

New Jersey Bankers Association Commercial Lending Committee

Small Business Bankruptcy Cases Under Subchapter V of Chapter 11

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US Bankruptcy Code – Generally

US insolvency proceedings are filed in specialized Bankruptcy Courts, overseen by Bankruptcy Judges and governed by the Bankruptcy Code, a federal statute that applies in all 50 states

Chapters 1, 3, 5 of the Bankruptcy Code contain definitions and provisions concerning the administration of claims and cases and generally apply in all cases

Although Bankruptcy Code is a federal statute, it incorporates applicable state or federal law governing underlying issues regarding property, contracts, security interests, etc.

Effect of Filing – Automatic Stay

Cases under all chapters of the Bankruptcy Code are commenced by filing a petition:

- Each debtor must file a separate petition and separately qualify as a debtor under the applicable chapter.
- Venue of case need only be proper for first filed debtor; all others may file wherever an affiliate has filed.
- Filing of petition is a watershed – everything in case is either “pre” or “post” petition

Automatic Stay:

- In a plenary or full case, the “automatic stay” of Section 362 becomes effective immediately, serving to stay debt collection efforts and litigation involving the debtor
- Stay goes into effect regardless of whether a creditor has actual notice of a bankruptcy filing
- Does not stay “health, safety & welfare” regulations including environmental laws, criminal proceedings, certain other excepted acts
- Does not stay actions against third parties, such as affiliates or co-defendants, if not also a debtor, but court can extend the stay for cause to non-debtors under limited circumstances for limited purposes; Creditors can seek relief from the automatic stay, for cause and other reasons

Section 109 -- Who may be a debtor?

Must be a “person” that resides, has a domicile, a place of business or property in the U.S. at time of filing to be debtor under U.S. law

- Value of U.S. based assets need not be significant (as little as a “peppercorn”); sometimes money in a law firm trust account
- US Bankruptcy Courts assert jurisdiction over insolvency proceedings of entities formed under foreign law, unlike insolvency regimes in other countries.

Section 109 also limits who may or may not be a debtor under each chapter:

- Cannot be a debtor under chapter 7 if a railroad, domestic insurance company, domestic bank, savings bank, credit union or other insured bank, or if a foreign insurance company engaged in business in the US or a foreign bank with a branch in the US; ok if a bank or insurance holding company
- Railroads, uninsured state banks and entities that file under chapter 7 (except stockbrokers and commodities brokers) can file under chapter 11

Where should the case be filed?

28 U.S.C. 1408 provides venue rules for filing the petition

Venue of case proper

- wherever debtor is incorporated,
- where its principal place of business/assets in the US have been located for the 180 days preceding the filing;
- affiliates may file in district where venue is appropriate for first filed debtor

Venue often may be proper in more than one district

Determination as to where to file will be guided by issues specific to the particular debtor

- Location of significant creditors/assets/witnesses
- Choice of law issues that could affect success of case
- Location of counsel/perceptions as to experience of court/speed with which case may be handled

Effect of Filing – Estate

Filing petition creates an “estate”

Estate is comprised of all of the debtor’s legal and equitable interests in property as of the petition date;

Estate includes property/rights forfeited solely due to insolvency/financial condition/commencement of case

Estate defined very broadly; extent of debtor’s interest in property is determined by applicable state or non-bankruptcy federal law and includes pre-petition causes of action.

Filing does not expand existing property rights, but merely includes rights as of the petition date. If debtor is holding property in trust or in escrow it remains as such.

Estate does not include property transferred pre-petition unless and until such property is recovered in an avoidance action In SBD Case, estate includes disposable income earned post-petition and during plan period

Effect of Filing – Claims

Petition Date is watershed date for “claims.” Bankruptcy Code defines “claim” **broadly as:**

“a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, un-matured, disputed, undisputed, legal, equitable, secured or unsecured”

and

“the right to an equitable remedy for breach of performance if such equitable remedy gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, un-matured, disputed, undisputed, secured or unsecured.”

