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Streamlined Small Business Reorganizations Under Subchapter V: Concepts and Early Decisions

Brian M. Rothschild, Moderator
Parsons Behle & Latimer | Salt Lake City

Jonathan Dickey
Buechler Law Office, LLC | Denver

Hon. Joseph G. Rosania, Jr.
U.S. Bankruptcy Court (D. Colo.) | Denver

John C. Smiley
Sender & Smiley LLC | Denver

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The Small Business Reorganization Act of 2019

Congress in 2019 passed the "Small Business Reorganization Act, H.R. 3311, which was signed into law on August 26, 2019, which added Subchapter V comprising sections 1181-1195 to chapter 11 of the Bankruptcy Code (aka "**Sub V**").

The stated goal was to provide a streamlined procedure for reorganization of businesses that could not reorganize under the ordinary provisions of chapter 11.

A slight revision to SBRA was made under The Coronavirus Aid, Relief, and Economic Security Act (the "**CARES Act**") enacted and effective March 27, 2020, which increased the debt limit to $7.5 million, discussed in more below.

Notable Features of Subchapter V vis-à-vis Traditional Chapter 11

Trustee. Unlike other chapter 11 cases, has a "trustee," although the trustee's role is very limited.

No U.S. Trustee Fees. There are no quarterly fees, which is a substantial savings.

No Committees. Unless the court orders otherwise, there are no committees

Debtor in Possession. Like other chapter 11 cases, the debtor remains in possession of its estate despite the presence of a trustee.

Tight Deadlines. A Sub V debtor must file a plan within 90 days of the petition date unless extended, *but* no confirmation deadline.

Debtor in Control. Only the debtor may propose a plan.

Discharge and Abrogation of Absolute Priority Rule. Subject to certain requirements, a debtor may receive a discharge upon completion of a plan and retain its interests notwithstanding that all creditors are not paid in full.

No disclosure statement required. The plan may be solicited without a disclosure statement.

Debtor Eligibility for Subchapter V

A debtor may elect to proceed under Sub V (§ 1181(a)) if it is a "small business debtor," as defined in § 101(51D), which is essentially a debtor with not more than $2,725,625 in aggregate noncontingent liquidated secured and unsecured business debts as of the date of the petition date.

The CARES Act upped the debt limit to $7.5 million temporarily for one year beginning on March 27, 2020. There are proposals to make the increase permanent or even increase the limit to $10 million. (Fingers crossed.)

The Subchapter V Trustee

Section 1183 provides that the Sub V trustee's duties are limited. The primary duty is to "facilitate the development of a consensual plan of reorganization." § 1183(b)(7). Other duties include—

- Appear and be heard at any hearing concerning: (1) the value of property subject to a lien; (2) confirmation of the plan; (3) modification of the plan after confirmation; and (4) the sale of property of the estate. § 1183(b)(3).
- If ordered by the court, (1) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business, the desirability of its continuance, and any other matter relevant to the case or formulation of a plan; (2) file a statement of the investigation, including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor or to a cause of action available to the estate, and to transmit a copy or summary of it to entities that the court directs; and (3) file postconfirmation reports as the court directs. § 1183(b)(2).
- The role of the trustee is not yet well fleshed out. The trustee may do very little (non-possessory, no payment routing, just observing) or a lot (ordered to investigate, take possession, operate the business, disburse property, file reports, object to claims, etc.).

The Subchapter V Trustee (cont.)

The Sub V trustee also has the following duties:

- Be accountable for all property received. § 1183(b)(1) (but rarely does the trustee come into property).
- Examine proofs of claim and object to allowance of any claim that is improper, if a purpose would be served. § 1183(b)(1).
- Oppose the discharge of the debtor, if advisable. § 1183(b)(1).
- Furnish information concerning the estate and the estate's administration that a party in interest requests, unless the court orders otherwise. § 1183(b)(1).
- Make a final report and file it. § 1183(b)(1).
- Ensure that the debtor commences timely payments under a confirmed plan. § 1183(b)(4).

