United States Exceptionalism in SME Restructuring: The Small Business Reorganization Act of 2019

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Introduction

Like many other countries, the United States has long struggled with accommodating small and medium enterprises (SMEs) within the expensive and complex procedure of corporate reorganization. The relatively low asset values involved in these cases generally fail to attract significant attention from creditors, and cumbersome and costly traditional procedures tend to absorb all or most of that available value.[1] It has thus been neither cost-effective nor especially productive to apply the world-famous provisions of Chapter 11 of the US Bankruptcy Code to such SME debtors.

After experimenting with several different approaches in earlier years, in August 2019, the US adopted a watershed new reorganization procedure tailor made for SMEs. Effective 19 February 2020, the Small Business Reorganization Act[2] introduced a new subchapter V within Chapter 11 of the Bankruptcy Code, radically simplifying the rules otherwise applicable in ordinary corporate reorganization cases involving SMEs.

While this new law responds to international calls for less burdensome and more supportive treatment of financially distressed SMEs, it takes a bold approach that deviates from evolving international norms. While international standard-setting organizations continue to prefer fully creditor-controlled procedures, with a reorganization plan adopted only by the affirmative vote of a majority of participating creditors,[3] the new US law takes a significant step further. It empowers courts to impose ("cram down") reorganization plans over creditor dissent so long as several statutory guidelines are satisfied. For both entirely domestic entities and US subsidiaries of foreign companies, the SBRA offers a much more accessible and powerful pathway to reorganization than most other world models, and certainly more so than a traditional full-blown Chapter 11 reorganization.

Eligibility

The new, streamlined reorganization procedure is available only to "small business debtors" who elect to engage it. Debtors who qualify are not compelled to use it. The traditional full-blown Chapter 11 process remains the default business reorganization mechanism, but a company that qualifies as a "small business debtor" may elect to pursue the faster track of subchapter V of Chapter 11 if the company satisfies two tests of "smallness."

"Small business" = small debts

Because the procedure is available to both natural and juridical persons, the first part of the qualifying test requires that the person be "engaged in commercial or

1 For a discussion of the unique challenges of applying traditional reorganization procedures to SMEs, see World Bank Group, *Report on the Treatment of MSME Insolvency* (2017). For a discussion of approaches by other countries to overcome these challenges, see World Bank Group, *Saving Entrepreneurs, Saving Enterprises: Proposals on the Treatment of MSME Insolvency* 13-15, 22-24, 31-33 (2019).

2 Pub. L. 116-54, codified at 11 United States Code [USC] §§ 1181-1195.

3 World Bank Group, *Saving Entrepreneurs, Saving Enterprises: Proposals on the Treatment of MSME Insolvency* 18-19 (2019); see also UNCITRAL, Working Group V (Insolvency Law) (2020), *Draft text on a simplified insolvency regime*, Doc. No. A/CN.9/WG.V/WP.170.

business activities" (as opposed to just non-business consumption, like the overwhelming majority of debtors in US bankruptcy, dominated by consumers) and at least half of the person's indebtedness must arise from business activities.[4] For business entities, this part of the test goes without saying, so the real focus is on size, but it is not the size of the debtor or even the business that matters. Rather, it is the size of the company's *debts* that determines "smallness" and therefore a business debtor's qualification for the subchapter V procedure.

A "small business debtor" is one whose aggregate noncontingent liquidated secured and unsecured debts total no more than a defined limit. In the original 2019 law, that limit was US$ 2,725,625 (to be indexed every three years for inflation).[5] This figure would narrow the field of qualifiers very substantially. The proper threshold for identifying "small business debtors" has been the subject of academic and industry study and debate for many years, and commentators have consistently concluded that the limiting figure should be much higher to encompass the target group. The National Bankruptcy Review Commission chose US$ 5 million in total debt as the proper dividing line (more than 20 years ago, which would equal US$ 8.5 million today, adjusted for inflation),[6] while the American Bankruptcy Institute Chapter 11 Commission chose US$ 10 million in either total liabilities or total assets.[7]

A silver lining behind the cloud of the COVID-19 pandemic was a substantial increase in the "small business" qualification threshold, though only for a limited time. Recognizing that the pandemic posed special challenges for small and medium businesses, Congress in 2020 passed, and then in 2021 renewed, a provision of the so-called CARES Act that doubled the small business criterion to US$ 7.5 million in total debt. The higher threshold is set to expire and revert to the lower, original level on 27 March 2022, though it will at that time be ready for its triennial increase for inflation indexing, and many have suggested that the higher figure should be maintained permanently. Time will tell.