11 U.S.C. §101(5)

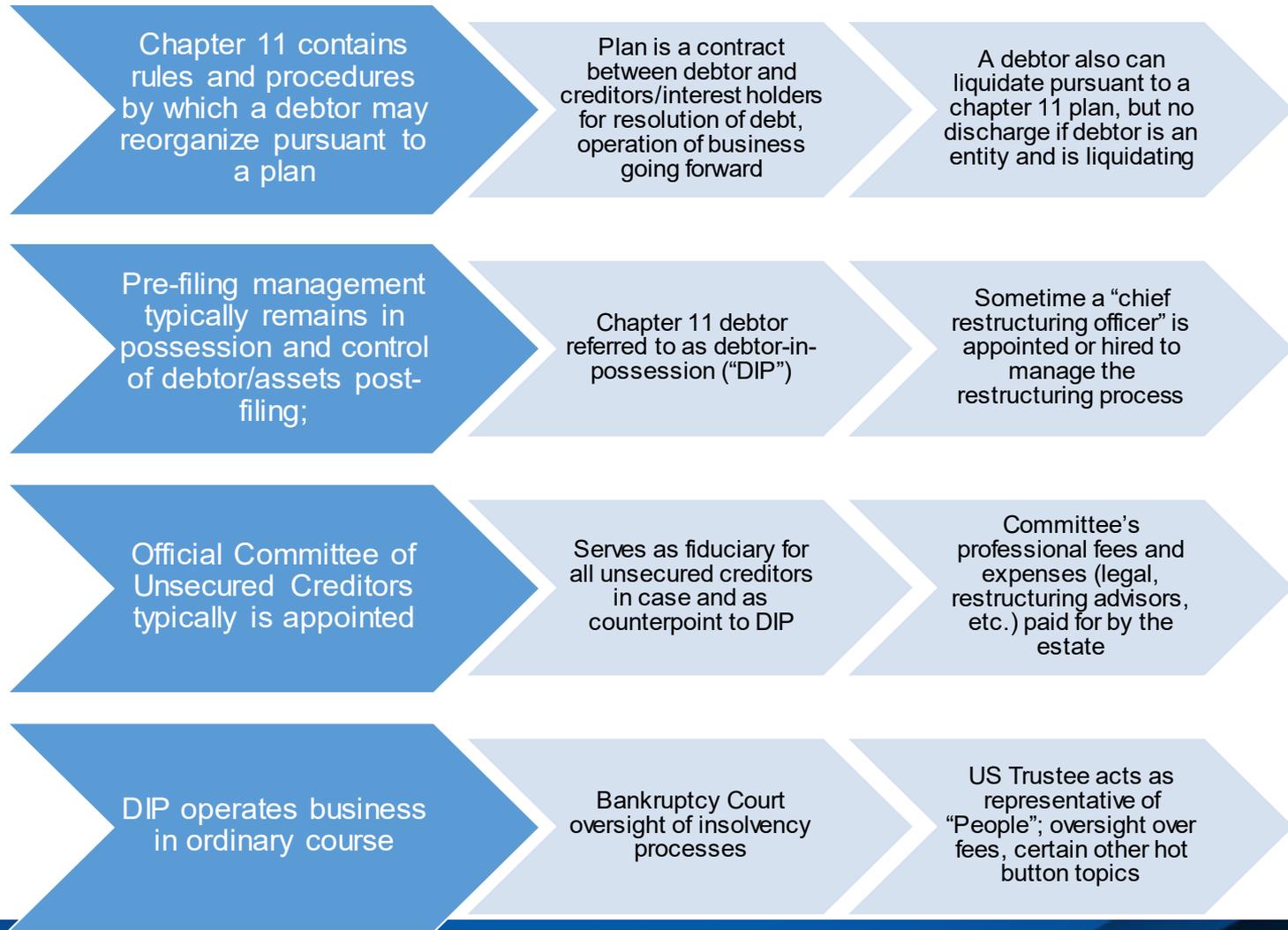
Tort claims treated as “pre-petition” if there is a connection between debtor’s pre-filing conduct and claimant’s injury even if the injury does not manifest until after the petition date; tort claims arising out of actions after petition date are “post-petition”

Claims from contracts executed before petition date deemed “pre-petition” even if breach occurs post-filing

Pre-petition claims generally can be discharged in a chapter 11 case; no discharge if debtor is liquidating under chapter 7 or chapter 11; Post-petition claims not subject to discharge;

Regulatory actions for mandatory injunctive relief not a “claim” subject to discharge; Notice may affect whether a party is deemed to have a dischargeable “claim”

Chapter 11 -- Generally



Chapter 11 Plans – generally

DIP has exclusive right to file a plan for first 120 days post-petition, with such period subject to extension for up to 18 months; exclusivity may be terminated for cause; once exclusive period ends, other parties in interest may file a plan

Debtor usually prepares disclosure statement (or combined DS/Plan) to distribute to creditors, parties in interest; DS must contain “adequate information” as required by section 1125

Plan must satisfy requirements of section 1129 to be confirmed; including, *inter alia*, 2/3 in value and majority in number of claims voting in each impaired class must approve plan or debtor must satisfy requirements for cram down under 1129(b); even in cram down, one impaired class must vote in favor of [;am

In either case, equity may not retain stake unless impaired classes agree or all impaired creditors paid in full unless debtor contributes “new value” -- absolute priority rule

The purpose of a chapter 11 case is to employ the Code's tools to spur a negotiated resolution or drag recalcitrant creditors along.

