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CLIENT ALERT

The Future of Small Business Bankruptcies and Creditors' Committees After the SBRA: *In re Bonert and In re Lear Capital*

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With the passage of the Small Business Reorganization Act (the "SBRA") in 2019,[1] Congress made significant changes to the Bankruptcy Code[2] that affect small businesses.[3]

In Brief

- These changes include removing the appointment of a creditors' committee as a matter of course for small businesses and the creation of subchapter V,[4] a new, additional, and streamlined bankruptcy option for eligible small businesses.[5]
- Two recent cases, *In re Bonert*[6] and *In re Lear Capital, Inc.*,[7] offer an opportunity to examine these changes and may offer insight into what lies in store for small business chapter 11 bankruptcy cases.

BACKGROUND TO THE SBRA

Congress has long attempted to assist small businesses seeking to reorganize rather than liquidate their business. In 1994, the Bankruptcy Reform Act[8] created the "small business debtor" designation and procedures applicable to qualifying debtors, which the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA")[9] modified. However, while such Acts introduced various procedural protections, the substantive statutory regime for small business debtors largely mirrored the regime in place for traditional chapter 11 debtors, including its administrative costliness and complexity.[10] Accordingly, the changes introduced in 1994 and 2005 proved largely ineffective to reduce the costs associated with the administration of chapter 11 cases, and many small business reorganizations failed.[11]

The SBRA amended the provisions of the Bankruptcy Code, introducing several substantive changes to the provisions affecting small businesses. Two notable changes are: (1) the creation of subchapter V, a streamlined alternative to a traditional small business chapter 11 case; and (2) the modification of the procedure surrounding the appointment of creditors' committees in small business and subchapter V cases.

SUBCHAPTER V

The SBRA introduced a new type of chapter 11 case, called a subchapter V case, for eligible small businesses that elect subchapter V designation. Subchapter V cases differ from small business cases in several ways.[12] For example, the SBRA provides for the appointment of a subchapter V trustee, who does not displace management in the operation of the debtor, to assist in developing a consensual restructuring plan.[13] In addition, subchapter V debtors face stricter timelines than small business debtors, encouraging a prompt confirmation process and reducing the administrative costs associated with lengthier chapter 11 cases.[14]

Additional advantages of subchapter V for debtors include: (a) equity holders' ability to retain their ownership interests without paying all creditors in full (elimination of the "absolute priority rule");[15] (b) elimination of the general requirement to file a disclosure statement;[16] (c) the subchapter V debtor's exclusive right to file a plan;[17] and (d) the ability to confirm a plan even if all classes reject the plan so long as the plan does not discriminate unfairly, is fair and equitable to any dissenting class, and the debtor commits its projected disposable income (or the value thereof) for a period of three to five years to distributions to creditors.[18] In addition, in order to alleviate the costs of chapter 11 administration, subchapter V debtors do not have to pay quarterly U.S. trustee fees[19] and are allowed to pay administrative expenses over time under a plan.[20]

> "The SBRA, as originally enacted, provides that the qualifications to be a subchapter V debtor are the same as for any small business debtor.[21] However, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act temporarily increased the debt limit for subchapter V debtors to $7,500,000.[22] This temporary increase has been extended twice,[23] with the current extension set to sunset on June 21, 2024."

CREDITORS' COMMITTEE APPOINTMENTS UNDER THE SBRA

The SBRA alters the appointment of creditors' committees in small business chapter 11 cases. In traditional chapter 11 cases and small business cases before the enactment of the SBRA, the United States Trustee ("UST") is required to appoint a committee of general unsecured creditors to represent the interests of general unsecured creditors.[24] The UST may also appoint additional creditors' or equity holders' committees as appropriate.[25] The bankruptcy court may also order, upon request, the appointment of additional committees "to assure adequate representation of creditors or of equity security holders."[26]

Whereas, before the SBRA, a party in interest could request that no creditors' committee be appointed in a small business case, under the SBRA a committee is only appointed in either a small business or subchapter V case if a court so orders "for cause" shown.[27] In at least one case, *Bonert*, the court held that where a debtor opted for subchapter V treatment after the passage of the SBRA, a creditors' committee that had been appointed before the subchapter V designation would not be automatically grandfathered in, but instead needed to show cause why it ought to remain in place after the case became a subchapter V case.[28]