"Small business" = small filing group and securities distribution

For non-US entities with US subsidiaries, another aspect of the "small business debtor" limiting definition is particularly relevant. It excludes business entities that otherwise meet the definition but are considered "not small" for other reasons, including a relationship with other, presumably larger debtors. Three factors potentially exclude an otherwise qualifying debtor from subchapter V.

For the first of these three exclusions, the key is proper statutory reading. The debt limit is aggregated for any "group of affiliated debtors,"[8] so if the total debt of all of these affiliated "debtors" together exceeds the ceiling, every member of the group is excluded, even the otherwise "small" members. But the word "debtor" here is not a generic reference to any member of a group of companies that owes debts; rather, it is a defined term in the Bankruptcy Code. A "debtor" for purposes of the

4 11 USC §§ 101(51D), 1182. Debts to affiliates and insiders are excluded from the calculation of this ceiling, and the "business" in which the debtor is engaged must be something beyond merely operating a single immovable property or project. 11 USC § 101(51B).

5 11 USC §§ 101(51D), 1182.

6 National Bankruptcy Review Commission, *Bankruptcy: The Next Twenty Years* 618 (1997).

7 American Bankruptcy Institute Commission to Study the Reform of Chapter 11, *Final Report and Recommendation* 279 (2014).

8 11 USC § 101(51D)(B)(i).

Code is a person "concerning which a case under this title has been commenced."[9] Thus, only considered are the debts of the group members who have sought (or, much less likely, been pushed into) a bankruptcy case *in the US*; the debts of other affiliates, including a non-US parent or sibling entity, are not included in the calculation, even if they are in insolvency proceedings in their own countries.

The second and third exclusions coordinate with US securities trading laws. While it is virtually inconceivable that a company with such significant market capitalization would otherwise qualify as "small," public companies with reporting requirements under the Securities Exchange Act of 1934 are excluded from subchapter V.[10] If the equity securities of a US subsidiary of a non-US company are listed on a public exchange, that clearly disqualifies the subsidiary from subchapter V treatment, but again, one would hardly expect such a company to qualify as a "small business" debtor. Even if the equity securities of such a company are not listed, however, the company might nonetheless become subject to reporting requirements if its assets exceed US$ 10 million and its equity is held by "the public," meaning 500 or more persons who are not "accredited investors" or 2000 persons in any case. The intricacies of the securities trading laws are well beyond the scope of this contribution, but suffice it to say that distribution of equity securities substantially beyond a non-US parent company might subject a US subsidiary to burdensome regulatory compliance duties, which would commensurately exclude such a company from reorganization under subchapter V. Potentially more troublesome is a final, seemingly capacious exclusion of any affiliate of an "issuer" as defined in section 3 of that same Exchange Act. As one prominent commentator has noted, "Congress could not have intended" to exclude any affiliate of any company that has issued any security; rather, the right interpretation is that the exclusion applies only to "an affiliate of an issuer that is subject to the reporting requirements" of the Exchange Act, just previously discussed (i.e., issuers of US-listed "public" securities).[11]

Consensual Reorganization – Reducing Complexity, Adding Support

For those debtors who qualify, subchapter V proceedings differ from ordinary Chapter 11 business reorganizations in two major sets of ways, both designed to entice debtors into the system and to facilitate reorganization plans – either with or without creditor approval. As an initial enticement for debtors to engage the process, subchapter V carries through the tradition of "debtors in possession" in this new context. Small business debtors remain in possession and control of their property and businesses until and unless fraud or gross mismanagement leads to the appointment of a trustee, which is extremely rare in the US.[12]

Further enticements to enter and remain in subchapter V concentrate on reducing complexity and greatly simplifying the negotiation and confirmation of consensual reorganization plans. Much of the expense of a traditional Chapter 11 reorganization effort stems from debtors' obligations to interact (that is, fight) with the official committee of unsecured creditors and to provide elaborate and detailed information to creditors on the past, present, and future of the company

9 11 USC § 101(13).

10 11 USC § 101(51D)(B)(ii).