Tools Include:

- Reject burdensome leases and executory contracts
- Results in a “rejection damages” claim that must be dealt with in a plan of reorganization
- “Claw back” assets that have been “preferentially transferred” or “fraudulently transferred”
- Avoid unperfected liens and other interests
- Sell assets free and clear of all liens, claims and encumbrances
- Object to and have disputed claims adjudicated by the court

Procedures For Invoking Those Tools Vary:

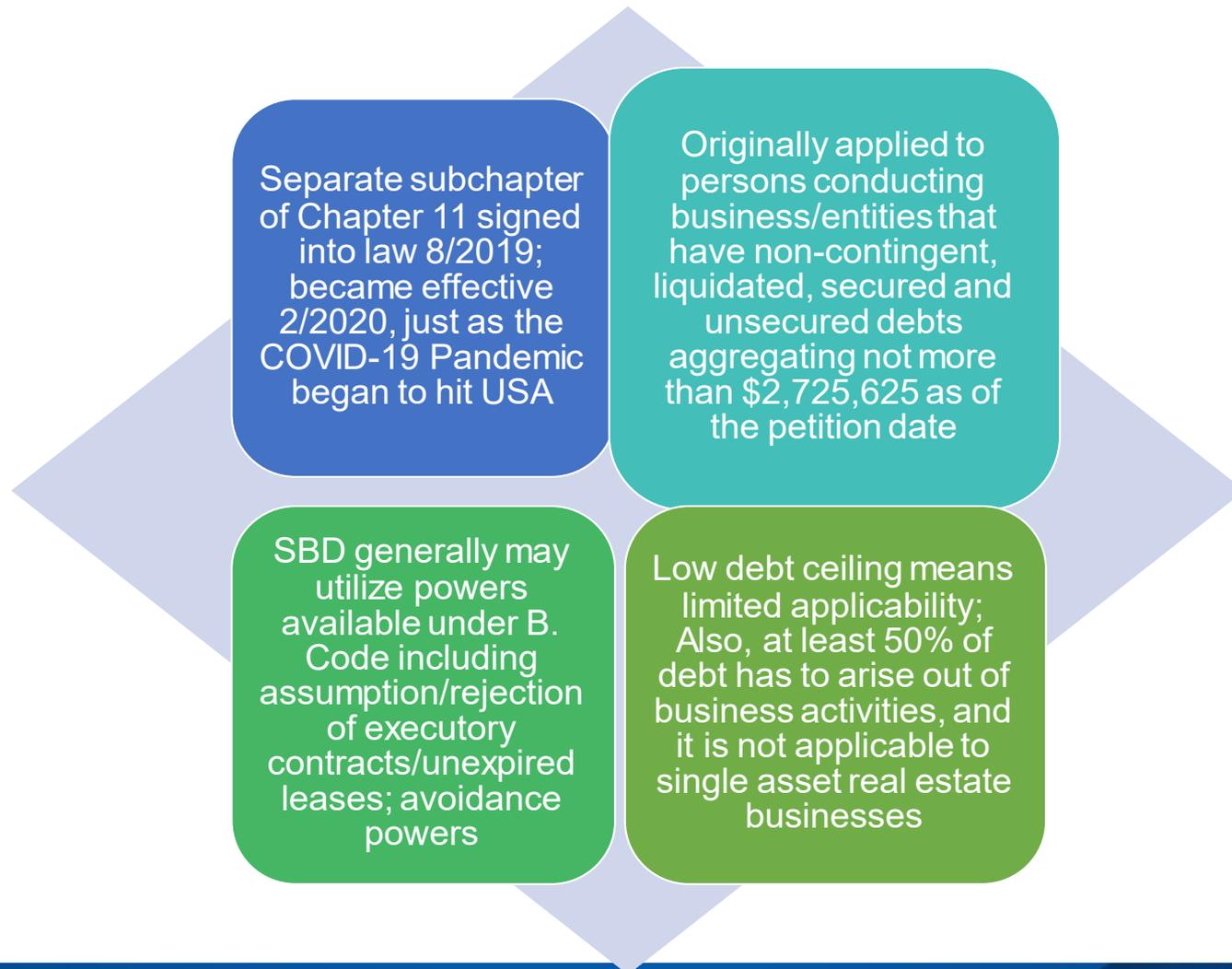
- “Contested Matters” are commenced by filing a motion
- Contested matters include motions relating to DIP financing, use of cash collateral, contract/lease rejections
- Notice periods are generally between 14 and 28 days
- Objections filed before the deadline are resolved at a hearing generally 30 or more days after the motion is filed
- “Adversary proceedings” are commenced by filing a complaint:
- Adversary proceedings include claw back, avoidance and turnover actions
- Final disposition can take more than a year

