LOS ANGELES & SAN FRANCISCO
Daily Journal
www.dailyjournal.com
WEDNESDAY, NOVEMBER 27, 2019

PERSPECTIVE

Thinking out loud about the new Small Business Chapter 11

By M. Jonathan Hayes

I haven't had occasion to discuss the new Small Business Chapter 11 with a potential client so far. I've read several summaries and even put the language of the statute into the Word version of the code I carry around. But I have not yet walked through the alternatives with a potential client. So let's think that through, the big stuff at least.

First, the debtor must be engaged in business or commercial activities. That doesn't seem tough. Sounds like most Chapter 11 debtors except the debtor whose sole source of income is a paycheck. The business activities can include operation of rental properties as long as there is more than a single piece of property.

Second, the person's "aggregate noncontingent liquidated secured and unsecured debts [on the petition date must be less than] $2,725,625 (excluding debts owed to ... affiliates or insiders)." That is a little trickier. Debtors are often unsure of the extent of their debts. We often note that a debt is estimated or unknown at the outset. "Noncontingent" means guarantees are not included. Liquidated means the amount of the debt is known or easily determinable. Unliquidated is a debt where determination of the amount of the debt would require an extensive hearing (borrowing a phrase from the Chapter 13 rules). Anyway, $2.8 million in total debt more or less. That determination will be easy with most debtors.

Third, now what? Remember, the debtor can elect not to use the new law. What are the key factors to consider? The first is that the plan must be filed within 90 days of the petition date. The plan is a big job. But that is partially because of the need to prepare a disclosure statement. I have described the disclosure statement as "half the case." I have also described it as a huge waste of time although it does force the debtor to get his act together and at least think about all the things required to be disclosed. It is not useful for helping most creditors figure out how to vote (which is its purpose). Under the new law, no disclosure statement is required (unless the court decides to require it — gulp!). The plan must include some of the information usually in the disclosure statement, but cutting it out is a huge savings in time and effort and therefore cost for the debtor — huge.

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Fourth, thinking further about the 90-day plan deadline, in the big scheme of things, we spend the bulk of our time leading up to the plan dealing with secured creditors. The battle is often over the value of the creditor's collateral. If we can't resolve that with the creditor, we get an appraisal and ask the court to peg the value. If the creditor gets its own appraisal, an evidentiary hearing is coming — that ain't happening in 90 days. I suppose the plan would just say that the value is so much and that that amount is disputed. Then the plan confirmation would trail the valuation issues. With most secured creditors, plan treatment is worked out and the creditor votes for the plan. That fails usually when the creditor is convinced that the debtor can't make the required plan payments anyway or when the debtor is pushing hard for a very low value or very low interest. The secured creditor digs in its heels. I don't see the 90 day deadline to file a plan as a problem.

As to unsecured creditors, unless there is a large creditor who controls the vote of the unsecured class, the typical issue is the liquidation analysis. This involves valuing all of the debtor's assets to see how much creditors would get in a liquidation. If that is going to be an issue, I assume the court would permit the debtor additional time to get that done. I'm convincing myself that 90 days to file the plan is not an obstacle.

Another common issue is feasibility. Where is all this money coming from? Sometimes it helps to go several months before proposing the plan because the debtor (and counsel) can get a better picture of the profit to come and therefore how much the debtor can (and must) pay.

The new rules do not state what happens after the plan is filed. Creditors get at least 25 days to vote on the plan. So the initial hearing on confirmation of the Plan will probably be 45 to 60 days after it is filed. Again, I am comfortable our judges will give the debtor more time if there appears to be progress towards confirmation.

Fifth, the "consenting class" rule is gone. That is the bane of many cases, especially when the debtor has only unsecured creditors, i.e., a single class. The general Chapter 11 rule is that the debtor cannot cram down everyone. That rule is gone in the small business case.

Sixth, the absolute priority rule is gone. Without subchapter V, when the unsecured class

votes no, the plan cannot be confirmed unless the owners pay in "new value." That requirement is gone removing a lot of bluster between the large unsecured creditors and the debtor.

Seventh, the plan must pay all of the debtor's disposable income to creditors for at least three years and up to five years. This includes corporate entities which is a pretty big change.

Eighth, the discharge is entered only after the plan payments are completed, including for corporate entities. And, debts that would not be discharged under section 523(a) are not discharged in the new small business case. That is a pretty big change for corporate debtors. Corporations now receive a discharge of almost all debts, even fraud, and usually immediately. I assume creditors will now have to file non-dischargeability actions for fraud, willful and malicious injury and the like even in the corporate case.

Ninth, there will be a chapter 11 trustee in every new small business case. The trustee will do a lot of typical trustee stuff, i.e., investigate the financial affairs of the debtor etc. But the trustee will also "appear and be heard at the status conference, ... [and] any hearing that concerns — (A) the value of property...; (B) confirmation of a plan ... (C) modification of the plan... ; or (D) the sale of property of the estate." Apparently the trustee will collect the payments during the plan period and pay the creditors. I say apparently because section 1183(c) says that if the plan is consensual, the trustee's job is basically over. But section 1190(2) requires the debtor to submit future earnings "to the supervision and control of the trustee as is necessary for the execution of the plan." But 1194 seems to suggest that the trustee is the payment conduit only when the plan is a cramdown plan. So who knows on that? Anyway, the trustee is also instructed to "facilitate the development of a consensual plan of reorganization." Nice! A built in mediator. The trustee will be paid 5% of Plan payments. That is not a cost to the debtor as the payment comes out of money that would otherwise go to creditors.

Tenth, the plan may modify the terms of a loan secured by the debtor's home if (and only if) the loan was "used primarily in connection with the small business of the debtor." So the debtor who got a loan on their home and used the funds in the business may essentially rewrite the terms of the loan, including the interest rate and due date. This doesn't apply if the loan was used to buy the property.

Eleventh, no U.S. trustee quarterly fees! Thank you! Thank you!

In short, I think the debtor who qualifies elects subchapter V unless the debtor is a corporation that has non-dischargeable debts that would otherwise be discharged in the typical Chapter 11. The corporate debtor also might want to avoid the requirement that it pay its net income for three years to creditors. Sometimes the liquidation value of the assets is low and therefore the required payments to creditors less than the disposable income for three years. It would be the rare case where that could be determined prior to the petition date. The push for the plan within 90 days might be problematic for some debtors but the benefits including no disclosure statement, no consenting class, no absolute priority rule, no U.S. trustee fees outweigh the compressed time frame. ■

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