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CLIENT ALERT

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What Creditors Need to Know About The Small Business Reorganization Act

With the government-ordered closures and an increasing number of business failures, those extending credit in any form – whether they be lenders, suppliers, landlords or service providers – face the likelihood that one or more of their customers will simply close its doors or end up in a bankruptcy proceeding. While Chapter 11 has provided a lifeline for many businesses, allowing them a second chance by restructuring and reducing their debt, for way too many businesses the cost of Chapter 11 proceedings has been prohibitive, leaving the business with no choice but to cease operations. For many creditors, this is a double loss, resulting not only in unpaid existing receivables but also in unrealized future business. And, even if the business were able to reorganize, the administrative costs of the Chapter 11 proceedings all too often have eaten up much of what otherwise might have been available to pay creditors.

In order to address this problem, Congress passed the Small Business Reorganization Act (SBRA), which went into effect on February 19, 2020. The SBRA greatly simplifies Chapter 11 for small businesses, providing more certainty and reducing expenses considerably. To do this, creditor participation has been reduced and some of the obligations of a debtor in a traditional Chapter 11 case been eliminated. With the passage of the CARES Act, until March 27, 2021, any business whose total debt does not exceed $7.5 million is eligible for relief under the SBRA, except for single-asset real estate businesses and those required to report under the federal securities laws..

After that date, only businesses with debt of $2,725,625 or less will be eligible. With the large number of businesses that will be eligible during the next ten months, it is important that creditors understand how the SBRA works.

Changes Made by the SBRA

There are three changes effected by the SBRA that have the most direct impact on creditors:

1. A plan of reorganization can be confirmed without the affirmative vote of creditors. In lieu of a vote of creditors, under the SBRA, the debtor can get a plan confirmed if it devotes all of its projected future disposable income to payment of creditors over a 3- to 5-year period of time or pays an amount equal to the present value of what those payments would be.
2. In a traditional Chapter 11 case, the debtor is given a certain period of time in which it has the exclusive right to file a plan of reorganization, after which the creditors' committee or any single creditor may file a plan. Under the SBRA, only the debtor may submit a plan of reorganization.
3. As a general rule, creditors' committees will not be appointed in cases under the SBRA.

This does not mean that creditors do not have a right to participate. Indeed, while the issues have been narrowed creditors still have certain rights, many of which remain unchanged.

Treatment of Claims of Specific Creditors

Banks and Other Secured Creditors. As with all other creditors, confirmation of a plan does not depend on the affirmative vote of the secured creditor as long as the plan otherwise complies with the provisions of the Bankruptcy Code. Other than that, the SBRA does little to affect the rights of secured creditors. The automatic stay preventing secured creditors from seizing their collateral or conducting a secured party sale or mortgage foreclosure still applies, but so do the same rules for secured creditors obtaining a modification of the automatic stay to permit them to do that. Debtors wanting to use cash collateral will still need to provide secured creditors with adequate protection.

If the secured creditor has a lien on cash collateral, debtors will still not be able to use it without either obtaining the consent of the secured creditor or demonstrating that the secured creditor is adequately protected. With one small exception applicable only to non-purchase money mortgage loans on residences, the standards for treatment of secured creditors under a plan also have not changed. The plan still must provide for the secured creditor to retain its lien and to be paid deferred cash payments equal to the present value of its claim.

Landlords. The SBRA does not change the rights or treatment of landlord claims. Landlords still have a right to be paid currently under their leases and to be paid any arrears if the debtor decides to assume the lease. Should the debtor decide to reject the lease the landlord's claim will be limited to the greater of one year's rent or 15 percent of the rent reserved under the balance of the lease. Landlords also continue to be entitled to receive adequate assurance that the debtor will perform under the lease.

Unsecured Claims. The claims of unsecured creditors are the ones most affected by the SBRA. Because the SBRA no longer requires the approval of creditors for a debtor to obtain confirmation of a plan, the debtor is not compelled to negotiate with them. Instead all the debtor need do is to satisfy two requirements: (1) pay an aggregate amount to all creditors equal to its projected disposable income for three to five years; and (2) pay more than creditors would receive in a liquidation under Chapter 7 of the Bankruptcy Code.

What Rights Remain for Creditors?

