Plan Confirmation Requirements in a Subchapter V Chapter 11 Case Under The SBRA

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A Practice Note discussing the plan confirmation requirements in a subchapter V case in Chapter 11 under the Small Business Reorganization Act (SBRA). This Note addresses the various plan provisions and considerations when seeking confirmation of a subchapter V plan.

Congress enacted the Small Business Reorganization Act (SBRA), which became effective as of February 19, 2020. The SBRA adds a new subchapter V to Chapter 11 of the Bankruptcy Code (Subchapter V). This new Subchapter V provides small businesses having aggregate liabilities of up to $2,725,625 with an opportunity to resolve outstanding liabilities in a streamlined, cost-effective Chapter 11 bankruptcy proceeding. The SBRA is designed to foster successful restructurings of small businesses, saving jobs and preserving small business enterprise value. For a detailed overview of the provisions of the SBRA, see Practice Note, Small Business Bankruptcy Under The SBRA: Overview (W-000-7094).

Subchapter V created a new scheme for debtors to propose and confirm a plan. This Note addresses the most significant plan confirmation requirements of Subchapter V and discusses the various plan provisions and considerations when seeking to propose a Subchapter V plan.

Because the SBRA does not repeal existing provisions that govern small business debtors in Chapter 11 cases, those provisions continue to apply to small business debtors that do not elect to proceed under subchapter V. For information on small business cases under Chapter 11, see Practice Note, Small Business Chapter 11 Case: Overview (W-000-7094).

CARES ACT CHANGE TO SUBCHAPTER V DEBT QUALIFYING THRESHOLD

On March 27, 2020, Congress passed and President Trump signed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) (Pub. L. No. 116-136 (H.R. 748)), which is the third major piece of legislation enacted in response to the COVID-19 outbreak in the US. The CARES Act is intended to provide economic relief to individuals and businesses facing economic hardship due to the outbreak.

Section 1113 of the CARES Act revises the definition of debtor in section 1182 of Subchapter V of the Bankruptcy Code by increasing the maximum debt threshold for a debtor to qualify as a Subchapter V debtor from $2,725,625 to $7,500,000. Therefore, for a period of one year from the effective date of the CARES Act, the maximum amount of noncontingent, liquidated, secured and unsecured non-insider debt that a debtor may have to file a Subchapter V case may be $7,500,000.

DISCLOSURE STATEMENT

In traditional Chapter 11 cases, votes on a plan cannot be solicited without a court-approved disclosure statement (§ 1125(a), Bankruptcy Code). The disclosure statement is designed to give parties adequate disclosure to make an informed decision relating to the acceptability of the plan. However, creating a disclosure statement typically requires the expenditure of significant professional fees. The disclosure statement approval process may also delay a debtor's exit from Chapter 11.

Under the existing small business case rules, disclosure statements are required unless the court determines to waive the requirement or streamline the timeline approving the disclosure statement (see Practice Note, Small Business Chapter 11 Case: Overview: Disclosure Statement (W-000-7094)). In a Subchapter V case, the presumption is reversed and a disclosure statement is not required unless the court orders otherwise (§ 1181(b), Bankruptcy Code). This can save Subchapter V debtors significant time and money.

If the court requires a Subchapter V debtor to file a disclosure statement, section 1125(f) of the Bankruptcy Code applies (§1187(c), Bankruptcy Code). Section 1125(f) reduces and adjusts a small business debtor's disclosure obligations, recognizing:

- The reduced level of information available and required in small business cases.
- The need for a speedy case.

Section 1125(f) specifically provides that a bankruptcy court in a small business case may:

- Find that the plan contains adequate information and allow the debtor to not file a separate disclosure statement (§ 1125(f)(1), Bankruptcy Code).
- Approve a disclosure statement submitted as a standard form disclosure statement previously approved by the bankruptcy court or adopted by the Federal Rules of Bankruptcy Procedure (§ 1125(f)(2), Bankruptcy Code and Fed. R. Bankr. P. 3016(d)).
- Conditionally approve a disclosure statement and consolidate a final hearing on the disclosure statement with the plan confirmation hearing (§ 1125(f)(3), Bankruptcy Code; Fed. R. Bankr. P. 3017(a)(4)).