Ultimate Goal of a Chapter 11 Case

- The overall goal of chapter 11 from the debtor's perspective is to re-set the debt side of the balance sheet to equal the orderly liquidation value of the company's assets.
 - Secured creditors are entitled to a payment stream with a present value capped at the value of their collateral.
 - Unsecured creditors are entitled to a payment stream with a present value capped at what they would receive in a liquidation.
 - The net result is that the total of the debt side of the balance sheet is capped at the orderly liquidation value of the company.
 - But, equity is at a high degree of risk in a chapter 11 case:
 - The “absolute priority” rule mandates that equity retain nothing absent (i) full payment of unsecured creditors, (ii) plan acceptance by all classes of unsecured creditors, or (iii) a “new value” contribution.

- **To achieve plan confirmation, there are several gating items in addition to the minimum financial treatment outlined above.**
 - At least one “impaired class” must vote to accept the plan by 2/3 in amount and a majority in number.
 - The plan proponent must demonstrate “feasibility”, e.g., that confirmation of plan is not likely to be followed by the need for further financial restructuring.

Small Business Cases under Subchapter V



CARES Act and Subchapter V

CARES ACT enacted in connection with COVID-19 Pandemic expanded definition of “small business debtor” or “SBD”

- Now includes those with an aggregate of \$7.5 million debt
- Debt ceiling will revert after one year unless further extended
- At least 50% of debt still has to arise out of business activities
- Still not applicable to single asset real estate businesses

Increase to debt ceiling greatly expands universe of persons/entities that may benefit

Cases under subchapter V differ from other chapter 11 cases in significant ways

Trustee appointed to facilitate plan development, but no committee is appointed

Small Business Debtor has exclusive authority to file a Chapter 11 plan of reorganization

- Exclusivity is not subject to termination as in regular chapter 11 case

SBRA imposes truncated timeline to file a plan of reorganization, with a plan to be filed 90 days post-petition; period may be extended if need for extension due to circumstances for which the debtor should not be held accountable – high standard

Confirming a Subchapter V Plan

Subchapter V eliminates/changes certain requirements for confirming a plan:

- Plan may confirmed as long as all 1129(a) requirements met except (a)(8); admin claims payable over time
- Plan may be crammed down without vote of single impaired class, as long it meets “fair and equitable” requirements
- Fair and equitable requirements for secured creditors same as in regular chapter 11, e.g., creditor retains lien, receives distribution equal to value of the collateral
- SBD also must show (a) all projected disposable income for a period of three years or up to five years post-effective date is directed to make payments under the plan; **or** (b) value of property to be distributed is at least equal to SBA’s projected disposable income during the three years or up to five years post-effective date;
- SBD likely to be able to make all plan payments

Confirming a Subchapter V Plan

Disposable income defined as income not reasonably required for

- Maintenance/support of SBD or SBD's dependents
- Domestic support obligations
- Operation of SBD's business

Discharge available once all plan payments completed

Plan may be modified pre-and post confirmation, but only if as modified plan conforms to statutory requirements

Cases under subchapter V differ from other chapter 11 cases in significant ways

No separate disclosure statement required, but information typically required in DS incorporated in Plan including liquidation analysis, projections, brief history of debtor's business operations

Shortened timeline, absence of committee significantly reduces expense of case

Plan must provide that all or a portion of debtor's future disposable income be directed to trustee's supervision to execute plan

Cases under subchapter V differ from other chapter 11 cases in significant ways

No absolute priority rule; No need for new value contribution to retain equity in SBD and still confirm plan

No requirement that impaired class vote in favor as long as satisfy fair and equitable requirements applicable to SBD plan

Administrative expenses need not be paid in cash at confirmation; may be paid over time pursuant to special cram down rules applicable to SBD cases

Creditors that supply goods and services to SBD during 20 days pre-petition (e.g., 503(b)(9) claims) and post-petition may not be paid in full as of confirmation, but over plan period out of “disposable income”

Similar to Chapter 13 in that estate includes post-petition income, Trustee distributes payments to creditors, retains oversight