REAL ESTATE ISSUES®

Published by THE COUNSELORS OF REAL ESTATE®

PERSPECTIVE

The Small Business Reorganization Act: The Answers You Need to Know

Volume 45, Number 4

February 19, 2021

By Lori A. Schwartz

Photo: M_Agency/Shutterstock.com

ABOUT THE AUTHOR

Lori A. Schwartz is a Partner in Robinson Brog's Business Finance & Restructuring Department. Ms. Schwartz's practice focuses on Chapter 11 reorganizations representing debtors, trustees, committees, landlords, lenders, secured creditors and other interested parties in a variety of industries. Ms. Schwartz has been involved in the confirmation of complex plans of reorganization for numerous companies in the Bankruptcy Courts for the Southern and Eastern Districts of New York.

The COVID-19 pandemic and the attendant "stay at home" orders that took effect throughout the country starting in March 2020 had and continue to have a significant impact on many businesses and their ability to operate at all, let alone to operate profitably. We've all seen the bankruptcy headlines, which have focused largely on recognizable retail or fitness chains, like Lord & Taylor, J.C. Penney, Neiman Marcus, Forever 21, J. Crew and Brooks Brothers, 24 Hour Fitness, Flywheel Sports, Gold's Gym, Town Sports International Holdings Inc. (the owner of New York Sports Clubs), and YogaWorks. Clearly, the future of large brick-and-mortar retail chains and gyms is an open question. And yet, we've heard very little about small business bankruptcy filings while these businesses continue to struggle and face uncertain futures.

The anticipated wave of small business bankruptcy filings has not yet materialized, but it is likely coming. Temporary 'safety net' measures provided and continue to provide some relief which may explain why fewer businesses have sought the protections afforded by the Bankruptcy Code. For example, the Coronavirus Aid, Relief and Economic Security Act of 2020, known as the CARES Act, established the original Paycheck Protection Program which closed on August 8, 2020. The recently enacted Consolidated Appropriations Act of 2021 ("CAA") provides for a second round of PPP funding and includes a number of amendments to the Bankruptcy Code. In a significant change from the first round of PPP funding, debtors in a bankruptcy proceeding are now eligible to apply for a PPP loan. Note, however, that the Small Business Administration must still provide its consent to a debtor obtaining a PPP Loan. The SBA's position previously is that debtors are not eligible for a PPP loan. If an eligible debtor obtains the requisite Bankruptcy Court and SBA approval for a PPP loan, those funds do not become estate property available for distribution to other creditors. In New York, Governor Cuomo has issued various Executive Orders, including most recently Executive Order 202.92 which provides for, amongst other relief, a continuation of the tolling of certain commercial foreclosure and eviction proceedings through February 26, 2021. The New York State Assembly and Senate have passed legislation to extend this deadline to May 1, 2021, but it has not yet been signed into law.

Meanwhile, the country is still in the throes of the COVID-19 pandemic. Locally, winter weather continues to impact New York City's restaurant industry as indoor dining, although recently reopened, remains at a limited capacity. While economies may soon start to show signs of recovery, businesses will continue to struggle until widespread vaccinations permit the reopening of the economy. Without any additional relief, struggling small businesses will become more and more vulnerable and will soon be faced with challenging decisions about their continued viability.

Sadly, some small businesses do not have the financial wherewithal to stay afloat. They will be washed away in the coming wave. Others, however, are in a stronger position and may be able to survive with the help of the protections afforded by the Bankruptcy Code. Changes to the Bankruptcy Code including the Small Business Reorganization Act of 2019 or "SBRA" as enhanced by the CARES Act and the CAA make a small business reorganization far more manageable. With the opportunity to reorganize rather than liquidate a small business, we can expect that many such small businesses will find much-needed relief in the Bankruptcy Court and will be able to keep their doors open as a result.

Q&A: SMALL BUSINESS REORGANIZATION ACT

If you're unfamiliar with the Chapter 11 provisions of the Bankruptcy Code, in particular the small business provisions, including the SBRA, which was enacted in February 2020 and which established the Subchapter V debtor option that is meant to make reorganization more accessible to many small businesses—such as your current tenants or clients—this Q&A should serve as a useful primer as you seek to help them navigate the rough surf ahead.

What is a "Small Business Debtor"?

A small business debtor is anybody, other than an individual or company whose income derives from real estate holdings, that has "aggregate noncontingent liquidated secured and unsecured debts" of $2,725,625 or less (excluding debts owed to or more affiliates or insiders). In addition, a small business' debt may not be less than 50% composed of money owed as a result of commercial or business activities. In other words, if your business owes less than $2,725,625, it may qualify as a Small Business Debtor.