Plans under Subchapter V

A Sub V plan can look like a regular chapter 11 plan for the most part. But because no disclosure statement is required, it must include the following things usually found in a disclosure statement:

> (A) a brief history of the business operations of the debtor;
>
> (B) a liquidation analysis; and
>
> (C) projections with respect to the ability of the debtor to make payments under the proposed plan of reorganization;

§ 1190(1).

Also, a plan must "provide for the submission of all or such portion of the future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan." § 1190(2). This just means that the debtor must provide sufficient income for the performance of the plan, *i.e.*, it provides a means of implementation the same as required in § 1123(a)(5).

Plan Confirmation under Subchapter V

Perhaps the most significant difference in Subchapter V is the abrogation of the Absolute Priority Rule[tm] in section 1191.

Section 1191 incorporates all of section 1129(a) except 1129(a)(15). So the same tests apply. BUT, in a cramdown of unsecured creditors, the plan may be confirmed so long as—

> (A) the plan provides that all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date that the first payment is due under the plan will be applied to make payments under the plan; or
>
> (B) the value of the property to be distributed under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date on which the first distribution is due under the plan is not less than the projected disposable income of the debtor.

§ 1191(c)(2) (aka the "**Best Efforts Test**").

Interesting Recent Decisions

Subchapter V of Chapter 11 is obviously a new area of the law. Cases are beginning to come in from around the country. And the early returns are all over the place, with cases going in either direction.

There are some contentious issues which have not hit yet - simply because Subchapter V is less than a year old. Below are some interesting cases from around the country.

I. Amending the petition to opt-in to Subchapter V

A. Converting quickly after the effective date of Subchapter V

The first SBRA opinions were about whether a debtor could belatedly elect into a subchapter V. The debtor filed before the enactment of SBRA and would have qualified in SBRA was active on the Petition Date. Several early cases allowed debtors to belatedly make the election.

In re Twin Peaks, LLC, 2020 WL 5576957 (Bankr. D. N.M. April 30, 2020) is representative of the majority of holdings around the country.

In *Twin Peaks*, the case was pending for a year when the Debtor sought to opt into Subchapter V. The UST objected for a variety of reasons - including that the Debtor could not comply with the deadlines set in §§ 1188 and 1189. The Court held that it had the discretion to extend the deadlines. Basically, because subchapter V was not available to the Debtor when it filed, and it moved to amend shortly after Subchapter V became effective, the Court would allow the amendment.

I. Amending the petition to opt-in to Subchapter V

B. Conversion after the §§ 1188 and 1189 deadlines have run

Courts liberally allowing debtors in Chapter 11 prior to the effective date of Subchapter V to opt-in to subchapter V is not surprising. But how will are courts looking at a debtor who shifts gears now that subchapter V has been in place for almost a year?

In *In re Seven Stars on the Hudson, Corp.*, 618 B.R. 333 (Bankr. S.D. Fla. 2020), the debtor filed in June 2019. The case was moving along until COVID hit and the debtor was shutdown. On June 19, 2020 - four months after the Subchapter V effective date - debtor moved to opt-in to subchapter V.

The court denied the motion to opt-in. The court in *Seven Stars* sets something of a bright line rule. Namely, that the deadlines in §§ 1188 and 1189 are statutory deadlines. The debtor was aware of COVID-19 a month after the effective date of Subchapter V. Yet it waited to make the election until after all subchapter V's statutory deadlines had run.

The court's rule, sounding in the court's broad discretion, is that you can opt-in to Subchapter V prior to the statutory deadlines running. But you cannot first try your hand in a regular 11 and, when that fails, seek shelter under Subchapter V.

I. Amending the petition to opt-in to Subchapter V

B. Conversion after the §§ 1188 and 1189 deadlines have run (cont.)

Other decisions on the subject include the following:

In re Trepetin, 617 B.R. 841 (Bankr. D. Md. 2020). The court found cause to extend the deadlines. Debtor was eligible for a Chapter 7 discharge. The case was a no-asset case. By voluntarily removing the case from Chapter 7 at that point, the debtor was pursuing a course which would be better for creditors than the 7. As a result, cause existed to allow the conversion, regardless of timing.

