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Guidance for Arizona Banks on the Small Business Reorganization Act of 2019

As a result of the coronavirus pandemic, Arizona banks and their borrowers are facing economic uncertainty. Bankruptcy filings are on the rise, and many eligible borrowers are opting to file under the Small Business Reorganization Act of 2019 (SBRA), a new fast-track bankruptcy option that alters lenders' and other creditors' rights in certain Chapter 11 bankruptcy cases.

The SBRA is quickly becoming an important tool for debtors in bankruptcy as the effects of COVID-19 are felt across the country.

The SBRA became effective Feb. 2020 and modified traditional Chapter 11 practices and procedures intending to create a faster, more efficient Chapter 11 process for small business debtors. For example, the SBRA requires debtors to attend a case status conference within 60 days and file a plan within 90 days. Fourteen days before the status conference, debtors are required to file a case status report detailing the debtor's efforts to obtain a consensual plan. Debtors are not required to file a separate disclosure statement, but the plan must include a brief history of the debtor, a liquidation analysis, and financial projections relating to the debtor's ability to make payments under the proposed plan of reorganization.

Shortly after the SBRA became effective, the Coronavirus Aid, Relief and Economic Security Act (CARES Act) expanded the SBRA, making it available to more small businesses.

Under the original provisions of the SBRA, a small business debtor could not have more than $2,725,625 in non-contingent, liquidated, secured and unsecured debts, excluding debts owed to affiliates or insiders. The CARES Act, signed into law by President Trump March 27, 2020, temporarily (effective for only one year) expands the debt cap to $7,500,000, increasing the number of debtors who will utilize the debtor-friendly SBRA.

Before the SBRA, a trustee was appointed in a Chapter 11 case only if the court entered an order appointing a trustee, usually because of the debtor's fraud, dishonesty, incompetence or gross mismanagement.

Under the SBRA, however, a standing bankruptcy trustee is automatically appointed. The trustee's duties include, among other things:

1. Facilitating the development of a consensual plan of reorganization;
2. Ensuring the debtor makes the payments required by the plan until the plan has been substantially consummated;
3. Receiving plan payments or other property from the debtor and making distributions to creditors if the plan is confirmed as a "cram down" or by agreement of the parties in a consensually confirmed plan (similar to cases under Chapter 12 and Chapter 13);
4. Examining and objecting to proofs of claim;
5. Investigating the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business, and the desirability of the continuance of such business;
6. Investigating and reporting on fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the debtor's affairs.

Perhaps the most notable characteristic of the SBRA is that it allows, under certain circumstances, a debtor to "cram down" a non-consensual plan of reorganization.

Under the SBRA, only the debtor can file a reorganization plan, and the court can confirm a debtor's plan without the support of any class of claims as long as the plan is deemed to be fair and equitable for each class of claims and does not discriminate unfairly. To be fair and equitable, the Chapter 11 plan must provide that all the debtor's projected disposable income will be applied to payments under the plan for a commitment period of three to five years.

Alternatively, the plan may provide that the value of property to be distributed under the plan is equal to the debtor's disposable income during the plan's commitment period.

In addition to the disposable income requirement, the SBRA requires a finding that the debtor will be able to make, or there is a reasonable likelihood that the debtor will be able to make all payments under the plan. Moreover, the plan must provide appropriate remedies to protect the holders of claims or interests in the event that the debtor does not make plan payments.

Furthermore, the "absolute priority rule" does not apply to SBRA cases.

Typically, when a Chapter 11 plan does not propose to creditors in full, equity owners lose their ownership interest unless they reinvest a sufficient amount to buy back their interest in the business. The SBRA, however, allows for confirmation of a Chapter 11 plan that maintains pre-bankruptcy ownership while discharging the reorganized debtor's unpaid debts, as long as the debtor's plan meets the SBRA's plan confirmation requirements.

To offset this advantage for debtors, banks might consider obtaining a lien on owners' equity as part of any pre-bankruptcy negotiated forbearance agreements.

In light of current uncertainty about commercial real estate values, real estate lenders also need to be aware of the Bankruptcy Code's provisions relating to under-secured real estate loans. Valuation is among the most hotly contested issues in bankruptcy restructurings, with debtors and lenders battling over opinions of value.

Valuation is important because the Bankruptcy Code treats an under-secured real estate loan as two claims: (1) a secured claim to the extent of the value of the property and (2) an unsecured claim in the amount of the shortfall (the deficiency) between the debt and the property's value. Since the secured claim has to be paid in full, a court's valuation decision has serious consequences for lenders. The Bankruptcy Code allows a lender who believes its collateral has been under-valued to elect (under Section 1111(b)) to be treated as fully secured (in a limited sense) rather than partially secured and partially unsecured. If the lender makes the election, the lender retains the entire amount of its secured claim.

Planned payments to the lender only need to have a present value, as of the plan's effective date, of the property's court-determined value. The nuances of the election are complex and beyond the scope of this article, but lenders should be aware that the election is available, especially in light of current uncertainty about commercial real estate values.

Because plans of reorganization under the SBRA may only be filed by the debtor, can be confirmed through “cram down” without any classes of creditors voting in favor of the plan, and are not subject to the absolute priority rule, prepared debtors with valuation evidence and financial forecasts may be able to quickly confirm a “cram down” plan. Therefore, banks confronted with SBRA cases must be prepared to quickly act to engage in negotiations with the debtor and trustee, to explore the terms of a consensual plan, to establish and defend the bank’s claims and liens, to evaluate whether an election under Section 1111(b) is available, and to challenge a debtor’s valuation evidence and financial projections.

Although it is too early to tell how the SBRA will affect the lending landscape, it has the potential to alter the dynamic of negotiations between banks and their small business borrowers who file bankruptcy under Chapter 11. Accordingly, lenders should be proactive in identifying experienced counsel that can protect a lender’s rights in the coming wave of small business bankruptcies.

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