Small Business Reorganization Act Takes Effect in February 2020

By Jonathan Helfat and Richard Kohn, SFNet Co-General Counsel

On August 23, 2019, President Trump signed into law the Small Business Reorganization Act of 2019 ("SBRA"), which will take effect on February 23, 2020. The SBRA provides for a new Subchapter V to existing Chapter 11 of the Bankruptcy Code dealing exclusively with the reorganization of Small Business Debtors.[1]

The Secured Finance Network advocated on behalf of our industry on certain aspects of the bill to limited avail and believes that this legislation, which had bipartisan support in the Congress, may have a significant impact on certain borrowers that are experiencing financial difficulties.

Outlined below are the key provisions of this legislation and the reasoning supporting its enactment.

I. BACKGROUND

According to the legislative history supporting the SBRA, in all the small business bankruptcies filed under the pre-SBRA Bankruptcy Code, the overwhelming majority of the debtors do not ultimately reorganize, but rather end up in liquidation. According to the commentary, this disappointing result can be traced to two main causes. First, the existing small business bankruptcy provisions contained in Chapter 11 of the Bankruptcy Code are not providing the relief necessary to allow Small Business Debtors to reorganize. Second, existing Chapter 11, save the small business provisions, do not offer appropriate relief for a Small Business Debtor as Chapter 11 was primarily designed for larger, often publically traded, entities, with complicated debt structures. The Chapter 11 proceedings for

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[1] *A Small Business Debtor as defined by the SBRA is a person engaged in commercial or business activities [including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning (or operating real property or activities incidental thereto) single asset real estate] with non-contingent secured and unsecured debt as of the filing date not to exceed $2,725,625.*

The Secured Finance Network believes that increasing this amount would be more beneficial to small businesses as the legislation is as a practical matter only available to smaller businesses.

these entities generally are expensive to administer (including by engendering substantial professional fees), have a protracted timeline with regard to confirming a plan of reorganization ("Plan") and are based upon what is known as the "Absolute Priority Rule" (referred to below).

The SBRA changes this paradigm and allows the Small Business Debtor to retain the equity in its business (assuming compliance with the provisions of the new legislation), limits creditor input, accelerates the time period necessary for confirmation of a Plan, eliminates the need for a Disclosure Statement and the necessity of an unsecured creditors committee (with its attendant professional fees) while at the same time offering the Small Business Debtor all of the discharge benefits currently available to Chapter 11 debtors who successfully reorganize, as well as, the other benefits of Chapter 11 including debtor-in-possession status and the benefits of the automatic stay.

The SBRA also abrogates the "Absolute Priority Rule" which requires, subject only to a consensual arrangement between the debtor and its creditors, that all secured debt must be paid in full under the terms of a Plan before the holders of unsecured debt receive a distribution and that all unsecured debt must be paid in full under the terms of a Plan before equity can retain its ownership interest (with the consequence that, in almost all cases, the shareholders of the Small Business Debtors lose their equity). As a result, most Small Business Debtors do not seek relief under Chapter 11. The SBRA eliminates the necessity of complying with the Absolute Priority Rule and allows the owners of a Small Business Debtor to retain their equity even if the Small Business Debtor does not pay its unsecured creditors in full.

II. KEY TERMS OF THE SBRA

A. **Voluntary**: Filing for relief under the SBRA is totally voluntary on the part of the Small Business Debtor. The Small Business Debtor remains the exclusive party allowed to propose and confirm a Plan.

B. **Plan Terms**: The Small Business Debtor's Plan under the SBRA must be filed within 90 days of the filing date unless, for cause shown, that date is extended by the Bankruptcy Court.

The terms of a Plan under parameters of SBRA are radically different and more limited than those that currently exist under Chapter 11. Secured and unsecured creditors of the Small Business Debtor are still free to consensually agree on the terms of a Plan if unsecured creditors object to the Debtor's Plan but, nevertheless, if the Bankruptcy Court finds that the Small Business Debtor's Plan is

"fair and equitable" and that it and "does not discriminate unfairly," unsecured creditors are only entitled, at the option of the Small Business Debtor, to receive pro rata share of either (i) the Small Business Debtor's Disposable Income[2] over a minimum of three years and a maximum of five years after the confirmation of the Plan depending on the terms of the Plan and (ii) the proceeds arising from the sale of a portion of the Small Business Debtor's unencumbered property in an amount equal to the anticipated Small Business Debtor's Disposable Income for either the three- or five- year period as long as this Disposable Income is more than would be available to creditors in a liquidation.