In re Wetter, 620 B.R. 243 (Bankr. W.D. Vir. 2020). The chapter 7 debtor sought to convert to Sub V after the UST and creditors begin investigations of the estate's transfers and assets and seek to deny a discharge. The court denied the conversion on *Marrama* grounds. The attempted conversion was an attempt to keep assets out of the chapter 7 trustee's hands without a viable path to a confirmable subchapter V. As a result, the conversion attempt was not in good faith, and the court denied it.

I. Amending the petition to opt-in to Subchapter V

C. Cares Act Increase

In re Peak Serum, 2020 WL 7353766 (Bankr. D. Colo. December 8, 2020).

Debtor filed its Chapter 11 prior to the effective date of subchapter V. After the CARES Act increased the debt limit to $7,500,000, the Debtor moved to elect under subchapter V because it was now within the higher CARES Act debt limit.

Judge Rosania held the CARES Act on its face did not apply to debtors already in bankruptcy. Because the debtors were already in bankruptcy when the debt limit was increased, and based on the plain language of the CARES Act, the court denied the attempt to opt-in.

BUT

In Bonert, 619 B.R. 248 (Bankr. C.D. Cal. 2020).

Bonert involves a conversion from a standard 11 to one under subchapter V after a creditor's committee had been established. Judge Robles holds the higher limit applies to all cases regardless of when filed, ignoring the plain language of the CARES Act. The court also found the fact the debtor converted after a committee was formed to not be done in bad faith, because the committee was newly formed, and really had not done anything yet.

II. What is a "Small Business Debtor" under Section 1182(1)/101(51(D)?

Subchapter V is a powerful tool for individuals who do not qualify for a Chapter 13 due to the lack of the absolute priority rule. But to qualify, not less than 50% of the debts must arise "from the commercial or business activities of the debtor."

A. When does a debt arise from commercial or business activities of the debtor?

In re Ventura, 615 B.R. 1 (Bankr. E.D. NY 2020). In *Ventura*, the debtor operated a bed and breakfast out of her personal residence. The mortgage on the residence was incurred six years prior to the opening of the bed and breakfast. The parties agreed that, if the mortgage debt on the property arose "from the commercial or business activities of the debtor," the debtor was eligible to be a debtor under Subchapter V. If the debt was consumer in nature, debtor did not qualify.

The court in *Ventura* liberally construed the language of 1182(1)(a) in finding the mortgage debt arose from the commercial or business activities of the debtor. The court found the debtor purchased the property with the goal of converting the house into a guest house. She rented rooms on various travel websites, and ultimately decided to make it a B&B. Thus, the debt was incurred for a commercial or business purpose, notwithstanding any prior statements - including in a prior bankruptcy case - that the mortgage debt was a consumer debt.

A. <u>When does a debt arise from commercial or business activities of the debtor? (cont.)</u>

In re Crilly, 2020 WL 3549848 (Bankr. W.D. Okla. June 30, 2020). *Crilly* is a case about serial filer debtors trying to find shelter in subchapter V. The court denies the attempt for a number of reasons. Relevant to § 1182, however, is the court's analysis of the facts as contrasted from *Ventura*.

90% of the debt in this case was held by the debtors' mother. The mother financed the buildout and completion of a renovation of the second floor of the debtor's residence. The mother resided there briefly after completion until the debtors removed her (you read that right).

The court found the debt to the mother was not a commercial or business transaction. There was no profit motive involved. It was incurred to allow the mother to reside at the house - not as a business activity motivated by profit. Thus, debtors did not qualify as small business debtors.

B. <u>What if the business is no longer operating?</u>

In re Wright, 2020 WL 2193240 (Bankr. D. S.C. April 27, 2020).

In *Wright*, the debtor had two businesses that had been liquidated. The debtor filed under subchapter V to get rid of his guarantees associated with those businesses. The UST moved to strike the election on the basis that debtor was not currently operating a business.

The court held there is no requirement that a debtor currently be engaged in business to meet the definition of a small business debtor under § 1182. So long as the debts resulted from commercial or business activities, the debtor was eligible. This was the majority (only) position, which was undisturbed until. . .