PLAN DEADLINE

Only the debtor may file a plan in a Subchapter V case (§ 1189(a), Bankruptcy Code). This differs from a small business case, where the debtor has the exclusive right to file a plan for 180 days from the petition date (§ 1121(e)(1), Bankruptcy Code) and a proposed Chapter 11 plan and disclosure statement must be filed by any party within 300 days of the petition date (§ 1121(e)(2), Bankruptcy Code). In a small business case, section 1121(d) of the Bankruptcy Code also allows a party in interest to request that the bankruptcy court reduce or terminate the debtor's exclusive period (see Practice Note, Small Business Chapter 11 Case: Overview: Plan Deadline (W-000-7094)).

The requirement that the Subchapter V debtor be the only one to file a plan is advantageous for the debtor because other parties may never:

- File competing plans.
- Seek to reduce or terminate the debtor's exclusive period.

However, the Subchapter V debtor must file its plan within a 90-day time period, which is half the amount time permitted in a small business case (§ 1189(b), Bankruptcy Code). The court may also only extend the 90-day deadline under the stringent requirement that "the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable." When determining whether to file a small business case or a Subchapter V case, debtors must consider the significant time difference for filing a plan.

CONTENTS OF A SUBCHAPTER V PLAN

In Subchapter V cases, like traditional Chapter 11 cases, the plan must define the classes of claims and interests and provide for their treatment (§ 1123(a)(1), Bankruptcy Code and see Practice Note, Chapter 11 Plan Process: Overview: Classification and Treatment of Claims and Interests (0-502-7396)). Claims and interests must be classified together with substantially similar claims and interests (§ 1122, Bankruptcy Code and see Practice Note, Drafting Chapter 11 Plans: Overview: Mandatory Plan Provisions (W-001-0647)).

Sections 1123(a)(8) and 1123(c) of the Bankruptcy Code do not apply in Subchapter V cases and only apply in individual Chapter 11 cases (§1181(a), Bankruptcy Code and see Practice Note, Individual Chapter 11 Bankruptcy: Overview: Plan Provisions (W-008-8977)).

Apart from the requirements of section 1122 and section 1123 of the Bankruptcy Code, a Subchapter V plan:

- Must include:
  - a brief history of the debtor's business operations;
  - a liquidation analysis; and
  - projections regarding the debtor's ability to make payments under the proposed plan.
- (§ 1190(1), Bankruptcy Code.)
- Must provide for the submission of all or a portion of the debtor's future earnings or other future income to the Subchapter V trustee's supervision and control, as needed to execute the plan (§ 1190(2), Bankruptcy Code).
- May modify claims of mortgagees holding a security interest in the debtor's principal residence if:
  - the loan was not primarily used to acquire the debtor's residence; and
  - the new value received in connection with granting the security interest was primarily used for the debtor's small business.
- (§ 1190(3), Bankruptcy Code.)

The ability to modify a mortgage claim in Subchapter V cases under section 1190(3) of the Bankruptcy Code trumps section 1123(b)(5) of the Bankruptcy Code. As courts address the application of this provision, it remains to be seen whether a prepetition grant of a security interest in connection with an attempted workout of the debtor's business will be sufficient to satisfy the new value requirement.

CONFIRMATION OF A SUBCHAPTER V PLAN

CONSENSUAL PLAN

The bankruptcy court can confirm a consensual Subchapter V plan only if all of the requirements of section 1129(a) are met (§1191(a), Bankruptcy Code and see Practice Note, Chapter 11 Plan Process: Overview: Mandatory Plan Provisions (0-502-7396)). For a plan to be consensual, all impaired classes must accept the plan (§ 1129(a)(8), Bankruptcy Code and see Practice Note, Chapter 11 Plan Process: Overview: Confirmation of a Plan: Consensual Plans (0-502-7396)).

