Big Change, Small Business

How the Small Business Reorganization Act of 2019 affects bankruptcy practitioners in Eastern Washington

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On August 23, 2019, House Bill 3311 was signed by the President and became law. Commonly known as the Small Business Reorganization Act or Subchapter V ("the Act"), this new law is meant to streamline the bankruptcy process by which small business debtors reorganize and rehabilitate their financial affairs.[2] Because a high percentage of its businesses are small businesses, the Bankruptcy Court in the Eastern District of Washington could be uniquely affected by the new Act. This article will serve as a brief summary of the Chapter 11 changes and as an analytical and anecdotal perspective on how debtors and debtor's attorneys in the Eastern District of Washington could experience the effects of these changes.

Background

Small businesses throughout the United States are facing significant longevity concerns. Nearly 80% of all small business do not survive their first year. By the five-year mark, only half of those that survived the first year still have the lights on.[3] Because Chapter 11 allows the debtor to remain in control its business while formulating a plan of reorganization, it is a popular bankruptcy option for small businesses. Close to 45% of Chapter 11 filings in the United States between 2014 and 2018 were small businesses.[4] Unfortunately, "the model for Chapter 11 was the publicly-traded manufacturer, not the local diner."[5] The complex debt and asset structures of large corporations justify many of the administrative hurdles of Chapter 11 but often these same procedures are too expensive, too complicated, and too time consuming to be of any benefit to the typical American small business that is attempting to reorganize. As such, many small business bankruptcy cases fail to reorganize successfully and are converted to a Chapter 7 liquidation or are dismissed. The handful of small businesses that do succeed in reorganization often find that 20% or more of their assets were consumed by administrative costs of the bankruptcy process.[6]

Significant Changes to Chapter 11 in 2020

The Small Business Debtor

To be eligible to file under the Act, the entity or individual filing the petition must be a "small business debtor." This means the debtor must be a person or entity engaged in commercial or business activity with aggregate debts not exceeding $2,725,625 as of the date of

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[2] H.R. Rep. No. 116-171, at 1 (2019).
[3] 165 Cong. Rec. E977-05 (2019).
[4] Brubaker, Ralph, Bankruptcy Law Letter, Volume 39, Issue 10, The Small Business Reorganization Act of 2019, at 6 (2019).
[5] National Bankruptcy Conference, A Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize, at 1 (2010).
[6] *Id*.

filing of the petition or the order of relief.[7] New to the definition of "small business debtor" is the requirement that not less than 50% of aggregate debt arise from the commercial or business activities of the debtor.[8] This clarifies the previously ambiguous qualification of "engaged in commercial business activities" and specifies exactly who qualifies as a "small business debtor."[9]

In a Subchapter V case, a small business debtor may choose to operate as a debtor-in-possession. Should the debtor choose this option, the debtor must file all forms required by 11 U.S.C. § 521(a). A debtor choosing to operate as a debtor-in-possession may be removed from their position of control upon a showing of cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor.[10] In this scenario, the small business trustee would take over operation of the debtor's business.[11]

A debtor must opt-in to coverage under Subchapter V. Little guidance is provided about when the decision to opt-in must be made. The prevailing assumption among practitioners is that this decision must be made at the time of filing, but the law neither explicitly states nor even suggests that a small business debtor is precluded from opting-in at any time throughout the proceedings.

Committees

Subchapter V excludes all sections of Chapter 11 detailing the appointment procedure, powers, and voting rights of committees. In other words, a small business case filed under Subchapter V will not have a committee of creditors appointed, unless the court, for cause, orders otherwise.[12]

Trustees

The U.S. Trustee is required to appoint a trustee in every Subchapter V case. This trustee acts much like a Chapter 13 trustee and will be responsible for investigating the financial affairs of the debtor, objecting to the allowance of proofs of claim, and acts as a conduit for plan payments.[13] The small business trustee must also "appear and be heard at the status conference . . . and any hearing that concerns: (A) the value of property subject to a lien; (B) confirmation of a plan filed under this subchapter; (C) modification of the plan after confirmation; or (D) the sale of property of the estate."[14] A trustee's service is terminated under Subchapter V when the plan has been "substantially consummated."[15]

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[7] 11 U.S.C. § 101(51D).
[8] Act § 4(a)(1)(B)(i)
[9] Brubaker, Ralph, Bankruptcy Law Letter, Volume 39, Issue 10, The Small Business Reorganization Act of 2019, at 5 (2019).
[10] 11 U.S.C. § 1185
[11] 11 U.S.C. § 1183(b)(5)
[12] 11 U.S.C. § 1181(b)
[13] Kucera, Jeffrey, US Restructuring and Insolvency Alert, Small Business Debtor Reorganization: An Overview of Chapter 11's New Subchapter V (2019).
[14] 11 U.S.C. § 1183(b)(3)
[15] 11 U.S.C. § 1183(c)

Status Conference and the Plan of Reorganization

In order to "further the expeditious and economical resolution of a case" under Subchapter V, a status conference must be held no later than 60 days after filing the petition.[16] This time may be extended if the need for an extension is attributable to circumstances for which the debtor should not justly be held accountable.[17] In addition to a hastened status conference, the debtor is required to file, no later than 14 days before the status conference, a report that details the efforts the debtor has undertaken and will undertake to attain a consensual plan of reorganization.[18]

The plan of reorganization has undergone significant changes under Subchapter V. For example, only the debtor can file a plan. While not unique to bankruptcy generally, as this closely mirrors both Chapter 12 and Chapter 13 plan filing requirements, it is distinct from usual Chapter 11 practices.[19] The contents of the plan have also been simplified. Rather than requiring the small business debtor to solicit plan acceptances via disclosure statements, the small business debtor need only include in the plan a brief history of their business operations, a liquidation analysis, and projections with respect to the ability of the debtor to make payments under the proposed plan of reorganization.[20] Finally, the plan must be filed no later than 90 days after the filing of the petition.[21] As a result, a debtor under the Act should be able to confirm a plan quickly and significantly limit expenses incurred in the process.

