CAN CORPORATE BANKRUPTCY HELP YOUR SMALL BUSINESS?

EXPANSION OF THE SMALL BUSINESS REORGANIZATION ACT

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INTRODUCTION

In the wake of the COVID-19 pandemic, the country's small businesses have suffered systemic and catastrophic disruption to operations, demand and supply that will make it impossible for many such businesses to fulfill their obligations to creditors and to access financing for continued business operations. The recent enactment of the Small Business Reorganization Act ("SBRA") of 2019, which created a new Subchapter V ("SubV") as part of chapter 11 of title 11 of the United State Code (the "Bankruptcy Code") both extends the eligibility requirements of the Chapter 11 process to more small businesses, as well as expands the leverage and options by which small businesses can restructure their financial obligations and rehabilitate the economic viability of their operations.

Prior to the enactment of SubV, the Chapter 11 process proved too expensive for most small businesses because the process has become a battle of professionals – attorneys, accountants, advisors and investment bankers - all working to promote the interests of different constituents. The assets and resources of the debtor's estate are utilized first and foremost to pay these professionals. Hence, like any adversarial legal process, the cost of the Chapter 11 process has become a substantial obstacle to its effectiveness.

SubV, however, seeks to make the Chapter 11 process a viable alternative for small business entities by modifying the "rules" that govern the process, including, omitting certain disclosure obligations and reducing opportunities for disputes among the debtor and its creditors, both of which will result in significantly less professional fees being paid by the debtor's estate. SubV also provides an easier mechanism and incentives for business owners to restructure their business and obtain relief from past obligations, all while maintaining control over their business operations during the bankruptcy process and retaining equity in the future business after the bankruptcy is concluded – something that was not possible prior to the enactment of SubV without the infusion of new value into the reorganized entity.

Understanding the Nature and Goals of the Chapter 11 Process

To provide better context to the significant advantages afforded small businesses under SubV, a brief overview of the nature of corporate restructuring is helpful:

1. The Goal of Corporate Restructuring

In the course of producing goods and services, corporate entities incur legal obligations – contractual, equitable and punitive. The parties to the obligation are the debtor that owes the obligation and the creditor to whom the obligation is owed. Corporate insolvency is that state of corporate-being in which the corporate debtor is unable to fulfill its legal obligations to its creditors and unable to provide a return to its investors. In general, the goal of corporate restructuring is to modify the company's obligations in size and timing, such that the company can continue to effectively utilize assets to provide jobs, good and services.

2. The Nature of Corporate Restructuring

Corporate restructuring often occurs in a chaotic environment in which a lack of resources and hostile creditor actions threaten the debtor's ability to operate. From this chaos, the company's fiduciaries and restructuring professionals must infuse an organized process that begins with an assessment of the company's (i) assets; (ii) obligations; and (iii) business prospects. Such a comprehensive assessment must include, among other things, considerations of the company's creditors' rights, resource needs, access to resources, expected cash flows, legal issues, and short term and longer term business goals.

The corporate restructuring goal is achieved when corporate obligations are normalized among creditors, value is distributed, and the company's assets and resources are organized through a plan that maximizes value for employees, creditors and stakeholders. Corporate restructuring, thus, refers to this entire process of assessment, investigation and modification of some or all of the obligations, resources, rights and forces that impact a corporate entity. Ultimately, through this process, a company formulates an achievable plan for its short term and long term future and, consensually or by other legal means, modifies the existing relationship with its creditors to correspond to the plan.

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3. The Inter-related Rights of Creditors

The relationship of any particular debtor-creditor is more complex than it may, at first blush, appear, and must be assessed on a case-by-case basis. By definition, a debtor has an obligation to pay its creditor, but what are the rights of a creditor when the debtor: (i) disputes the obligation or the scope of such obligation; or (ii) is simply unable to fulfill the obligation? In addition, what is the process and cost to the creditor of enforcing its rights?