The concept of a creditor voting to accept or reject a Plan as currently exists under Chapter 11 is not applicable under the SBRA as unsecured creditors do not vote on the Small Business Debtor's Plan under the SBRA. Therefore, at the end of the proposed five-year period or a minimum of three years, the unsecured creditors, absent a sale of the Debtor's business, have no further claim against the Small Business Debtor, who may continue to operate its business. To be clear, absent a consensual resolution, this Small Business Debtor's Disposable Income represents 100% of what the unsecured creditors can expect to receive other than through a sale of the business or discrete assets.

Finally, upon the confirmation of a Plan, the SBRA does not require the payment of any fees to the United States Trustee as exists presently under Chapter 11.

The Secured Finance Network raised the issue of what is to be the disposition of the Small Business Debtor case if the Small Business Debtor has little or no Disposable Income, since many Small Business Debtors are unable to generate Disposable Income due to the fact that they are often undercapitalized and do not have Disposable Income.

C. Operating Under the SBRA: The SBRA provides for the role of a "Standing Trustee" to be appointed by the Office of the United States Trustee in a Small Business Debtor case. The Standing Trustee in effect supersedes the concept of a Creditors' Committee which is not provided for under the SBRA, except under extraordinary circumstances. The Standing Trustee, among other obligations, is charged with:

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[2] *Disposable Income means the income that is received by the Debtor and that is not reasonably necessary to be expended from the payment of expenditure necessary for the continuation, preservation or operation of the business of the Debtor.*

1. Insuring compliance with the statute.

2. Advising the court as to the viability of the reorganization and assisting in the reorganization process.

3. Providing an accounting for all property received by the Debtor.

4. Examining and rejecting, if required, any claims against the Debtor.

5. Conducting a review of the Debtor's financial condition and business operations.

6. Reporting any fraud or misconduct to the Court.

7. Appearing at status conferences and materially significant hearings.

8. Preparing a final report of the case for the Bankruptcy Court.

9. Assisting as necessary in the facilitation of the Plan.

10. Distributing the Debtor's property in accordance with the Plan.

11. Confirming the Debtor's adherence to the court-approved Plan during the payment period.

12. Valuing the property subject to liens.

13. Overseeing the sale of any property of the Debtor sold prior to the confirmation of the Plan or during the payment period provided for under the Plan.

The Secured Finance Network unsuccessfully argued to expand the role of the Standing Trustee to include a neutral adviser who would provide financial assistance and counseling to small business owners with regard to the restructuring of the small business, including preparing a meaningful budget for the court and creditors and developing a plan of reorganization. The Secured Finance Network was of the belief that, without financial consulting, it was highly likely that the small business ownerwould repeat the same mistakes that caused the business to fail in the first instance.

D. **Secured Claims:** Under the SBRA, and unless a consensual resolution is reached, the Standing Trustee would first value each secured lender's collateral and the Small Business Debtor would have four Plan options when dealing with thes secured lender:

1. Surrender the collateral to the secured lender.

2. Allow theof secured lender to retain its liens and receive on account of its claims deferred cash payments totaling the allowed amount of its secured claims as valued by the Bankruptcy Court with interest commencing on the Plan's Effective Date. While this result may or may not be satisfactory to the secured lender, it raises the issue of whether such a result is viable for the Small Business Debtor, as the Small Business debtor would, in effect, be obligated to repay the secured lender 100% of the value of thitsollateral over an extended period without any relief.

3. If the Plan contemplates the sale of the property securing a secured claim, then the Plan must provide that the security interests attach to the proceeds of the sale.

4. If the Small Business Debtor chooses neither option (2) nor (3) above, then the Plan can provide that the secured creditor receive the indubitable equivalent of its claim. This concept is a carryover from existing Chapter 11 and has not been extensively implemented as a remedy at the indubitable equivalent is extremely difficult to value.

Valuation will be determined either consensually or through a contested hearing. That portion of the secured lender debt which is in excess of the valuation will be treated as unsecured debt under the Small Business Debtor's Plan.

