CLIENT ALERT

Allen Law Group P.C.
allenlaw-group.com

April 2020

New Small Business Chapter 11 Laws: Overview of New Subchapter V of Chapter 11 Bankruptcy And The Impact of The CARES Act

<u>Eligibility Debt Limit Increased to $7.5 Million For One Year Under Subchapter V</u>

In response to the COVID-19 coronavirus pandemic, enacted on March 27, 2020, the Coronavirus Aid, Relief and Economic Security Act ("CARES Act") increased the eligibility debt limit up to $7.5 million from $2.7 million for a period of one year for businesses and individuals to qualify to file for reorganizing their debts under the new subchapter V of the Bankruptcy Code's Chapter 11. After one year the debt limit will return to $2.7 million. Thus, the CARES Act temporarily nearly triples the debt limit for businesses to file to reorganize their debts under the new subchapter V for one year.

On February 19, 2020, the Small Business Reorganization Act of 2019 ("SBRA") went into effect. Congress enacted the SBRA to allow small businesses to reorganize their debts in a greatly streamlined and cost effective manner. Under the SBRA's new subchapter V of Chapter 11, a small business may qualify to reorganize in bankruptcy if their total non-contingent, liquidated, secured and unsecured debt is not more than $7.5 million, as revised by the CARES Act, for one year.[1]

<u>Impact of CARES Act On Subchapter V's Debt Limit</u>

Many bankruptcy professionals viewed the original debt limit of $2.7 million as one of the primary impediments for a business to make use of the new subchapter V. By increasing the debt limit to $7.5 million, nearly three times the original debt limit, temporarily for a one year period, a far greater amount of businesses likely can qualify for the new subchapter V, and thereby enjoy the substantial savings in expenses and time, as explained in this article.

<u>Why File For Subchapter V?</u>

Businesses often file to reorganize in Chapter 11 in order to restructure their debts, reject unexpired leases and executory contracts, sell unexpired leases and executory contracts via assumption and assignment and in order to negotiate a settlement of pending lawsuits. These benefits are also available to businesses filing for reorganization under the new subchapter V.

Time & Expense Greatly Decreased Under New Subchapter V

A unique feature of subchapter V is that a business or individual has 90 days to file a plan of reorganization after the bankruptcy petition is filed with the court and the court enters an order of relief.[2] Normally in Chapter 11, the plan can take over a year to be confirmed, and also, as explained in this article, the plan requires at least one class of impaired creditors to approve the plan. In contrast, subchapter V allows a business to confirm a plan without approval from any class of creditors. Since creditors cannot reject the plan, the court will likely confirm the plan shortly after the plan is filed, in contrast to regular Chapter 11 proceedings, which allow for creditors to reject the plan. Thus, the new subchapter V will greatly decrease the time and expense of Chapter 11 for small businesses.

Cramdown On All Creditors: A Unique Feature of Subchapter V

As mentioned, another unique feature of subchapter V is that the business has the ability to cramdown on all creditors to confirm its plan of reorganization. Normally in Chapter 11, at least one impaired class of creditors must approve the plan in order for a court to confirm the plan. However, subchapter V allows the business to confirm a plan without any creditors approving the plan (i.e. cramdown on all dissenting creditors) as long as the plan does not discriminate unfairly against any impaired unsecured creditors and treats each class of unsecured creditor fairly and equitably.[3] Thus, the business can confirm a plan over the objection of any secured or unsecured creditor under subchapter V.

The business' ability to cramdown on all creditors provides the business with substantial leverage in negotiating the plan of reorganization. The business must provide feasibility projections over the life of the plan including carve-outs for the bankruptcy professionals such as the restructuring financial advisor, bankruptcy lawyer and other professionals. Feasibility projections are an analysis of the viability of the business as a going concern. Also, the business needs to cure defaults and demonstrate adequate assurances through the use of feasibility projections.[4]

Modifying a Mortgage of a Principal Residence

Also, under subchapter V, another unique restructuring tool available to a business is that the plan can modify the rights of a mortgage claim holder on the business owner's principal residence if the mortgage loan was used primarily as security "in connection" with the business. In other words, if the terms of a business loan included a lien on the business owner's principal

residence mortgage then that lien can be modified under the plan, and the business owner may be able to retain his or her ownership rights in the principal residence under subchapter V.[5]

No Creditor Committee Required

Yet another advantage to filing under the new subchapter V is that unlike regular Chapter 11 reorganizations, there is no requirement for the U.S. Trustee to appoint a committee for unsecured creditors.[6] In regular Chapter 11 reorganizations, the reorganizing business must pay for the expenses relating to the committee for unsecured creditors such as the fees for professionals representing the committee (e.g. fees for attorneys and financial advisors). Thus, by eliminating the requirement for the appointment of a committee for unsecured creditors, subchapter V yet again offers further cost savings to small businesses.