A Subchapter V debtor may be incentivized to negotiate a consensual plan because of certain benefits applying only to consensual plans, including:

- The service of a Subchapter V trustee terminates when a consensual plan is substantially consummated (§1183(c), Bankruptcy Code), which reduces fees and expenses incurred by and paid by the estate.
- The debtor receives an immediate discharge on confirmation of a consensual plan (§1141(d), Bankruptcy Code). However, section 1141(d)(5) of the Bankruptcy Code does not apply in Subchapter V cases (see Practice Note, Chapter 11 Plan Process: Overview: Chapter 11 Discharge (0-502-7396)).

CRAMDOWN PLAN

In traditional Chapter 11 cases and small business cases, a court may confirm the plan over the objection of an impaired rejecting class if the plan satisfies the Bankruptcy Code's cramdown provisions (§ 1129(b), Bankruptcy Code). This requires a showing that:

- All mandatory confirmation requirements have been satisfied (except for the requirement that all impaired classes have

accepted the plan), including that at least one impaired class has accepted the plan (§ 1129(a)(10), Bankruptcy Code).
- The plan does not discriminate unfairly against any impaired, non-consenting class.
- The plan is fair and equitable.

(See Practice Note, Chapter 11 Plan Process: Overview: Confirmation of a Plan: Cramdown Plans (0-502-7396).)

However, Subchapter V modifies the rules under which particular classes of claims can be crammed down. Subchapter V permits a court to disregard section 1129(a)(10) of the Bankruptcy Code and cram down a plan even if no impaired class of claims accepts the plan. Specifically, section 1191(b) of the Bankruptcy Code provides that if all the applicable requirements of section 1129(a) of the Bankruptcy Code are met other than sections 1129(a)(8), (10), and (15), the bankruptcy court can confirm the plan if:
- The plan does not discriminate unfairly against any impaired, non-consenting class (see Unfair Discrimination).
- Is fair and equitable regarding each class of impaired claims or interests that has rejected the plan (see Fair and Equitable).

The removal of the requirement that at least one impaired class of creditors must accept the plan can be beneficial to the debtor, particularly in cases where one or more hostile creditors dominate all classes of claims. Under the non-Subchapter V rules, section 1129(a)(10) prevents a plan from being crammed down on hostile creditors that control all creditor classes.

Unfair Discrimination

The SBRA did not modify the unfair discrimination requirement of section 1129(b) of the Bankruptcy Code. The plan does not discriminate unfairly if holders of substantially similar claims, classified in different classes with the same priority, receive the same treatment. However, if they receive different treatment then the plan may still be confirmed by a cramdown if separately classified, similarly situated claim holders receive property having substantially equal present value (meaning the same percentage recovery).

Conversely, a plan may discriminate against any impaired, non-consenting class if the discrimination is fair. To determine the fairness of discrimination under a plan, courts have considered:
- Whether there is a reasonable basis for the discrimination.
- Whether the debtor can confirm a plan without the discrimination.
- Whether the discrimination is proposed in good faith.
- The manner in which the discriminated class is treated under the plan.

(See *In re Ratledge*, 31 B.R. 897, 898 (Bankr. E.D. Tenn. 1983).)

On the other hand, for example, unfair discrimination may exist under a plan that arbitrarily provides better treatment to insider claims than to claims of other unsecured creditors. Any material difference in treatment between claims of the same priority may generally justify an objection to a cramdown (see Practice Note, Objecting to Plan Confirmation: Overview: The Plan Discriminates Unfairly (W-000-5955)).