The answer to these questions impacts the level of complexity between a company and its creditors, and drives the decisions of how best to approach and negotiate with such creditors. Although creditors can be grouped by the characteristics that

define their relations, contracts and legal rights, each debtor-creditor relationship may give rise to unique considerations that affect the debtor's obligation and the creditor's rights to collect. Considering that for a small business concern there may range from several to hundreds, if not thousands of individual creditors depending upon the type of business. Even relatively "small" businesses are subject to the complex web of inter-related rights as any large business, all of which will significantly impact the company's on-going operations, cash flow and assets.

4. Corporate Restructuring and Chapter 11 of the Bankruptcy Code

Reaching consensual agreements with creditors in an organized process can be the least expensive process for restructuring a business. It is, however, extremely rare that debtors and all of their separate creditors reach the degree of understanding and cooperation necessary, among all of them, to successfully restructure a company without resort to

a court-supervised process. Most often, corporate debtors will resort to the federal Chapter 11 process when one or more creditors take actions to enforce their state law rights that threaten the business-debtor's resources and operations. A key premise of the Chapter 11 process is that there can be a more fair and efficient distribution and realization from a company's assets for all creditors and interest-holders if all of the company's obligations and assets are addressed in a single proceeding.

A business debtor commences the Chapter 11 process by filing required forms with the Bankruptcy Court that detail all of its assets, liabilities, business operations, insiders, creditors and recent business transactions. Upon filing the "chapter 11 petition" all creditors must stop all activities (i.e., collections, lawsuits, etc…) with respect to obligations that arose on or before the date the company filed its chapter 11 petition, except as such obligations are addressed within the Chapter 11 process. While the process is too cumbersome to detail here, in a very general sense the Chapter 11 process is a "rule-based" adversarial process through which a corporate debtor seeks the Bankruptcy Court's final approval of a "plan of reorganization" which will legally modify its obligations and the rights of its creditors. During the Chapter 11 Process, the company's creditors are encouraged to participate in active negotiation, on their own behalf and in groups with other similarly-situated and diverse groups of creditors, to influence the compromises ultimately contained in the debtor's plan of reorganization.

The Impact and Importance of SubV

As previously explained, the Chapter 11 process, while historically advantageous and effective for large businesses, has increasingly become too expensive of a restructuring option for most potential small business debtors. Congress attempted to remedy this problem through SubV by providing a more streamlined and less expensive Chapter 11 process for small businesses that meet certain threshold requirements. The following discussion provides an overview of some of the key provisions of SubV that impact small businesses and their decision to invoke

the protections of the Bankruptcy Code as a viable and affordable restructuring alternative. The availability of SubV for small businesses and small business owners will be particularly useful in the coming months to overcome financial difficulties due to the COVID-19 pandemic and to enable small businesses to continue to stay in business as the economy slowly recovers.

1. Which Small Businesses Qualify for SubV

Protection under SubV is available to small businesses with aggregate, non-contingent debts (both secured and unsecured) of less than $2,725,625, of which more than 50 percent of such debt arises from commercial or business activities. In addition to corporate entities with small business operations, debtor's engaged in commercial or business activities include independent contractors, sole proprietorships and self-employed individuals, but do not include any person or entity whose primary activity is a single-asset real estate holding. Moreover, the $2,725,625 debt limit has been temporarily increased by the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") to $7,500,000 for Chapter 11 cases filed by small business debtors electing to proceed under SubV, but only for cases filed prior to March 26, 2021. This provides a very small window of opportunity for small businesses and business owners that otherwise would not qualify to file under SubV to take advantage of this more streamlined and less expensive Chapter 11 process.

Although the SubV debt limit requirements may appear straightforward, there are latent ambiguities regarding the obligations that will be counted within the $2,725,625 (temporarily increased to $7,500,000) limitation and the manner in which obligations arose that may affect whether a small business concern will qualify to utilize a SubV proceeding.

2. The Procedural/Cost Benefits of SubV[1]

The enactment of SubV modifies the Chapter 11 process in ways intended to make it cheaper and more accessible for small business debtors. In most SubV cases, for example: (i) there will be no committee of unsecured creditors appointed; (ii) the debtor will file a basic plan and seek court approval within 90 days; (iii) the debtor will not be required to undertake the cost and expense of filing a disclosure statement as part of its plan approval process; (iv) the process of gaining Court-approval of the debtor's plan will be significantly abbreviated; and (v) small business owners will retain their equity interests even if creditors are not paid in full. These modifications represent significant cost savings and incentives for a small corporate debtor to implement a restructuring through a SubV proceeding as compared to the regular Chapter 11 process.