While the acceptance of a plan by creditors is no longer required for cases filed under the SBRA, that does not mean that creditors are not without rights. These include the following:

Future Disposable Income. The concept of "future disposable income" is not defined in the Bankruptcy Code nor, as of this writing, are there any cases under the SBRA defining what that means. Courts will likely be guided by a Supreme Court decision interpreting "future disposable income" in the Chapter 13 context, which, according to the Supreme Court should take into account "changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation."[1] That definition may be easier to apply in Chapter 13 cases,

[1] Hamilton v. Lanning, 560 U.S. 505, 507 (2010).

which only apply to individuals. But, this concept may prove to be more difficult to apply to an operating business, especially one that has been hit hard by the pandemic with an unpredictable future. This is likely to be a ripe area for litigation and an issue that creditors may want to pay particular attention to if they want to challenge their treatment under a plan.

Payment More than in a Chapter 7 Liquidation. Even if the debtor is devoting all of its projected future disposable income to a plan, that plan cannot be confirmed if the debtor is not paying creditors more than they would receive in a liquidation of its assets under Chapter 7 of the Bankruptcy Code. While this is not a new requirement, it is also an area in which creditors may challenge the confirmability of a plan.

Length of Plan Payments. Under the SBRA, the amount that the debtor will pay to creditors must equal or exceed the amount of the debtor's future disposable income over a period of 36 to 60 months, whether that payment is actually made over the 36- to 60-month period or, as the law permits, over a shorter period of time. The Bankruptcy Code does not provide any guidance as to how many months of future disposable income the debtor needs to pay, although if practice in Chapter 13 cases, which also permits plan payments for individuals to be made over 36 to 60 months, can be used as a guide, it is likely that the plans will tend to the 60-month variety. Creditors, of course, will want to push for 60 months of future disposable income, assuming the debtor cannot pay them in full over a shorter period of time.

Feasibility. As with a traditional Chapter 11 case, plans under the SBRA must be feasible, meaning that it is likely that the debtor will be able to make the plan payments. Some debtors may overestimate their ability to make payments in order to show that they are paying more than in a Chapter 7 liquidation or for other reasons. Creditors have a right to object to such a plan under the feasibility requirement.

Hidden Assets, Fraudulent Transfers and Preferences. The rights of creditors to ensure that the debtor is reporting all of its assets or has not made any fraudulent transfers or preference payments to insiders or others are not affected by the SBRA. At a minimum, the value of these assets and transfers should be included in calculating the amount to which creditors are entitled.

Other Remedies. A small business trustee will oversee all cases under the SBRA but his or her powers are limited. Under normal circumstances, the debtor will still run the business subject to this oversight. However, the debtor's right to operate as a debtor-in-possession may be terminated upon the request of a creditor "for cause," which includes fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the date of commencement of the case, or for failure to perform the obligations of the debtor under the SBRA. Creditors may also seek to have the case converted to a Chapter 7 liquidation or dismissed if the debtor is being grossly mismanaged, is losing money, or failing to comply with the court rules, as well as for other cause.

Is Negotiation Dead?

While the SBRA no longer requires the acceptance by creditors of their treatment under a plan, there will be enough open issues, including, among other things, the calculation of future disposable income and asset valuation, which will need to be resolved either by the Court or through negotiation with creditors of a consensual plan. So, while the consent of creditors is not technically required, there will be opportunities for creditors to negotiate plan payments in order to resolve these open issues.

What's In It for Creditors?

Mention the word "bankruptcy" to most creditors and their reaction is predictably negative. But, faced with the possible alternative of their account debtor going out of business, creditors may find a process that provides them with a fair, albeit incomplete, recovery to be a better alternative. Banks will find that the ability of their customers to more easily shed unsecured debt will put the business in a healthier, more viable state. Landlords, too, will also find that their tenant, no longer overburdened with debt that it cannot pay, will be in a better position to pay rent. Even trade creditors, who are most affected by the SBRA, will find the streamlined, more cost-efficient process beneficial by making it easier for debtors to come up with a payment plan based on reasonably predictable standards. And, for those trade creditors that continue to do business with the debtor the additional income that they receive from a financially healthy customer may more than offset the write-offs they may be required to take.

We Are Here to Help

Rubin and Rudman is committed to helping our clients through these extraordinary times. If you have any questions about the SBRA, please contact any of the following attorneys at our firm:

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