Creditors' committees possess a number of powers and responsibilities.[29] These include: (1) consulting with the chapter 11 trustee or the debtor in possession;[30] (2) investigating the debtor or its business activities;[31] (3) participating in the formulation of a chapter 11 plan;[32] and (4) requesting the appointment of a chapter 11 trustee or an examiner.[33] Many courts have held that creditors' committees may seek "derivative standing" from the bankruptcy court to bring actions to avoid fraudulent or preferential transfers on behalf of a debtor in possession who unjustifiably refuses to do so.[34] In addition, a creditors' committee may employ professionals such as attorneys and accountants to represent it or perform services on its behalf.[35]

Creditors' committees can pose challenges in small business and subchapter V cases. From a practical perspective, excessively adversarial participation by a creditors' committee can hinder or delay confirmation of a plan of reorganization. From an administrative perspective, a creditors' committee can be costly—its retained professionals' fees are paid, with court approval, from the debtor's estate.[36] Such administrative expenses receive priority in

payment (i.e., they are paid off before most kinds of debts) and thereby leave fewer funds available for distribution to unsecured creditors under a debtor's plan. A chapter 11 case without a creditors' committee will reduce costs, arguably facilitating the ability of debtors to more quickly formulate and fund their plans. Accordingly, changing the default so that no creditors' committee is automatically appointed in small business and subchapter V cases forces interested parties to justify the attendant cost as compared to any benefit.[37]

A creditors' committee may still be appointed "for cause."[38] The SBRA does not define "cause," and no published cases have yet attempted to define "cause" in small business or subchapter V cases. The *Lear Capital* case, in which the Bankruptcy Court ordered the appointment of a creditors' committee, offers an opportunity to examine the issues that might inform future courts that address the issue of "cause" in small business and subchapter V cases.

CREDITORS' COMMITTEE APPOINTED IN *IN RE LEAR CAPITAL, INC.*

Lear Capital, Inc. ("Lear") is a metal and coin investment firm. In the years before its subchapter V chapter 11 bankruptcy filing, Lear had reached settlements with the Los Angeles City Attorney's Office and the State of New York regarding its alleged business practices. In anticipation of further legal action by government agencies and customers, Lear sought chapter 11 bankruptcy relief to resolve potential claims in a single forum.

A group of Lear's customers sought the appointment of an official committee of unsecured creditors to represent the interests of Lear's customers, most of whom had insufficient resources to effectively hire their own representation to protect their interests in the case.[39] The customers' motion further argued that other parties, such as the government agencies that were pursuing their own claims against the debtor, and the subchapter V trustee, whose role was not to advocate for any particular group of creditors, could not adequately provide a "voice" for customers.

Lear initially opposed the appointment of a creditors' committee.[40] It contended that Congress intended the appointment of a creditors' committee "only in rare and unusual circumstances." Lear also argued that oversight from the UST and the involvement of the subchapter V trustee and several state agencies provided sufficient oversight of the debtor. Moreover, Lear argued that, because a subchapter V debtor can confirm a plan without the acceptance of an impaired class if it commits its projected disposable income for three to five years to distributions to creditors, a creditors' committee could not result in creditors receiving more under a plan; rather, the committee's professional fees could only reduce the amount available to creditors.

Despite these initial objections, Lear ultimately submitted for court approval a settlement with state agencies and customers that would provide for, among other things, the appointment of a committee of customer creditors.[41] On June 23, 2022, the Bankruptcy Court approved the settlement.[42]

Although the court did not have to address what might constitute "cause" for the appointment of a committee under the SBRA, the case highlights various issues that may prove critical in future cases.

DIFFERENT STANDARDS FOR SMALL BUSINESS CASES AND SUBCHAPTER V CASES

The Bankruptcy Code does not distinguish between small business cases and subchapter V cases in mandating that a creditors' committee not be appointed except for cause shown. This suggests that the distinctions between small business cases and subchapter V cases should not result in different standards for what constitutes "cause." However, *Lear Capital* raises the possibility that courts may develop separate tests for small business and subchapter V cases to determine whether "cause" to appoint a creditors' committee exists. Lear (a subchapter V debtor) made two arguments against appointing a creditors' committee that would be inapplicable to a small business case: (1) that the subchapter V trustee can provide necessary oversight, and (2) that the ability to confirm a plan over creditors' objections and to commit three to five years' worth of projected disposable income to distribution to creditors eliminates the ability of creditors' committees to maximize payment in favor of their constituents.