11 Hon. Paul W. Bonapfel, *SBRA: A Guide to Subchapter V of the U.S. Bankruptcy Code* 34 (2021).

12 11 USC §§ 1184-1186.

and its reorganization effort. Subchapter V sweeps away these cumbersome institutions and their associated expense.

Creditors have shown very little interest in small business cases in the past, so in subchapter V cases, an appointed committee of unsecured creditors is the rare exception rather than the rule.[13] Debtors are left to communicate directly with the body of creditors as a whole, and given the low debt figures involved, the presumption is that this communication should be simple and straightforward. Traditional Chapter 11 plan negotiations require a court-approved Disclosure Statement, which is in many cases so voluminous and intricate that it resembles a prospectus for an initial public offering of securities – with all of the attendant expense for auditors, advisors, and other experts to gather and present both backward- and forward-looking data and analysis. Subchapter V does away with this burdensome formalism. Instead, the debtor must simply present to creditors a report detailing vastly simplified core information about its business dealings and future turnaround plans, presumably with far less, if any, need for outside expert input.[14] The timing rules for developing and presenting turnaround plans pose both a blessing and a curse for small business debtors. Only the debtor may propose a plan, but this plan must be presented within 90 days of case initiation.[15] The timeline is thus mercifully yet brutally short. Subchapter V is not designed to delay the inevitable demise of zombie companies, but to give viable companies a reasonable chance, and the accelerated timeline further reduces the burden of professional expenses dragging down struggling small businesses.

While professional advice can be expensive, it is also very often desperately needed by small business debtors. An important additional measure thus concerns the nature of the official overseer of small business reorganization cases. As noted above, trustees are appointed in only the rarest of cases where aggressive intervention is necessary to thwart debtor wrongdoing and protect creditor interests. In subchapter V, in contrast, a unique and novel kind of trustee is appointed in every case, but not to intervene in an antagonistic situation. Rather, the subchapter V trustee's express remit is to support and advise the debtor-in-possession and, in particular, to "facilitate the development of a consensual plan of reorganization."[16] These subchapter V trustees are experienced business professionals and dealmakers who know how to bring creditors onboard in support of a viable plan (or tell debtors the frank truth about non-viable plans). This expert assistance comes at a price, reducing the value available for distribution to creditors under the plan, but this financial burden is far less than in a traditional Chapter 11 restructuring,[17] and the input is more likely to redound to the benefit of debtors and creditors alike.

In other respects, the plan adoption and confirmation rules for subchapter V are the same as in a traditional Chapter 11 case. All classes of creditors must approve the plan by affirmative vote of a majority of creditors actually participating in the voting, and those creditors' claims must equal at least two-thirds of the dollar

13 11 USC § 1181(b).

14 11 USC §§ 1181(b), 1187-88.

15 11 USC § 1189.

16 11 USC § 1183(b)(7).

17 Of particular note, debtors in subchapter V proceedings are not required to make quarterly payments to the United States Trustee System, otherwise required in Chapter 11 cases. 28 USC § 1930(a)(6).

value of all of the claims of voting creditors in that class.[18] A creditor-approved plan must be additionally confirmed by the court as meeting a number of statutory requirements. Most notable among these are (1) that the plan is practically feasible, (2) that the plan offers creditors at least the same financial benefits as an immediate liquidation and distribution of the debtor's available asset value, and (3) that the debtor is proceeding in good faith.[19] These assessments place both great responsibility and great trust in judges, but for subchapter V cases as in ordinary Chapter 11 proceedings, US Bankruptcy Judges are appointed after significant careers in bankruptcy law and finance. While some judges have tended to favor reorganization to a degree unwelcome by some, they have generally shown a willingness to scrutinize small business plans in particular and to conclude that the time has come to move on to the next venture.

Non-Negotiated Cramdown of "Disposable Income" Plans

The most radical and, in international terms, exceptional innovation of subchapter V is a new procedure for "cramdown" of reorganization plans over creditor dissent. Even if the requisite majorities of creditors reject a proffered plan, the court may nonetheless confirm the plan and impose it (a process informally but universally referred to as "cramdown") so long as its terms are objectively reasonable as defined by law. This alternative, statutory alternative produces important backward pressure on the negotiation process, establishing the presumptive outer boundaries of a plan and encouraging creditors and debtors voluntarily to seek reasonable compromises within these boundaries. Defining these limits has produced tremendous debate over the years.

