thereby harming not just the debtor, but its creditors and the bankruptcy case.

Subchapter V is not the Bankruptcy Code's magic eraser that with one check of the box on a petition makes all of a Chapter 11 case's warts, scars and ulcers go away.

For example, if a debtor's secured creditor contests the debtor's use of cash collateral, Subchapter V does not help the debtor overcome that challenge. Rather, the first 30 or more days of the debtor's bankruptcy case — i.e., one-third of the debtor's plan period — will be spent litigating over the use of cash collateral and that time will pass before the debtor even knows if it will be able to use its cash to reorganize.

The same is true if a debtor has a vindictive creditor who challenges the good faith basis of the bankruptcy filing, or a landlord counterparty to a key lease that insists on fighting assumption. Subchapter V removes some very significant burdens to small businesses and their owners seeking relief under Chapter 11 — but it does not magically make the difficult case simple — and those debtors and their counsel who mistakenly believe so are losers under the SBRA.

Another bankruptcy constituent that loses under the SBRA is the administrative claimant.[24]

Traditionally, for a Chapter 11 plan to be confirmable, it must provide that all administrative claims will be paid in full on or before its effective date — unless the administrative creditor agrees to alternative treatment.[25]

This requirement does not just entail payment in full of the cost of doing business during the bankruptcy case, but also the cost of the bankruptcy case itself, i.e., professional fees. And it is one of the principal issues that often makes the economics of Chapter 11 unbearable for the small business debtor.

The SBRA alleviates this issue by providing that debtors may stretch out payments on account of allowed administrative claims, including those of the debtor's professionals, over the course of the entire three-to-five-year plan,[26] and that is about three to five years longer than administrative creditors previously had to wait to get paid.

The final loser under the SBRA is the official committee of unsecured creditors. Under Subchapter V, creditors' committees are disfavored, and only allowed under unusual circumstances.[27]

On the whole, the absence of creditors' committees in Subchapter V cases will not harm the committee institution that much, as many of the Subchapter V cases would not have had committees anyway due to lack of creditor interest or the economics of the case.

However, the formal evisceration of the committee from the Subchapter V process, the replacement of it with an independent third-party neutral meant to push the parties to a consensual plan, and the resulting economic benefit to the debtor and its estate, and hence its creditors, does raise legitimate questions about the viability of a similar change in cases that exceed the current Subchapter V debt threshold.

To Be Determined

Subchapter V has been well-received in the bankruptcy community. Most constituents view the increase in small businesses' access to Chapter 11 as a favorable outcome. But that sentiment does not mean that Subchapter V will ultimately be deemed a success.

Rather, success should ultimately be measured by (1) whether there is an increase in the percentage return received by creditors in Subchapter V cases, as compared to other Chapter 11 cases, and (2) the percentage of reorganized Subchapter V debtors that successfully satisfy their plan obligations rather than seek further insolvency relief.

These benchmarks are at least 18 months from being evaluated, as the timing of Subchapter V's enactment means that this information will not begin to surface until late 2023.[28]

Similarly, while it is too early to tell how the Subchapter V trustees will fare under the SBRA, there will be two relevant questions. First, has the position worked for the system? Second, have the economics of the position worked for the Subchapter V trustee? It will take a little more time for the answers to both of these questions to appear, but from a systematic perspective a positive answer to both questions would seem necessary for Subchapter V to succeed.

Finally, Congress is a "TBD" as well. On March 27, Congress confirmed it would tarnish its most well-received change to the Bankruptcy Code in recent

memory when it failed to extend or make permanent the $7.5 million debt threshold that had been in place since March 27, 2019.[29]

Congress' failure had nothing to do with opposition to the higher debt threshold being extended or made permanent. In fact, it has been reported there is no opposition to such a change.[30] Rather, the bill was proposed too late to be passed before the March 27, 2022, expiration date. Instead of a smooth transition to a permanent debt threshold of $7.5 million, or even a smooth transition to another stop-gap provision, Congress managed to drop the ball and the debt threshold, which as of March 28, reverted back to $2,725,625.[31]

As noted above, this will materially reduce the number of small business that are eligible for relief under Subchapter V, particularly in larger metropolitan areas where the cost of doing business makes it more likely that small businesses will be over the original Subchapter V debt threshold.

