Banking & Financial Services Report

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About the Firm

Shapiro Sher was founded in 1972 with the mission of providing outstanding legal counsel for businesses of all sizes. Based in Baltimore, the Firm is nationally recognized for its practices in business law, litigation, bankruptcy, banking, and creditors' rights.

Shapiro Sher's banking lawyers provide experienced counsel in connection with all aspects of commercial loans. Chaired by **Scott Foley**, the firm's **Banking & Financial Services Group** regularly represents regional and community banks, credit unions, finance companies, and other financial institutions in the Mid-Atlantic and in transactions throughout the country.

The banking group includes partner **Pat Gill**, who represents financial institutions in connection with re-documenting troubled loans and structuring, negotiating, documenting, and closing commercial finance transactions. Attorneys in the group also advise financial institutions regarding under-performing and distressed loans. The group routinely handles loan modifications, workouts, restructurings, short and long-term forbearance agreements, and bankruptcy litigation. Because the group has extensive experience in the origination of loans and in workout situations, it is prepared to provide efficient representation at every stage in the lending process.

With decades of experience in the banking industry, Mr. Foley and the firm's other seasoned banking attorneys appreciate the potential hazards facing clients in the commercial loan process, and strive to protect lenders' interests throughout the lifecycle of the loan.

THE SMALL BUSINESS REORGANIZATION ACT:

WHAT A LENDER NEEDS TO KNOW

By Scott W. Foley, Susan S. Maher, and Wes Parker

The Small Business Reorganization Act ("SBRA") became effective February 19, 2020, just in time for the Covid-19 pandemic and the resulting calamitous effects on the global economy and specifically, small businesses. The SBRA, although largely untested, is designed to facilitate cost-effective, streamlined reorganizations of small businesses and is now available to an expanded universe of larger businesses through the CARES Act. As originally enacted, the SBRA defined a "small business" to include businesses with debts under $2,725,625. As part of the response to the pandemic, the CARES Act expanded SBRA eligibility by increasing the debt ceiling to include businesses with debts of up to $7,500,000, opening the door for more substantial businesses to avail themselves of the debtor-friendly SBRA reorganization process. This expanded eligibility expires on March 27, 2021, which may well contribute to a rush to the courthouse for relief prior to that date. As more normalized business operations resume and falter, lenders should anticipate a wave of SBRA cases to follow the current influx of loan deferrals and modifications, and the funding of potentially forgivable loans under the CARES Act.[1] Due to the condensed timeframe under which SBRA cases are intended to proceed, lenders should be aware of the SBRA's key features.

Brief Overview of a SBRA Case

In theory, SBRA debtors should have a better chance of emerging from bankruptcy as a reorganized debtor as a result of a streamlined and less costly reorganization process stemming from the elimination of certain fees associated with traditional Chapter 11 cases. Also beneficial to debtors is a more simplified and favorable plan confirmation process that does away with, among other things, the need to file a disclosure statement, the appointment of a creditor's committee, administrative fees to the U.S. Trustee, the "absolute priority" rule, competing plans, and the requirement to pay administrative claims on a plan's effective date. Time will tell whether this process will result in a greater number of successful reorganizations for the benefit of debtors and lenders alike or whether debtors will try to take advantage of the benefits of a SBRA case by, among other things, seeking to delay the pace of SBRA cases and potentially inevitable liquidations. In any event, although some of the advantages enjoyed by creditors in traditional Chapter 11 cases have been removed, lenders

[1] Applicable SBA regulations presently provide that a borrower under the Paycheck Protection Program (PPP) cannot be a debtor under the Bankruptcy Code at the time it applies for funds or such funds are disbursed, although some Chapter 11 debtors have attempted to challenge the PPP regulations.

should be mindful that certain familiar Chapter 11 creditor protections remain intact. A summary of certain key provisions of the SBRA and prudent lender actions follows.

Key Features of a SBRA Case

- **Eligible Businesses** – Entities and individuals (i.e. sole proprietorships) engaged in business activities with aggregate non-contingent liquidated secured and unsecured debt of not more than $7,500,000 (not less than 50% of which arose from the commercial activity of the debtor), exclusive of insider/affiliate debt, are eligible to elect to proceed under the SBRA.[2] Of note, single-asset real estate companies are not eligible under the SBRA.
- **Debtor in Possession** – Although a trustee is appointed, the debtor will remain in possession of its assets and be permitted to continue to operate its business, unless removed for "cause." Removal could be precipitated by fraud, dishonesty, incompetence and gross mismanagement, either *before* or *after* the petition date, or for a failure to perform the obligations under a confirmed plan.
- **Appointment of a Trustee** – Similar to Chapter 13 cases, a trustee is appointed to oversee, monitor and evaluate the debtor's affairs and assets, including making adequate protection payments to secured lenders prior to plan confirmation. A lender can expect and be prepared to engage with the trustee in an attempt to, among other things, facilitate a consensual plan process.[3] The trustee is discharged following substantial consummation of the plan of reorganization unless confirmation is by bankruptcy cramdown.[4] In the event that the debtor in possession is removed for cause, the trustee will take possession of the debtor's assets and assume management duties of the debtor's business.
- **Financial Reporting Requirements** – Due to certain financial reporting requirements imposed on a SBRA debtor, lenders should be afforded the opportunity to review (i) updated financials consisting of the debtor's most recent balance sheet, statement of operations, cash flow statement and tax return that are required to be filed with a SBRA election, (ii) a report detailing the debtor's efforts to attain a consensual plan that must be filed prior to an initial status conference to be held within 60 days from the petition date and (iii) periodic reports detailing profits, cash receipts and disbursements.