The Secured Financing Network raised the issue of providing the Small Business Debtor with financing during the Chapter 11 process rather than rely on the dictates of existing Chapter 11, which appear completely contrary to the aims of the SBRA.

E. Administrative Expenses: The SBRA removes the requirement of existing Chapter 11that all administrative expenses be paid in full at the time of the confirmation of a Plan, and permits the payment of post-petition indebtedness for goods and services to be "stretched" over the life of the Plan. An example would be the Debtor's legal fees which, are often an impediment to confirmation. A Small Business Debtor's plan no longer requires these fees to be paid upon confirmation of the Plan in one lump sum, but rather allow them to be paid over a longer period of time through the Plan.

III. PREFERENCE ACTIONS

The new statute has one change that will affect all bankruptcy cases, whether under the SBRA or Chapter 11 or Chapter 7, relating to the preference provision (Sec. 547(b) of the Bankruptcy Code). Umder the SBRA, the Trustee who commences an action to avoid pre-petition transfers must first engage in "reasonable due diligence" taking into account a party's known or reasonable knowable affirmative defenses. Any suit brought thereafter by a Trustee to collect the alleged preference must, if the claim is less than $25,000 be brought in the jurisdiction where the defendant subject to the preference resides.

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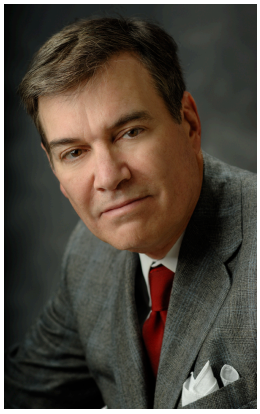
The foregoing is merely an overview of the legislation. SFNet will continue to seek opportunities to advance the interests of our industry relative to implementation and potential amendments to this statute. If you have any questions please contact Michele Ocejo at mocejo@sfnet.com.

Author bios



Jonathan Helfat specializes in the representation of foreign and domestic banks, commercial finance companies, hedge funds and other specialty lenders in the restructuring of secured loan transactions, including workouts, forbearance and restructuring agreements, Chapter 11 Debtor-in-Possession and "Exit" financing facilities and the use of cash collateral. Mr. Helfat has also had extensive experience enforcing and defending the rights of financial institutions in both state and federal court litigations.

Mr. Helfat graduated from American University, received his law degree from the University of Louisville School of Law and a Master of Laws (Corporation Law) from New York University.

Mr. Helfat is Co-General Counsel to the Commercial Finance Association and co-authors a column in The Secured Lender magazine relating to current legislative and judicial developments in asset-based lending. He has also represented the Commercial Finance Association in the filing of various amicus briefs before the United States Supreme Court and other appellate courts relating to issues affecting secured lenders.

Mr. Helfat is also a Fellow and Past Regent of the American College of Commercial Finance Lawyers and previously was a member of the Bankruptcy Judge Merit Selection Panel for the United States District Court, Eastern District of New York.

Richard Kohn is a co-founder of Goldberg Kohn and a Principal in its Commercial Finance Group, where he specializes in cross-border and other financing transactions. He has served as Co-General Counsel of the CFA/SFNet since 2001. He has been named by Chambers as a leading lawyer in the United States in Banking & Finance and is a Fellow of the American College of Commercial Finance Lawyers.

Kohn has represented CFA/SFNet at the United Nations Commission on International Trade Law (UNCITRAL) for almost 20 years, and has also served as a consultant to the United Nations in connection with UNCITRAL Legislative Guide on Secured Transactions and as a member of the UNCITRAL Expert Group on various projects. He has also participated in initiatives to promote secured credit in other countries, including the People's Republic of China and Mexico.

Kohn is a Lecturer in Law in Cross-Border Lending at The University of Chicago Law School, and writes and speaks frequently on commercial finance topics. He is also a member of the Board of Trustees of the Brain Research Foundation, which funds cutting-edge neuroscience research, and previously served as Chairman of the Board of Chicago Shakespeare Repertory Theater and President of Anshe Emet Synagogue.

Kohn received B.A., with distinction, in 1966, and his J.D., cum laude, in 1969, both from The University of Michigan. He lives in Chicago with his wife, Joan.