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In the Chapter 11 process, a committee, generally consisting of the debtor's largest unsecured creditors, is appointed to represent the interests of general unsecured creditors (the "Committee"). The Committee hires its own independent counsel and may also hire other professionals. These professionals work only for the Committee, however, all of their

1 11 U.S.C. §§1181-1195 ("Subchapter V") contains many textual modifications to Chapter 11 of the Bankruptcy Code that are applicable in qualified small business bankruptcy cases. An academic discussion of each modification is beyond the scope of this article; the modifications create ambiguities that will undoubtedly be the focus of many future court decisions. The observations contained herein regarding the effects of Subchapter V on the Chapter 11 Process are intended as generalizations.

professional fees must be paid from the debtor's estate. The fees and costs attendant to two sets of professionals (one for the debtor and one for the Committee) will often make chapter 11 unavailable to small business debtors. SubV eliminates the appointment of an official Committee unless the Court orders otherwise for cause. Instead, an independent SubV trustee is appointed to participate in limited aspects of the bankruptcy case (including payment disbursements under a plan) and to generally act as a watchdog for the rights of creditors through his or her participation in the bankruptcy proceedings.

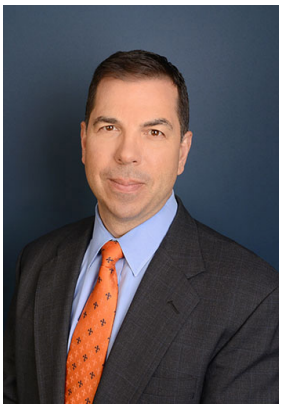
Pursuant to SubV, the debtor, and only the debtor, is expected to propose a written plan outlining the payment of creditors and restructuring of its business within 90 days of the commencement of the bankruptcy case. While the required contents of a SubV plan are very similar to a Chapter 11 plan, the scope of the plan and the approval process are greatly abbreviated for small business debtors. SubV sets forth the outline for a plan that can be proposed only by a corporate debtor and acceptance can be solicited from creditors without a separate disclosure statement. Moreover, provided that the Court finds that the plan is fair and equitable and does not discriminate unfairly amongst creditors, the Court may approve the plan regardless of creditors' votes.

A small business debtor will receive court-approval of its plan and its owners may retain ownership and control of their business if the plan utilizes all disposable income of the business to repay existing creditors over a period of 3 years.[2] After the three-year period is concluded, assuming that the small business debtor has fulfilled the terms and payments under its plan, any unpaid obligations addressed in the plan will be discharged. This represents a significant departure from the requirements of the Chapter 11 process, where, typically, owners cannot retain their equity without engaging in expensive corporate valuation fights and contributing significant new value. In this way, owners of a small business debtor are incentivized to utilize SubV to propose and fulfill a good faith plan that maximizes value for creditors while rehabilitating the corporate enterprise.

CONCLUSION

Small businesses that are suffering from the financial crisis resulting from the COVID-19 pandemic should speak with a restructuring professional about formulating a plan to keep their business going. Among other things, the expanded eligibility requirements for small business debtors to take advantage of the pared down Chapter 11 process pursuant to SubV provides small businesses with options, enhanced leverage in negotiating with creditors, and a more cost-effective process that can provide a path to solvency and liquidity.

2 In some cases, the Court may increase this period from 3 to 5 years under circumstances where, in the Court's discretion, fairness and equity may require that a longer time period apply.



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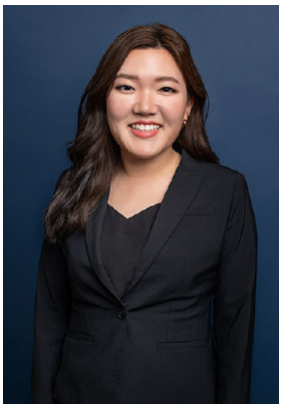

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