DAILY BUSINESS REVIEW

The Small Business Reorganization Act—a New Bankruptcy Law for Small Businesses

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By **Zach Shelomith** | October 24, 2019

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A Chapter 11 bankruptcy is not an easy process. While it can provide breathing room to negotiate with creditors and allow businesses a chance to continue operating, it is expensive, complicated and typically favors larger companies. The advantages of Chapter 11 bankruptcy are oftentimes unavailable to small businesses and its owners. The substantial disclosure and reporting requirements alone scare off many potential debtors.

Those small businesses who have taken the plunge and filed Chapter 11 bankruptcy have found success to be elusive. According to a recent study, of the small business debtors that have filed Chapter 11 bankruptcy from 2008 to 2015, only around 27% of those companies successfully confirmed a reorganization plan.

In response to this problem, Congress recently created the Small Business Reorganization Act of 2019, which takes effect on Feb. 19, 2020. The act implements a new subchapter of Chapter 11, 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 struggling businesses and its owners.

The act applies to debtors that have no more than $2,725,625 of secured and unsecured debt. It is available to both companies and individuals whose debts primarily arose from commercial or business activities. The act provides for a streamlined reorganization process and contains numerous powerful tools for debtors that are not typically available in Chapter 11. Some of the significant changes include:

Only the debtor may file a plan. Under the act, no creditor or other interested party may file a plan. However, the debtor must file the plan within 90 days after the bankruptcy is filed, with limited exceptions.

No creditors’ committee. In a typical Chapter 11 case, the U.S. trustee may appoint a committee of unsecured creditors, to represent this group of creditors. Under the act, no creditors’ committee is appointed, unless ordered by the court.

No disclosure statement. A disclosure statement, which is similar to a financial prospectus describing the plan, is no longer necessary under the act.

Appointment of a trustee. Under the act, 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 make distributions under the plan. Unless the court, for cause, orders otherwise, the debtor still runs the business and generally has the same rights as in a typical Chapter 11 case.

Votes are not needed. Perhaps the most radical change imposed by the act is that a debtor now has the ability to confirm a plan without having any creditors vote to accept the plan. Prior to the act, a debtor could not confirm a plan unless at least one impaired class of creditors voted to accept the plan. This requirement alone made many Chapter 11 plans impossible to confirm. Now, if other requirements are met, a plan can be confirmed with no votes at all.

No absolute priority rule. Another hindrance to confirming a typical Chapter 11 plan is the absolute priority rule. The rule essentially provides that if the company is unable to pay its debts in full (and all impaired classes do not vote to accept the plan), then the owners cannot retain their interests under a plan unless they contribute new value to the business. The act does away with the absolute priority rule, allowing business owners a greater opportunity to retain their ownership interests.

Modified cramdown rules. In Chapter 11, in the event that all impaired classes do not vote to accept the plan, 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.

Benefits to Individuals. The act also provides substantial benefits to individual small business debtors. Many business owners are ineligible for Chapter 13 bankruptcy because of its strict debt limits and are forced to file an individual Chapter 11 case in order to reorganize their financial affairs. Many of the same rules that apply in a typical business Chapter 11 case apply to individuals, as well. The more advantageous procedures under the act will also be available to individuals who meet the qualifications. In addition, unlike a typical Chapter 11 case, under the act, an individual debtor will be able 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 of the debtor.

These are just a few of the many benefits that will soon be available for small business debtors. The act also renders many of the existing provisions of Chapter 11 inapplicable for small business debtors who elect to have the new subchapter apply in their case. Struggling businesses should strongly consider these new provisions as a potential remedy to their financial problems. It is important for small business debtors to have experienced counsel that can navigate this new law and bring about a successful reorganization.

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