Congress can and should be able to fix this issue promptly. Whether it does, is a different matter. And if it doesn't, both it and the system will be the losers.

Brian Shaw is a member at Cozen O'Connor.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] www.abi.org/bankruptcy-statistics.

[2] "Bankruptcies are way down during the pandemic. Here's why," Los Angeles Times, March 23, 2021 (https://www.latimes.com/business/story/2021-03-23/covid-19-bankruptcies-pandemic); "The Year in Bankruptcy: 2021,: Jones Day – JD Supra, January 27, 2022 (https://www.jdsupra.com/legalnews/the-year-in-bankruptcy-2021-7192253/).

[3] See Small Business Reorganization Act of 2019, Pub. L. No. 116-171, 133 Stat. 1079.

[4] See, 11 U.S.C. §§ 1181-1195.

[5] 11 U.S.C. § 101(51D).

[6] See CARES Act; Pub. L. No. 116-136, 134 Stat. 281 (2020). While completely coincidental, the timing of the enactment of the SBRA, the onset of the COVID-19 pandemic and the CARES Act will forever link them.

[7] Bankruptcy Relief Extension Act of 2021; Pub. L. No. 117-5, 135 Stat. 249 (2021).

[8] See pages 7 and 8.

[9] "President Signs Small Business Reorganization Act Into Law," August 23, 2019 (https://www.abi.org/newsroom/press-releases/president-signs-small-business-reorganization-act-into-law).

[10] Id.

[11] 11 U.S.C. §§ 1191(b), 1191(c).

[12] See, LSTA's Response to the ABI Chapter 11 Commission, October 2015 (https://www.lsta.org/content/lstas-response-to-the-abi-chapter-11-commission-report/) criticizing, among other things, proposed treatment of small business debtors with aggregate debt under $10 million.

[13] These terms, particularly the term "loser," should be taken in the proper context. No party "lost" or "won" anything. Rather, a law was enacted. And like most laws, its effect on some is different than others.

[14] https://www.abi.org/sbra. https://www.abi.org/bankruptcy-statistics.

[15] https://www.abi.org/bankruptcy-statistics.

[16] Based on a review by the American Bankruptcy Institute of 548 out of the 759 Subchapter V cases filed in the first six months after the SBRA's enactment, of which 28.6% involved debtors whose liabilities exceeded the original debt threshold. The remaining cases 211 cases did not contain enough financial information to make such a determination.

[17] 11 U.S.C. § 1129(b)(2)(B); Bank of Am. Nat'l Trust & Savings Ass'n v. 203 N. LaSalle Street P'ship, 526 U.S. 434, 119 S.Ct. 1411, 143 L.Ed. 2d 607 (1999); In re Castleton Plaza, LP 707 F.3d 821, 823 (7th Cir. 2013).

[18] 11 U.S.C. §§ 1102(a)(3) and 1181(b); 11 U.S.C. § 1191(b)(2).

[19] 11 U.S.C. 1189(b) requiring debtor's plan to be filed within 90 days of the entry of the order for relief.

[20] 11 U.S.C. § 1191(e).

[21] Id., 11 U.S.C. § 1194.

[22] 11 U.S.C. § 101(51)(D).

[23] 11 U.S.C. § 1189(a).

[24] "Loser" is a relative term, as payment in full over time is still a better outcome than administrative insolvency.

[25] 11 U.S.C. § 1129(a)(9)(a)

[26] 11 U.S.C. § 1191(e).

[27] 11 U.S.C. §§ 1102(a)(3) and 1181(b).

[28] The earliest that Subchapter V plans would have been confirmed was in late second quarter 2020. Plans with a payment plan of three years, the shortest acceptable time period in a non-consensual plan, will only begin to be completed in the second half of 2023.

[29] "Expanded Subchapter V Debt Limit Returns to Original Amount; Work Continues on Capitol Hill for Permanent Higher Threshold," March 28, 2022 (https://www.abi.org/newsroom/bankruptcy-headlines/expanded-subchapter-v-debt-limit-returns-to-original-amount-work).

[30] Id.

[31] If Congress is unable to raise the Subchapter V debt threshold back to $7,500,000 by April 1, 2022, the original debt threshold will be raised to $3,024,725 as announced by the Judicial Conference of the United States.

All Content © 2003-2022, Portfolio Media, Inc.