Is a bankruptcy-seeking debtor who owes less than $2,725,625 required to file as a small business?

Yes. Until 2005, small businesses could choose whether to file under the small business designation. That changed with passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). The intent behind the BAPCPA was to expedite the bankruptcy process and make it less expensive for a small business. But due to a variety of unintended consequences, it became more costly—even cost-prohibitive—for eligible small businesses to file for bankruptcy and successfully reorganize.

Small businesses now have two options for filing. They can take the traditional route and file as a "small business case" under the Bankruptcy Code or they can file under the SBRA as a Subchapter V case.

With such familiar-sounding names, it is easy to become confused by the bankruptcy terminology and the Bankruptcy Code definitions of a "Small Business Debtor" and a "Small Business Case." As noted above, a Small Business Debtor is a debtor with debts of $2,725,625 or less. A Subchapter V Debtor is a Small Business Debtor who has elected to proceed under the SBRA. A Small Business Case is when a Small Business Debtor does not elect to proceed under the SBRA. Understanding the distinctions is critical as there are various filing deadlines that are governed by whether a debtor elects the designation as a Small Business Case or as a Subchapter V Debtor.

Is it still cost-prohibitive for many small businesses to file?

This requires some context. The intent of the SBRA is to make it so that a small business reorganization is no longer a cost-prohibitive proposition. However, it is too early to tell if this will be the practical result. The SBRA has effectively streamlined and made more cost-effective the process for eligible small businesses electing to proceed under Subchapter V as their pathway to reorganization.

How is the SBRA more cost-effective than filing the traditional way (i.e. as a small business case)?

Regardless of their chapter 11 designation, Small Business Debtors, whether in a Small Business Case or a Subchapter V case are legally required to make a number of financial disclosures, including filing along with the bankruptcy petition their most recent balance sheet, cash-flow statements, statement of operations and federal tax returns. They are also required to file monthly financial reporting while the case is pending with the Bankruptcy Court. Also, proceeding under the SBRA as a Subchapter V case does not modify a debtor's obligation to attend the standard initial debtor interview or the creditors' meeting.

Aside from these obligations, however, there is a bevy of cost-saving provisions available to debtors who elect to file under the SBRA's Subchapter V, which are not available in standard "Small Business Cases." These include the following:

- **Elimination of certain administrative costs of a bankruptcy proceeding, such as United States Trustee fees.** These fees are calculated based upon a debtor's quarterly disbursements and must be paid on a quarterly basis until the bankruptcy case is concluded. Dependent upon the aggregate amount of a debtor's disbursements, these charges can be substantial.
- **No creditors committees and therefore no responsibility to cover costs of a creditors committee.** In a traditional Chapter 11 case an unsecured creditors' committee may be appointed and the debtor is responsible to cover the committee's legal fees and expenses. Under the SBRA, creditors committees are not appointed in either a Small Business Case or a Subchapter V Case, unless the Court so directs for cause.
- **Extended payment period for administrative costs.** While traditional Chapter 11 Debtors and Small Business Case Debtors must pay all administrative expenses as soon as their reorganization plans are confirmed, Subchapter V debtors can pay off administrative costs over the three-to-five-year lifetime of their plan of reorganization. Rather than having to pay large administrative costs in a lump sum at the time a case is confirmed, which may deplete a reorganized debtor's available cash considerably, the ability to pay these expenses over time puts the Subchapter V debtor in a much stronger cash-flow position upon emergence from bankruptcy. This way a reorganized debtor is able to operate profitably post-confirmation while still making the payments required pursuant to their confirmed plan of reorganization.

What if a business owes more than $2,725,625 but is still "small" by usual standards?

Many of those businesses can still file under the SBRA since Congress enacted the CARES Act. In addition to measures such as payroll protection, the CARES Act expanded the debt threshold for Small Business Debtors electing to file a Subchapter V case from $2,725,625 to $7,500,000. **This expanded debt threshold will remain in place until the expiration of the CARES act on March 27, 2021, unless it is extended by Congress.** The CAA did not address this upcoming deadline and it is not currently known if it will be extended. While it remains in place, and to the extent the deadline is extended, expanding the debt threshold permits certain businesses that would not otherwise be eligible for the new SBRA provisions to elect to file a Subchapter V case and reorganize more rapidly and in a cost-effective manner.