While the traditional Chapter 11 process also allows for court imposition of plans, the "absolute priority rule" has long stood as a guardian of creditors' rights and a check on debtors' efforts to retain ownership at creditors' expense. The rule most commonly prohibits imposition of a plan that allows former owners to retain any stake in the reorganized company unless creditors are paid in full. This rule is not applicable in subchapter V cases. It thus does not inhibit the confirmation (cramdown) of a non-consensual plan that allows the owner(s) of a small business debtor to maintain an equity interest in the post-reorganization company (likely 100%), despite leaving creditors with less than full payment.[20] If the court finds that the simple prerequisites discussed below are fulfilled, the plan can be confirmed regardless of creditor opposition.

In this and other respects, subchapter V resembles the procedure used for decades, not for reorganizing corporate businesses in Chapter 11, but for unencumbering individual "wage earners" via payment plans in Chapter 13.[21] Developed in the 1930s, the far less well-known Chapter 13 was designed to allow individuals with predictable future income from stable employment to avoid the stigma of bankruptcy and asset liquidation by using that employment income to pay off at least a portion of their debts over time. With the revision of the Bankruptcy Code in the late 1970s, lawmakers recognized that such debtors had little if any negotiating leverage to entice creditors to support a consensual plan, so all payment

18 11 USC §§ 1191(a), 1126(c), 1129(a)(8).

19 11 USC §§ 1191(a), 1129(a)(3), (7), (11).

20 11 USC § 1181(a) (suspending application of section 1129(b)).

21 11 USC §§ 1301-1330.

arrangements in Chapter 13 were subjected to court "cramdown" applying statutory standards. That is, so long as the statutory terms regarding amount and timing of payment are observed, an individual debtor's Chapter 13 plan is confirmed by court decree, without creditor voting. This is the functional equivalent of what many countries throughout Europe have developed over the past 30 years in a wave of new "debt adjustment" or "consumer insolvency" laws, usually conferring a debt discharge on individuals in exchange for a non-negotiated series of some number of years of payments to creditors from the debtor's income in excess of that necessary to support debtors' and their families' reasonable domestic needs. Such court-approved, non-negotiated payment plans have been available in the US until now only to individual debtors (not business entities) with relatively limited debts (e.g., unsecured debt below US$ 420,000).[22]

Subchapter V essentially adopted this non-negotiated alternative for small business debtors, including artificial business entities, subject only to the much higher debt limits for qualification for subchapter V itself. The payment terms and timing in subchapter V mirror those in Chapter 13: A "cramdown" plan must promise *pari passu* payment to unsecured[23] creditors of all of the debtor's "projected disposable income" anticipated to be received by the debtor over the next following three to five years. This amount may be paid either in one immediate lump sum or in installments over this 36- to 60-month period, though if Chapter 13 practice is any guide, the standard plan term will be 60 months unless creditors are to be paid in full within a shorter period.

The pivotal notion of "disposable income" is defined as net income that is "not reasonably necessary to be expended for … the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor."[24] This definition leaves tremendous discretion in the court to assess "necessity" and "reasonableness" of business expenditures, not to mention prediction of the likelihood of the actual realization of future income by the business. It is one thing to project the receipt of future income by the average earner of fixed wages; it is quite another to project the production of future income by a small company with unpredictable – indeed, uncertain – and likely highly contingent business prospects. Different courts are likely to come to quite different conclusions on these points, but again, US Bankruptcy Judges are selected for their specialized knowledge and experience with such financial assessments in the specific context of distressed businesses.

Initial Empirical Results and Concluding Tentative Evaluation

The ultimate goal of subchapter V was to increase the number of confirmed reorganization plans in small business cases and, one hopes, consequently the number of successfully saved businesses. The timeline for assessing ultimate success is thus quite extended, and insufficient time has passed to render a final verdict on the new procedure. Nonetheless, initial empirical results are quite positive in numerous respects.

22 11 USC § 109(e).

23 Secured creditor are entitled to the full value of their secured claims. 11 USC § 1129(b)(2)(A).

24 11 USC § 1191(b)-(d).

The only notable aggregate study of the first results of subchapter V cases is a January 2021 report by the director of the Executive Office for United States Trustees.[25] The EOUST is the government supervisor of the US bankruptcy system, with a uniquely insightful vantage point and access to more fine-grained data. In the first seven months of the new procedure, from 19 February through 30 September 2020, about 1100 small business debtors – more than two-thirds of which were business entities, rather than natural individuals – elected to proceed under subchapter V. The EOUST reported on an analysis of a subset of 625 of these cases that had had sufficient time to have progressed through the entire procedure.