Disclosure Statement Not Required & No Absolute Priority Rule

Unlike regular Chapter 11 proceedings, the business does not need to file disclosure statement[7], and thus, further reduces costs for the business under subchapter V. Also, the absolute priority rule does not apply in subchapter V[8], unlike regular Chapter 11 proceedings. The absolute priority rule requires that all creditor claims be paid in full in order for the business to retain ownership in its assets. Courts have ruled that the business may retain ownership in its assets if the business provides "new value," such as additional capital provided by the business to fund a plan. Also, the "new value" rule does not apply under the new subchapter V as well, which allowed creditors to object to a plan on the grounds that the "new value" is inadequate.

Administrative Claims

Subchapter V does not require administrative claims, such as claims accrued post-petition, to be paid in full as a requirement for plan confirmation. Under subchapter V, administrative claims can be paid over time.

Automatic Stay Stops Creditor Collections & Other Liabilities

As soon as the business files for bankruptcy the automatic stay will go into effect, and thereby prevent creditors from collecting on debts, foreclosing on real property and obtaining certain judgments on lawsuits, such as tort liability claims, against the business. The automatic stay allows the business the opportunity to negotiate with creditors and other claim holders such as litigants with lawsuits adverse to the business during the bankruptcy period.

DIP Financing

Chapter 11, including the new subchapter V, allows a business to obtain debtor-in-possession ("DIP") financing while reorganizing in Chapter 11.

Plan Requirements & Confirmation

The plan of reorganization must include a brief history of the operations of the business, liquidation analysis and projections with respect to the business' ability to make payments under the plan.[9] For a nonconsensual plan, meaning the impaired creditors do not accept the plan, a business will make plan payments for at least three years and up to five years under subchapter V.[10] If the plan satisfies the requirements under subchapter V and the applicable sections of Chapter 11, and the bankruptcy court confirms the plan; then, for a nonconsensual plan, the business will operate in bankruptcy for at least three years and up to five years in order to make the plan payments, and then the business will be discharged of its debts. As to a consensual plan, if the bankruptcy court confirms a consensual plan, the business is entitled to a discharge upon plan confirmation.[11]

The bankruptcy court will confirm the plan as long as the plan does not discriminate unfairly and is "fair and equitable" to each impaired unsecured creditor.[12] Fair and equitable means the debtor needs to commit all of its "projected disposable income" or property of equivalent value in order to make payments under the plan for at least three years and at most five years.[13] Under the plan, the business must agree to provide the trustee with as much of the business' future income as necessary to fund the plan.[14] The business' "disposable income" is income the business receives and is not reasonably necessary for the business' maintenance and expenses for continuation, preservation or operation of the business.[15] The business must show a reasonable likelihood the business will be able to make all of the payments under the plan, and the plan must provide for appropriate remedies; such remedies may include liquidation of nonexempt assets to protect creditors if the business fails to make the payments under the plan. In other words, the business must show a bankruptcy court that the business is feasible as a going concern.[16]

Leases & Executory Contracts

In order for a business to assume a lease or executory contract, a business needs to cure promptly prepetition defaults and demonstrate adequate assurance of future performance, which can be demonstrated through financial projections.[17] Also, during the gap period between filing of the bankruptcy petition and rejection or assumption of a non-resident real estate lease, a business must "timely perform" all obligations under the non-residential real estate lease and start making the payments within 60 days.[18]

Limited Time to File

At this time the debt limit of $7.5 million under the new subchapter V is limited to one year. Accordingly, it is imperative that businesses in financial distress with assets over $2.7 million strongly consider their options for restructuring their businesses under the new subchapter V of Chapter 11 in a timely manner before the one year period expires and the debt limit returns to $2.7 million. Allen Law Group P.C. is available to assist your business with any questions you may have regarding the COVID-19 coronavirus outbreak and the new subchapter V and CARES Act. For additional information, please contact Allen Law Group P.C. via phone at (646) 679-4285 or email at info@allenlaw-group.com.

---

[1] 11 U.S.C. §1182.
[2] 11 U.S.C. § 1189(b).
[3] 11 U.S.C. § 1191(c)(1); § 1191(b).
[4] 11 U.S.C. § 1129(a).
[5] 11 U.S.C. § 1190(3).
[6] 11 U.S.C. § 1195.
[7] 11 U.S.C. § 1187.
[8] 11 U.S.C. § 1191(c).
[9] 11 U.S.C. § 1190(1).
[10] 11 U.S.C. § 1191(c).
[11] 11 U.S.C. § 1191; § 1181(c).
[12] 11 U.S.C. § 1191(b).
[13] 11 U.S.C. § 1191(c).
[14] 11 U.S.C. § 1186.
[15] 11 U.S.C. § 1191(d).
[16] 11 U.S.C. § 1191(c)(3)(B).
[17] 11 U.S.C. § 365(b)(1).
[18] 11 U.S.C. § 365 (d)(3).

© 2020 Allen Law Group P.C. All Rights Reserved. This publication is protected by copyright.

Attorney Advertising: The enclosed materials have been prepared for general informational purposes only and are not intended as legal advice.