B. What if the business is no longer operating? (cont.)

In re Kevin Lynn Thurmon and Susan Jane Thurmon, Debtors, 2020 WL 7249555 (Bankr. W.D. Mo. December 8, 2020).

The facts in *Thurmon* are the same as in many other cases on the subject. The business shut down and individuals with guarantees move for protection under subchapter V. The court in *Thurmon*, however, did a deep dive of the other places where the Code uses "engaged in" language, including farmers in chapter 12, and health care providers. Based on that analysis, the *Thurmon* court held "engaged in" means presently engaged in and guarantors of closed businesses cannot avail themselves of subchapter V.

C. What if the "business" was a non-profit?

In re Ellingsworth Residential Community Association, Inc., 619 B.R. 519 (Bankr. M.D. Fla. 2020).

In *Ellingsworth*, the debtor was a non-profit that elected to proceed under subchapter V. A creditor objected because a non-profit, by definition, does not have a profit motive. The court upheld the filing, holding any corporation which conducts "any 'commercial or business activity' can be a small business debtor, whether they operate for profit or not."

D. How do contingent, unliquidated, springing, or "future" liabilities figure in to the debt limit?

In re Parking Management, 620 B.R. 544 (Bankr. D. MD. 2020).

Debtor's schedules listed total debt of $8,922,928.95 - above the CARES Act adjusted debt limit. That amount, however, included roughly $1.8 million of PPP debt that was scheduled as contingent. Debtor also had unscheduled lease rejection claims.

Relying on similar determinations in Chapter 12 and 13 cases, the court held the determination of debts must be made as the debts existed on the petition date. As of the petition date, the lease rejection claims did not exist: they required a post-petition determination of the court and were therefore contingent on the petition date.

As to the PPP funds, the debtor had not completed the use of the PPP funds on the petition date. Therefore, there could be no determination as to the amount of debt, if any, owing regarding the PPP funds. The PPP funds were therefore unliquidated on the petition date and not counted for purposes of the debt limit.

III. The Powers and Duties of the Subchapter V Trustee

Section 1183 creates a trustee in subchapter V cases. There are a lot of unresolved issues regarding the role of the subchapter V trustee but few cases addressing them.

A. Can the Subchapter V Trustee Hire Counsel?

In re Penland Heating and Air Conditioning, Inc., 2020 WL 3124585 (Bankr. E.D.N.C. June 11, 2020).

In *Penland*, the subchapter V trustee moved to hire counsel nearly immediately after the petition date. The court did not slam the door on a subchapter V trustee ever hiring counsel. However, the trustee must have a "specific justification or purpose" in making the request.

B. How is the Subchapter V Trustee compensated?

In re Tri-State Roofing, 2020 WL 7345741 (Bankr. D. Idaho December 7, 2020).

After the subchapter V case was dismissed, the subchapter V trustee moved for $1,920.00 in allowed fees. The court *sua sponte* writes about whether § 326 places any limits on a subchapter V trustee's compensation, focusing on §326(b).

Section 326(b) expressly addresses compensation under subchapter V, chapter 12, or chapter 13. It is, perhaps, inelegantly drafted:

> (b) In a case under subchapter V of chapter 11 or chapter 12 or 13 of this title, the court may not allow compensation for services or reimbursement of expenses of the United States trustee or of a standing trustee appointed under section 586(b) of title 28, but may allow reasonable compensation under section 330 of this title of a trustee appointed under section 1202(a) or 1302(a) of this title for the trustee's services, payable after the trustee renders such services, not to exceed five percent upon all payments under the plan.

The court fleshes out what, if anything, is intended by the bolded section of § 326(b) only addressing trustees under §§ 1202(a) and 1302(a), but not subchapter V trustees. The court finds three possible readings - § 330 does not apply to subchapter V trustees; Congress only intended to place the 5% limit on compensation on chapter 12 and 13 trustees; and Congress just forgot to include § 1183(a) into the bolded section. The court finds the second reading most plausible, holding § 326(b) does not limit the compensation to a subchapter V trustee in the same way it limits chapter 12 and 13 trustees. And therefore, the subchapter V trustee was entitled to its fee regardless of the case's dismissal.