While not a New York-based business, one example is a small Massachusetts-based technology start-up, Beamable, which developed popular mobile video games based on television shows, such as Game of Thrones. Like many mobile-game developers, Beamable had a hard time generating revenue. But while it was developing games, it also developed a platform for managing game server tasks that proved useful to the broader industry. Beamable was in the process of pivoting its business model to focus on monetizing its server management technology when COVID-19 hit. Faced with the stark possibility of an immediate liquidation, in which its numerous creditors would see very little payout, the company chose instead to commence a Subchapter V case, with the goal being to remain in business and ultimately repay a larger sum to its creditors. Beamable scheduled its aggregate debt in the amount of $3,356,584.15. Without the increased debt threshold from $2,725,625 to $7.500,000, Beamable would not have qualified as a Small Business Debtor and would not be able to elect to file as a Subchapter V debtor. Beamable filed its case in October 2020 and on February 12, 2021, the Bankruptcy Court entered an order confirming its plan of reorganization which provides for a recovery to unsecured creditors as it implements its new business model.

Does the SBRA mandate trustees?

Yes. Every Subchapter V case will have an appointed trustee. The trustee's responsibilities include overseeing and monitoring the case as well as facilitating any proposed plan of reorganization. The trustee is also charged with reporting to the bankruptcy court on case status and reorganization developments. The Subchapter V trustee may play a large role in promoting a consensual reorganization benefitting both debtor and creditor alike.

In some cases, the trustee may be responsible to make distributions under a confirmed plan. But, in a Subchapter V case, the debtor remains in possession of its assets and continues to operate its business as a debtor in possession, although the court has authority to remove a debtor from possession for cause.

In a Subchapter V case, unlike a traditional Chapter 11 case, a debtor in possession may be removed after confirmation of a plan if the debtor fails to perform its obligations under a confirmed plan.

How is the Subchapter V timeline different from a "traditional small business case" under Chapter 11?

Neither debtors in a Small Business Case nor a Subchapter V case are required to file a separate disclosure statement from their plan of reorganization. But the deadline for filing a plan of reorganization in a Subchapter V case is much tighter than in a traditional chapter 11 case or in a Small Business Case.

Significantly, in a Subchapter V case, only a debtor may file a plan of reorganization. The statute requires that a plan of reorganization be filed within 90 days of the petition filing, but the filing deadline may be extended by the court under extenuating circumstances as determined by the court.

Do SBRA filers lose equity in their business?

No. Under Subchapter V, equity owners of a business (1) are permitted to maintain their ownership interests even if creditors are not fully repaid and (2) are not required to contribute "new value" to keep their interests in the business. This is only applicable to Subchapter V cases. However, the plan of reorganization in a Subchapter V case must provide for repayment to unsecured creditors over a period of three to five years and the debtor must contribute all of its "projected disposable income" to plan payments over the term of the plan.

Do reorganization plans under the SBRA require creditor approval?

No. But the plan of reorganization must provide for all "projected disposable income" be paid to its unsecured creditors over the period of the plan and a debtor is still bound by the "Best Interest Test" and will have to show that unsecured creditors are receiving more than they would in a liquidation in order for the plan to be confirmed.

For landlords, it is important to note that the SBRA does not modify the lease provisions set forth in the Bankruptcy Code. In general, when a debtor is preparing to emerge from Chapter 11, it has to cure any pre-petition monetary (and non-monetary) defaults and demonstrate "adequate assurance of future performance" in order to assume any lease or executory contract. The SBRA does not eliminate these requirements. This is where a landlord can and should recover on the amounts it is owed.

Similarly, the SBRA does not modify the lease provisions that permit a debtor to reject an unexpired lease or executory contract. If an unexpired lease is rejected, the non-debtor party landlord is entitled to a lease rejection damage claim which is treated as an unsecured claim and is determined by a formula set forth in Section 502(b)(6) of the Bankruptcy Code.

What is the overall timeline for a Subchapter V filing?

The SBRA was designed to move cases rapidly from filing to confirmation and conclusion. A status conference, establishing the steps the debtor has taken to advance its case, must take place within 60 days of the petition date. This deadline may be extended on the same basis as for filing a plan, "if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable."

However, 14 days prior to the status conference, the Subchapter V debtor must file a status report that details the steps taken to achieve consensus with its creditors regarding its proposed plan. Strict enforcement means a Subchapter V debtor only has 45 days to negotiate in good faith with its creditors before having to report to the bankruptcy court.

Undoubtedly, debtors will argue that the current economic climate, resulting from a global pandemic, is a circumstance outside of their control. It is assumed that extension requests will be granted by the Bankruptcy Courts due to the economic climate resulting from COVID-19 as a "circumstance for which the debtor should not justly be held accountable". While extending the status conference and plan filing deadlines is counter to the legislative intent of the SBRA, which was meant to streamline the bankruptcy process for smaller businesses, it is important to recall that the SBRA became effective in February 2020, before nationwide "stay at home" orders resulting from the COVID-19 pandemic were issued.