Fair and Equitable

A Subchapter V plan is considered fair and equitable for dissenting classes of impaired secured claims if it meets the existing requirements for secured claims under section 1129(b)(2)(A) of the Bankruptcy Code (§ 1191(c)(1), Bankruptcy Code). However, the fair and equitable standard has been modified for unsecured classes of claims. For the plan to be fair and equitable for dissenting classes of unsecured claims, section 1191(c) of the Bankruptcy Code requires that:
- As of the plan effective date:
  - the plan must provide that the debtor applies all of its projected disposable income received within the first three to five years of the plan to make payments under the plan; or
  - the value of the debtor's property distributed under the plan within the first three to five years of the plan must not be less than the projected disposable income of the debtor.
- (§ 1191(c)(2), Bankruptcy Code.)
- The debtor either:
  - can make all payments under the plan; or
  - has a reasonable likelihood that it can make all payments under the plan.
- (§ 1191(c)(3)(A), Bankruptcy Code.)
- The plan provides appropriate remedies, which may include the liquidation of nonexempt assets, to protect holders of claims or interests if payments are not made (§ 1191(c)(3)(B), Bankruptcy Code; see Creditor Remedies).

Section 1129(a)(11) typically requires only that confirmation is not likely to be followed by liquidation or the need for further reorganization unless proposed by the plan (see Practice Note, Feasibility Test: Confirmation of a Plan Under Section 1129(a)(11) (W-000-7570)). However, these requirements strengthen the feasibility test contained in section 1129(a)(11) of the Bankruptcy Code, imposing additional hurdles under section 1191(c)(3)(A) to ensure that the Subchapter V cramdown plan is feasible.

While the term disposable income is used elsewhere in the Bankruptcy Code, section 1191(d) of the Bankruptcy Code defines disposable income in Subchapter V cases to mean the income the debtor receives that is not reasonably necessary to be spent on:
- Maintenance or support of the debtor or its dependent.
- A domestic support obligation that first becomes payable after the petition date.
- Payments needed for the continuation, preservation, or operation of the debtor's business.

(§ 1191(d), Bankruptcy Code.)

Therefore, the Subchapter V debtor can decide to fund its plan with only its projected profits, making it more likely that a debtor can afford its Chapter 11 plan.

Unlike traditional Chapter 11 and small business cases, the absolute priority rule is not incorporated into section 1191(b) of the Bankruptcy Code and, therefore, does not apply in Subchapter V cases (see Practice Note, Chapter 11 Plan Process: Overview: Unsecured Creditor Cramdown (0-502-7396)). This means that a Subchapter V plan

may be crammed down on unsecured creditors even if stockholders, junior to unsecured creditors, receive distribution under the plan.

Because there is no absolute priority rule, there is no new value exception and equity owners are more likely to retain ownership interest in the debtor under a cramdown plan. This is a significant departure from the application of the absolute priority rule in Chapter 11 cases, which generally requires existing equity owners in cramdown plans to relinquish ownership interests or invest new money to retain an ownership stake.

Payment of Postpetition Administrative Expense Claims

The debtor is not required to pay postpetition administrative expenses in full and in cash on the effective date of the Subchapter V plan. Postpetition administrative expenses, including postpetition goods and services and professional fees, may instead be paid over a period of three to five years through the plan (§ 1191(e), Bankruptcy Code). This gives the Subchapter V debtor additional flexibility with its cash flow.