The headline result is that the percentage of subchapter V cases with a confirmed plan was six times the number in small business cases that had proceeded under the ordinary Chapter 11 process. This observation is difficult to evaluate, in large part because of the brief segment of time analyzed. An ordinary Chapter 11 small business case offers debtors six months to prepare a plan, followed by a noticed confirmation hearing up to a month-and-a-half later.[26] In the seven months of the EOUST study, it is surprising that *any* ordinary Chapter 11 case could manage to complete the plan development and confirmation process, so however many more plans emerged from subchapter V proceedings, this would have been entirely unsurprising. That being said, perhaps the comparison is simply unfair. It is a remarkable accomplishment that 100 of these 625 small business cases produced a confirmed plan within no more than seven months, and probably far less time than that. Beyond these successful cases, about 40 were found to be ineligible for subchapter V, and another about 80 were either dismissed or converted to a liquidation, though reportedly some substantial number of these left the formal process thanks to the subchapter V trustee's facilitation of a consensual, out-of-court resolution between debtors and creditors.

The 100 cases with confirmed reorganization plans included a group of about 20 related entities with a non-consensual (cramdown) plan, so a fair assessment of the denominator of total independent plans confirmed is 80. A remarkable 80% of these plans were consensual, approved by all classes of creditors. One hesitates to make rosy predictions on the basis of such small numbers from such a thin slice of the early period of subchapter V, but these figures seem to indicate that the new procedure is working as desired. In particular, some significant portion of these 80% consensual plans must have achieved confirmation as creditors considered the alternative: Refusal to approve the debtor's proposed plan would likely result in court-imposed cramdown of a "projected disposable income" plan, anyway, so why not accept the debtor's proposal so long as it was remotely reasonable. This, it seems, is the real success story of subchapter V – encouraging creditors to behave in a much more conciliatory, reality-acknowledging, compromise-friendly way in light of the cramdown alternative. The presence of the subchapter V trustee to serve as neutral intermediary doubtless has helped considerably, as well, in convincing creditors to accept reasonable compromise arrangements.[27] These points

25 Clifford J. White III, "Small Business Reorganization Act: Implementation and Trends," *American Bankruptcy Institute Journal*, Jan. 2021, p. 54.

26 11 USC §§ 1121(e), 1129(e).

27 See Jason J. Kilborn, "Determinants of Failure … and Success in Personal Debt Mediation," *Transnational Dispute Management* 14(4) (Winter 2017), available online https://ssrn.com/abstract=3015419 (suggesting the presence of a neutral intermediary is one of two keys to successful mediation).

represent the primary American exceptionalism in the subchapter V process, and they seem to have had an exceptionally positive impact.

In the year following the period examined in the EOUST study, another 1340 debtors have elected subchapter V proceedings, for a total of 2440 in the 19 months from mid-February 2020 to mid-September 2021.[28] As more empirical reporting is undertaken on the latest cases, time will tell if this US success story is sustainable and at what cost/benefit trade-off for creditors, entrepreneurship, and society. For non-US entities confronting the labyrinth of Chapter 11, however, subchapter V offers a potentially much more efficient and effective path to rescuing and reorganizing US operations conducted through "small business debtors."

Professor Jason Kilborn is a leading authority on the comparative law of personal and small business insolvency. He chaired the drafting group for the World Bank's landmark 2013 *Report on the Treatment of the Insolvency of Natural Persons* and has served as a short-term consultant on numerous other World Bank Group personal insolvency projects. He has advised several national governments on personal insolvency reforms and was appointed as an Advisory Commissioner of the Seoul (Korea) Bankruptcy Court's Administrative Committee. He most recently drafted and presented the World Bank Group's 2018 report, *Saving Entrepreneurs, Saving Enterprises: Proposals for the Treatment of MSME Insolvency*. In addition to his work on personal and small business bankruptcy, Professor Kilborn co-authored a book on international cooperation in cross-border business reorganization, and he is among the authors and editors of a comparative series on corporate liquidation and restructuring, both published by Oxford University Press. Professor Kilborn is an elected member of the International Insolvency Institute
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28 Statistics and other resources on subchapter V are available on a dedicated website hosted by the American Bankruptcy Institute, https://www.abi.org/sbra.