It remains to be seen if court-approved extensions prove beneficial to debtors and creditors alike. Additional time may result in negotiated repayment terms that are both satisfactory to the creditor and manageable to the reorganized debtor, promoting a consensual plan and a successfully reorganized business. This is a much better alternative to a liquidation scenario in which business operations cease, employees lose their jobs and, in all likelihood, there is limited, if any, repayment to creditors.

Where is the protection for creditors under the SBRA?

Creditors probably will not view these changes as beneficial to their position. They have no ability to propose their own plan, unlike in a standard Chapter 11 case or in a Small Business Case. Furthermore, creditors might not receive a large recovery relative to what they are owed based on a repayment from a debtor's "projected disposable income".

For obvious reasons, creditors often prefer a more immediate payment upon confirmation of a plan of reorganization. However, a steady stream of payments over a period of years, even in a reduced amount, may prove to be beneficial to both sides. Confirmation of a plan of reorganization of a business with limited cash on hand at the time of confirmation, but with a viable projected income going forward, can result in a far more meaningful creditor recovery over the longer term as well as a successfully reorganized business and a continued creditor relationship.

As the 16th century idiom says, "half a loaf is better than no bread." For creditors, there is no sugarcoating the new Subchapter V bankruptcy provisions. Less leverage means a distinct possibility that there will be less recovery when all is said and done. But there are opportunities throughout the bankruptcy process for creditors to work with a debtor to negotiate terms that will provide for a respectable return on what they are owed, to the benefit of creditors, while at the same time promoting a successfully reorganized business, benefitting the debtor, its patrons and its employees, who maintain their jobs.

Does the Consolidated Appropriations Act provide any additional relief?

The CAA, which was signed into law on December 27, 2020, provides some additional relief and protections for debtors and landlords. The CAA permits Subchapter V debtors to seek to defer rent payments due under a lease for up to 120 days if such financial hardship was the direct or indirect result of the COVID-19 pandemic. This is an increase of 60 days from what was previously allowed under section 365(d)(3) of the Bankruptcy Code. The deferred obligation receives administrative claim status, meaning it is given a higher priority for repayment in the bankruptcy case. Further, the CAA, as it applies to all debtors, not just subchapter V debtors, amends section 365(d)(4) of the Bankruptcy Code to increase the amount of time a debtor has to elect to assume or reject nonresidential real property leases from 120 days to 210 days. These amendments to section 365 of the Bankruptcy Code expire on December 27, 2022.

The CAA amendment to the preference provisions of the Bankruptcy Code provides for protection to landlords who negotiate with their tenants for payment plans on account of rent and rental arrears. Section 547 of the Bankruptcy Code, which governs preference payments, has been amended to prohibit the avoidance of payments of "covered payment of rental arrearages" made during the 90-day preference period. This is designed to encourage landlords to provide deferral accommodations to their tenants and thereby give the tenant some necessary breathing room while protecting the payments from being recoverable as a preference if the tenant files a bankruptcy case. However, in order to qualify for the exemption, such payments must be (a) made in connection with an agreement or arrangement between a debtor and lessor to defer or postpone the payment of rent under a lease of nonresidential real property that was made or entered into after March 13, 2020, (b) does not exceed the amount of rent agreed to under the nonresidential real property lease that was in place prior to March 13, 2020, and (c) does not include fees, penalties or interest in an amount greater than would otherwise be due under the lease. Like the amendments to section 365 of the Bankruptcy Code, the amendment to section 547 also expires on December 27, 2022.

CONCLUSION

This Q&A is meant to highlight some of the provisions of the SBRA as enhanced by the CARES Act and the CAA. There are other provisions of the SBRA not addressed in this article that are still important for debtors, landlords and creditors alike to be aware of in the event of a chapter 11 filing utilizing the Subchapter V election. We will all learn more about how the SBRA impacts bankruptcy cases going forward as we all negotiate through these unprecedented times. •

THE COUNSELORS OF REAL ESTATE®

www.cre.org

REAL ESTATE ISSUES®

Published by THE COUNSELORS OF REAL ESTATE®

Since its launch in 1976, *Real Estate Issues* has been the premier forum in which the world's foremost real estate thought leaders present innovative ideas, novel strategies, and intriguing commentary on all matters relating to real property.

Visit www.cre.org/rei to view the digital archive of *Real Estate Issues* articles.

Subscribe at www.cre.org/subscribe to receive digital or print editions of *Real Estate Issues*.

Please submit any comments to the *Real Estate Issues* Executive Editor (or Board) on this article to rei@cre.org.