The SBRA and Its Impact on Trade Creditors

The world of bankruptcy changed for small businesses earlier this year, and again one month later once the COVID-19 pandemic spread like wildfire across the U.S. That's quite notable since the last major bankruptcy amendments were in 2005—a change that was friendly for creditors, according to a recent NACM webinar, "The SBRA and Its Impact on Trade Creditors," presented by Jonathan Friedland and Hajar Jouglaf of Sugar Felsenthal Grais & Helsinger LLP.

The Small Business Reorganization Act (SBRA or Subchapter V) went into effect in February 2020, giving small businesses a new way to file bankruptcy as long as certain requirements are met. This includes having a debt limit under $2,725,625; however, the dollar amount threshold was increased to $7.5 million during the pandemic, which is expected to revert back to the lower threshold in March 2021.

The SBRA now requires the debtor/trustee to show it was conducting "reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmation defenses…" before filing suit, noted the webinar. It also amended venue statute for recovery actions like preferences and fraudulent transfer cases—any action against a non-insider must be brought in the judicial district where the defendant resides if the recovery threshold is less than $25,000. The language existed before, the attorneys noted, but the dollar amount increased from roughly $14,000.

"Subchapter V was designed to make it easier for small businesses to reorganize. End of story," said Friedland. For general unsecured creditors, "[Subchapter V] is bad no doubt about it." The absence of a committee of creditors, unless ordered by special cause, and the court grants it, is in stark contrast to traditional Chapter 11 cases. "There is no committee—this should be viewed as the first instance as really bad," he noted. "That, combined with a number of other attributes, gives a debtor the ability to steamroll creditors that debtors lack in traditional Chapter 11."

Other major changes within Subchapter V are that it eliminates the requirement to have at least one impaired class accept the proposed plan, and the definition of fair and equitable was altered. According to the American Bar Association, the SBRA was enacted to "strike a balance between chapter 7 and chapter 11 bankruptcies for small-business debtors." A disclosure statement will also "generally not be required."

The SBRA was constructed to make it cheaper and faster for the debtor, with the flexibility to do more. The debtor no longer has to deal with impaired classes to get the plan confirmed. There are several options for general unsecured creditors. They can move for a committee—the debtor or another party might want one in place as well despite committees not being appointed under the new regulations. The debtor might look to the committee as an ally, states the webinar. While unlikely to happen, the attorneys mentioned forming an *ad hoc* committee.

Creditors can also look for "levers" or ways to have leverage—look for insider preferences, fraudulent transfers and other causes of actions that exist against the debtor. Creditors can also try to leverage the personal guaranty, which is something to consider, and it has become that much more important with the advent of Subchapter V. Also mentioned in the webinar was to consider seeking to expand the trustee's duties under Subsection 1183(b)(2) and removing the debtor as a debtor-in-possession under Subsection 1185. Looking for leverage must be done before the motion is filed and before formal action is taken; once the motion is filed, it's too late and any leverage will be gone, said the attorneys.

Since the SBRA has only been in effect since February, case law and the experience of the courts and creditors is very limited because they don't know yet where things will go in the future. However, the attorneys noted that the number of companies able to file with the higher, pandemic dollar amount has expanded exponentially.

Early case law has focused on whether the SBRA has retroactive application. Most courts that have addressed this issue said the SBRA does not prevent the pending debtor from amending their Chapter 11 petition to a Subchapter V administration. Nevertheless, the debtor has to qualify, the amendment must not be filed in bad faith and it can't unfairly prejudice other parties in the case.

—Michael Miller, managing editor