EFFECTS OF CONFIRMING A CRAMDOWN PLAN

Subchapter V debtors should be incentivized to pursue a consensual plan because the consequences of a cramdown plan are less favorable to the debtor. If a cramdown plan is confirmed under section 1191(b):

- Property of the estate includes both the debtor's property under section 541(a) of the Bankruptcy Code and the debtor's postpetition acquired property and postpetition earnings from services performed before the closure, dismissal, or conversion of the case (§ 1186(a), Bankruptcy Code). The purpose of this is:
  - to require the debtor to use after-acquired property to fund payments under a cramdown plan, at least to the extent that the property is disposable income; and
  - to maintain judicial supervision of a debtor's assets and earnings after cramdown confirmation.
- The discharge provisions of section 1141(d) of the Bankruptcy Code do not apply (§ 1181(c), Bankruptcy Code). The debtor in a cramdown plan instead does not receive a discharge until it completes its payments under the plan within the three to five year period (§ 1192, Bankruptcy Code). Even when the discharge is granted, the following debts are not discharged:
  - any debt on which the last payment is due after the three to five year payment period under the plan; and
  - any debts specified in section 523(a) of the Bankruptcy Code.
- (§ 1192(1) and (2), Bankruptcy Code.)
- The Subchapter V trustee remains in the case to make payments under the cramdown plan (§ 1194, Bankruptcy Code). This adds additional cost to the estate because the fees and expenses of the trustee and its professionals are paid from the debtor's estate.

PLAN MODIFICATIONS

A Subchapter V debtor may modify a plan at any time before confirmation, provided the modified plan meets the requirements of sections 1122 and 1123 of the Bankruptcy Code (other than Section 1123(a)(8), which does not apply in Subchapter V cases) (§ 1193(a), Bankruptcy Code and see Practice Note, Chapter 11 Plan Process: Overview: Modification of a Plan (0-502-7396)).

MODIFICATION OF A CONSENSUAL PLAN

A Subchapter V debtor may modify a confirmed, consensual plan at any time after confirmation of the plan and before substantial consummation, provided that the modified plan meets the requirements of sections 1122 and 1123 of the Bankruptcy Code (other than Section 1123(a)(8) (§ 1193(b), Bankruptcy Code)). The modified version of the consensual plan only becomes effective if:

- The circumstances warrant the modification.
- After notice and a hearing, the bankruptcy court confirms the plan as modified under section 1191(a) of the Bankruptcy Code.

(§ 1193(b), Bankruptcy Code.)

Any holder of a claim or interest that voted on the plan is deemed to have voted the same way on the modified plan unless, within the time fixed by the court, the holder changes its previous vote (§ 1193(d), Bankruptcy Code).

MODIFICATION OF A CRAMDOWN PLAN

A Subchapter V debtor may modify a cramdown plan within the first three to five years after confirmation, provided the modified plan meets the requirements of section 1191(b) of the Bankruptcy Code (§ 1193(c), Bankruptcy Code). The modified version of the cramdown plan becomes effective if:

- The circumstances warrant the modification.
- After notice and a hearing, the bankruptcy court confirms the plan as modified under section 1191(b) of the Bankruptcy Code.

(§ 1193(c), Bankruptcy Code.)

CREDITOR REMEDIES

Because the provisions of a confirmed plan are binding on the debtor and its creditors, a plan's provisions control how a creditor may act if the debtor defaults.

In a consensual plan, creditors often negotiate the terms governing defaults and remedies as part of their agreement to accept the plan. For example, secured creditors are less likely to accept a plan unless it includes acceptable remedies that allow them to exercise their rights if the debtor defaults. Unsecured creditors and tax claimants that have the opportunity to negotiate acceptable terms to address default may also include their respective rights.

In a cramdown plan, section 1191(c)(3)(B) of the Bankruptcy Code provides the source of remedies for default, namely "appropriate remedies, which may include the liquidation of nonexempt assets, to protect the holders of claims or interests if the payments are not made." This means that:

- Active secured creditors and lessors are likely to require that the plan:
  - recognize their rights to proceed against the debtor's property; and

  - provide that the automatic stay and the discharge injunction do not restrict their efforts to enforce their rights.
- Because an unsecured creditor can only enforce its rights to a debtor's asset through a judicial process, which is often lengthy and expensive, appropriate remedies for unsecured creditors may include the right to convert to Chapter 7 to permit a trustee to liquidate the assets.