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[2] Lenders should be mindful that borrowers who are larger companies with significant contingent and unliquidated debts may try to qualify as a "small business" debtor under the SBRA in order to take advantage of debtor-friendly provisions not available in a traditional Chapter 11 case and, if appropriate, should seek to challenge the designation in a timely manner.

[3] Given that the trustee is required to, among other things, appear at the initial status conference and any hearing that concerns the value of property subject to a lien, plan confirmation, post-confirmation modifications, or the sale of property of the estate, the trustee could be an ally of a lender in safeguarding against the debtor taking advantage of SBRA protections without complying with its requirements to a lender's detriment.

[4] In the event of a bankruptcy cramdown (i.e. restructuring of secured debt despite objection from the secured creditor), the trustee remains in place to make distributions until payments under the confirmed plan are complete.

- **No Creditors' Committee or Disclosure Statement** – Although not necessarily in a creditor's best interest, SBRA debtors should benefit from significant reduction in costs given that no creditors' committee is appointed nor is a disclosure statement required (unless ordered by the court for cause).[5] However, as discussed infra, the plan must include some of the information that is traditionally included in a disclosure statement (i.e. history of operations, liquidation analysis, etc.).
- **No Competing Plans** – Under traditional Chapter 11 cases, only the debtor is permitted to file a plan during the "exclusivity period" and after the expiration thereof, any creditor or interested party may file a competing plan. However, only the debtor is permitted to file a plan under the SBRA and no such competing plans are authorized.
- **The Plan Itself** – A debtor's plan must be filed within 90 days from the petition date (unless extended due to "circumstances for which the debtor should not be held justly accountable") and the plan must include: (i) a brief history; (ii) a liquidation analysis; (iii) projections regarding the ability of the debtor to make the plan payments; and (iv) the submission of future earnings to the trustee necessary to execute the plan.
- **Modified Plan Confirmation Standards** – The SBRA implements an eased plan confirmation process due to the removal of certain obstacles to confirmation that creditors frequently utilize in traditional Chapter 11 cases. Specifically, the absolute priority rule does not apply[6], and a plan can be confirmed even if all impaired classes vote to reject the plan so long as the plan does not discriminate unfairly and is "fair and equitable" to each impaired nonconsenting class. A plan is fair and equitable if: (i) holders of secured claims retain liens and are paid value for their claims; (ii) all of the debtor's "disposable income" is paid to creditors over 3 years (or up to 5 years if extended by the Court); and (iii) the debtor demonstrates that it will be able, or there is a reasonable likelihood that it will be able, to make plan payments. The plan must also provide "appropriate remedies which may include the liquidation of nonexempt assets" to protect creditors if the debtor fails to make plan payments.

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[5] Generally, creditors ensure that debtors in traditional Chapter 11 cases file disclosure statements that provide "adequate information" about the affairs of the debtor so that creditors can make an informed decision when voting on plans. A debtor's inadequate or incomplete financial reporting in the initial stages of the SBRA case may provide a basis for the court to find "cause" to order the preparation of a disclosure statement.

[6] In traditional Chapter 11 cases, the absolute priority rule dictates that existing owners cannot retain equity in the debtor over the objection of a class of unsecured creditors, unless such class is paid in full or the owners make a new value capital contribution. Thus, the leverage creditors had over a small business owner in a traditional Chapter 11 case has been removed, and it should be easier for owners to retain their equity and control of the business.

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- **Modification of Certain Debts Secured by an Individual Debtor's Residence** – Unlike traditional Chapter 11 cases, lenders need to be mindful that individual debtors are allowed to modify certain residential mortgages where the underlying loan was not purchase money financing and was used for the individual debtor's commercial or business activities.

Creditor's Rights under a SBRA Case

Although the SBRA appears aimed at providing "small business" debtors a quick and cost-effective reorganization by eliminating certain advantages enjoyed by creditors under traditional Chapter 11 cases, a number of traditional creditor protections are preserved. By way of example, such protections include the following: (i) the right to adequate protection of collateral against diminution in value, the right to be granted relief from the automatic stay, and prohibitions against the debtor's use of a secured creditor's cash collateral; (ii) the ability of secured creditors to try to capture any post-confirmation increase in the value of their collateral through a Section 1111(b)(2) election; and (iii) the debtor's requirement to satisfy the "best interest of creditors" (or liquidation) test under Section 1129 (i.e. providing creditors at least as much as they would have received if the debtor were liquidated as opposed to reorganized). Thus, while certain of the processes and procedures for SBRA cases diverge from creditors' prior Chapter 11 experience, certain creditor's rights and potential leverage points should largely be familiar.

Moving Forward

It is yet to be seen whether the SBRA results in an increased amount of successful small business reorganizations. Regardless, lenders that are prepared for what appears to be an inevitable wave of businesses seeking relief under the SBRA's streamlined process should be able to avoid the pitfalls arising therefrom by, among other things, understanding the SBRA, analyzing debtor filings, and engaging with their borrower, borrower's counsel, and/or the trustee early in the process with the assistance of experienced counsel. In a perfect world, the SBRA will create value for the benefit of the debtor and the lender alike by salvaging the small business for the former and the customer of the latter. Rest assured that the Banking and Financial Services Group at Shapiro Sher is well-prepared to protect and guide lenders through the expedited SBRA process and other matters.