Faculty

Jonathan Dickey is a senior associate at the Buechler Law Office, LLC in Denver. He specializes in representing debtors, creditors and trustees across all Bankruptcy Code chapters, and has experience representing debtors and creditors in state court litigation. Prior to joining the Buechler Law Office in 2014, Mr. Dickey practiced bankruptcy law in Indianapolis from 2009-2014. He is active in the Colorado Bar Association, and was a speaker at the Colorado Bar Association Bankruptcy Case Law Update in April 2016. He also participated in the 2016 Judges' Roundtable at ABI's Rocky Mountain Bankruptcy Conference. Prior to moving to Colorado in 2014, Mr. Dickey practiced bankruptcy law in Indianapolis. While there, he was a frequent speaker on bankruptcy issues for the National Business Institute. Mr. Dickey received his B.S. in finance as a Chancellor's Scholar in 2005 from the University of Illinois, and his J.D. in 2008 from the University of Illinois College of Law, where he was a notes editor for the *Journal of Law, Technology and Policy*.

Hon. Joseph G. Rosania, Jr. is a U.S. Bankruptcy Judge for the District of Colorado in Denver. Previously, he was a shareholder of Connolly, Rosania & Lofstedt, P.C. (CR&L), where he focused onn bankruptcy-related litigation, and clerked for Hon. Jay L. Gueck, former U.S. Bankruptcy Judge for the District of Colorado. He also ran a successful solo law practice concentrating on bankruptcy and related litigation. Judge Rosania was a member of the Panel of Private Trustees for the District of Colorado from 1985-2015. He also served as a chapter 7 and 11 trustee, an examiner in three cases including a securities fraud case, and as counsel to unsecured creditors' committees in several cases, and he represented represented chapter 11 debtors. A frequent speaker, Judge Rosania has taught business law classes at the University of Colorado and Colorado State University. He received his J.D. in from the University of Colorado School of Law, where he was in the top 20 percent of his class.

Brian M. Rothschild is a shareholder with Parsons Behle & Latimer in Salt Lake City and a lecturer in law at the S.J. Quinney College of Law at the University of Utah, where he teaches chapter 11 business reorganization. His practice focuses on turning distressed situations and into distressed opportunities. Mr. Rothschild assists clients in chapter 11 bankruptcy proceedings, FDIC, SEC and state law receiverships, assignments for the benefit of creditors, out-of-court restructurings, and distressed asset sales, mergers and acquisitions. His experience includes bankruptcy appellate matters, including matters before the U.S. Supreme Court, and the liquidation/reorganization of national financial institutions, bank holding companies, gas, mining and natural resource properties, manufacturers, tech companies, real estate holding companies, agricultural concerns and entertainment companies. He represents debtors, creditors and other parties in interest, including executives and officers. Previously, Mr. Rothschild was an attorney with Peitzman Weg LLP and Akin Gump Strauss Hauer & Feld LLP. He is admitted in California, Utah, and Idaho. Mr. Rothschild received his J.D. from the University of Southern California Gould School of Law, after which he clerked for Chief Justice Matthew B. Durrant of the Supreme Court of Utah.

John C. Smiley is a partner in the Denver office of Sender & Smiley LLC, where he practices in bankruptcy law and commercial litigation. He has assisted clients with all aspects of commercial bankruptcy cases, and has represented debtors, creditors, trustees, committees and parties interested in acquiring assets from bankruptcy estates. Mr. Smiley has been appointed by the U.S. Department

of Justice as a chapter 7 panel trustee for the 19th District of Colorado and also by bankruptcy judges as a chapter 11 trustee and examiner, and he has represented receivers in state court proceedings. In addition, he has served as lead litigation counsel in bankruptcy court, federal district court and state courts on a number of complex bankruptcy and related commercial litigation matters, including all phases of bankruptcy litigation and related commercial litigation. A certified mediator, Mr. Smiley is a Fellow in the American College of Bankruptcy, has been listed in *The Best Lawyers in America* from 2012-19 and was named a "Colorado Super Lawyer" by *5280 Magazine* from 2006-19. he received his B.S. from Colorado State University in 1983 and his J.D. from the University of Wyoming College of Law in 1986.