A Closer Look

Washington, and the Eastern District in particular, is laden with small businesses.[22] According to the 2018 Small Business Profile of Washington conducted by the U.S. Small Business Administration, 99.5% of Washington business are small businesses.[23] Since June of 2015, the Bankruptcy Court for the Eastern District of Washington has had 58 cases filed under Chapter 11.[24] Of those 58 cases, the precise number that would have qualified for Subchapter V is unknown, but based on the composition of businesses in the Eastern District, it can be safely assumed that many could have opted-in to this new Subchapter.

[16] 11 U.S.C. § 1188(a)
[17] 11 U.S.C. § 1188(b)
[18] 11 U.S.C. § 1188(c)
[19] Kucera, Jeffrey, US Restructuring and Insolvency Alert, Small Business Debtor Reorganization: An Overview of Chapter 11's New Subchapter V, 23 September 2019.
[20] 11 U.S.C. § 1190(1)
[21] 11 U.S.C. § 1189(b)
[22] A small business, according to the U.S. Small Business Administration, is defined as a firm with fewer than 500 employees.
[23] Small Business Association Office of Advocacy, Washington Small Business Profile at 193 (2018).
[24] US Courts, Caseload Statistics Data Table, uscourts.gov.

One local case provides an example of just how much the Act could benefit small businesses filing under standard Chapter 11. David Cebert, joined by Coral Cebert, filed for bankruptcy under Chapter 11 on August 10, 2018 in the Eastern District of Washington (Cause No. 18-02224). Under the business name VU Music, the Ceberts had accrued $1,222,700 in debt. Nearly $700,000 of that debt was business-related. Because their aggregate debts did not exceed $2,725,625, and because well over half of their aggregate debt was business related, the Ceberts would have qualified for Subchapter V.

In the Cebert case, the parties had status conferences continued at least twice. The status conference was not held until January 23, 2019, 166 days after the filing of the petition. Had they opted-in to the new subchapter, and barring similar extensions of time, the Ceberts would have been required to file a report detailing their efforts to effectuate a successful reorganization on September 25, 2018 and would have had a mandatory status conference 14 days later on October 9, 2018. By this point in the proceedings under Subchapter V, the Ceberts would have been three months into plan payments and further on their way to reorganization. By contrast, as of 11/25/19, more than a year after the filing of the petition, the Chapter 11 Plan is still yet to be confirmed and the case has faced numerous motions to dismiss and to convert. After one hearing, Judge Corbit ordered the attorney for Debtor to submit a third amended plan and explained that conversion or dismissal would not benefit creditors or debtors. The Cebert case is now set for a hearing on June 4, 2020, to evaluate the liquidation efforts by the debtors and to reconsider whether dismissal or conversion is appropriate. Almost two years after the initial filing of the petition, the Ceberts will be without a confirmed plan and with increasing attorney's fees.

Another instance in which Subchapter V could have applied but was unavailable is *In Re JTWW, Inc.* ("JTWW"). This debtor had accrued $1,072,647 in debt, about $700,000 of which related to their business: Wasabi Asian Bistro. On January 30, 2019, JTWW filed for bankruptcy under Chapter 11. On a Subchapter V timeline, the debtor would have filed their report by March 18, a mandatory status conference would have been held April 1, and the plan would have been filed April 30, 2019. Interestingly, this case had two status conferences before Subchapter V would have required them to have one.[25] On April 30, 2019, a motion to extend time to file disclosure statements and the plan was filed with the court. After hearings and more continuances, a plan was finally filed on September 19, 2019, nine months after the petition was filed. This case is currently in limbo. The major creditors have questioned whether the debtor can reorganize successfully, the IRS has a claim on back-taxes, and conversion or dismissal remains a possibility if the case cannot be brought into a confirmable posture.

Concerns

In its effort to ensure that Subchapter V was not overly rigid, Congress left two "fallbacks" under which time can be extended "if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable."[26] In the two cases above, filed under standard Chapter 11, continuances were prevalent and damaged the

[25] Judge Corbit actively watches cases assigned to him and frequently sets status conferences to keep the reorganization process moving forward.
[26] 11 U.S.C. § 1188(b), 11 U.S.C § 1189(b).

possibilities of quick and economic solutions for the debtors. Subchapter V, with the sole purpose of providing "expeditious and economical" resolutions, seems to allow for similar repeated continuance requests. It remains to be seen how courts will interpret that language, but it is plausible that some will use this language as an over-arching allowance to extend time and the exception could very easily become the rule.

Conclusion

The Act has the potential to be a tremendous piece of legislation for small businesses contemplating bankruptcy. Chapter 11 is underserving the businesses it was meant to protect and providing the antithesis of an "expeditious and economical" resolution. The two local cases cited, both of which are currently without confirmed plans, highlight just how beneficial the Act could be. Small businesses are often cash and asset strapped and in need of quick and effective relief. The Act, with its bright-line filing deadlines and expedited procedures, may prove to be a legitimate answer to these growing concerns. There will almost certainly be some growing pains with administration of the Act and the potential for open-ended extensions of time remains, but small businesses around the country should be looking forward to February 19, 2020 when Subchapter V protections become available.