GENERAL COMMITTEES VERSUS SPECIFIC COMMITTEES

A comparison of *Lear Capital* with *Bonert* suggests that the appointment of creditors' committees will be strongly disfavored, but that there may be instances, such as in *Lear Capital*, where the need for a subset of creditors to have a voice may constitute cause to appoint a committee. In *Lear Capital*, the customers' motion sought, and Lear ultimately agreed to, the appointment of a special committee to represent customers' interests. In *Bonert*, however, the committee appointed and eventually disbanded was a general committee of unsecured creditors.

UNIQUE VERSUS "TYPICAL" CASES

Lear Capital may prove to be unique given certain underlying factors. Unlike "the typical bonafide Chapter 11 case, [in which] the debtor is dealing with trade creditors,"[43] Lear sought bankruptcy relief to address anticipated legal claims in a single forum. Had these claims reached judgment and become liquidated prepetition, Lear would have exceeded even the increased debt limit for subchapter V cases and would have had to proceed in a traditional chapter 11 case. Arguably there would have been a strong basis for the Bankruptcy Court to find "cause" given that: (1) there is a large class of similarly situated creditors holding contingent, unliquidated claims; (2) their claims, if they had become non-contingent and liquidated prepetition, would have rendered the debtor ineligible to be a small business or subchapter V debtor; and (3) use of the bankruptcy forum to settle or litigate the claims was a primary motivation for the bankruptcy filing.

It is too early to tell whether the *Lear Capital* case will remain an exception or become the rule and creditors' committees become more commonplace in the post-SBRA world. Nevertheless, the outcome in *Lear Capital* suggests possibilities for what the future holds for creditors' committees in small business and subchapter V cases.

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[1] Pub. L. No. 116-54 (August 23, 2019).

[2] 11 U.S.C. § 101 *et seq*.

[3] Prior to the SBRA, section 101(51D)(A) of the Bankruptcy Code defined a "small business debtor" as:

[A] person engaged in commercial or business activities … that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $2,000,000 [as adjusted pursuant to 11 U.S.C. § 104] … for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor[.]

The current definition is:

[A] person engaged in commercial or business activities … that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $3,024,725 [adjusted effective April 1, 2022] (excluding debts owed to 1 or more affiliates or insiders) not less than 50 percent of which arose from the commercial or business activities of the debtor[.]

[4] 11 U.S.C. §§ 1181–1195.

[5] The Bankruptcy Code as amended by the SBRA defines a "small business case" as "a case filed under chapter 11 of this title in which the debtor is a small business debtor and has not elected that subchapter V of chapter 11 of this title shall apply." 11 U.S.C. § 101(51C). Eligible debtors may pursue small business bankruptcies without opting for subchapter V treatment. Accordingly, for simplicity, this article uses "small business case" and "small business debtor" to refer only to cases and debtors, respectively, that are not proceeding under subchapter V, and uses "subchapter V case" and "subchapter V debtor" to refer, respectively, to cases and debtors under subchapter V.

[6] Case No. 2:19-bk-20836-ER (Bankr. C.D. Cal.).

[7] Case No. 1:22-bk-10165-BLS (Bankr. D. Del.).

[8] H.R. 5116, Pub. Law No. 103-394 (October 22, 1994).

[9] Pub. L. No. 109–8 (April 20, 2005).

[10] These procedural changes include: (1) a longer "exclusivity period," during which only the debtor may file a plan; (2) the ability of a debtor to seek conditional approval of the disclosure statement, with final approval to follow at a hearing before or combined with the hearing on confirmation; and (3) tighter deadlines to file the disclosure statement and plan and confirm the plan. *See* 11 U.S.C. §§ 1121(e)(1)-(2) & 1129(e); Fed. R. Bankr. P. 3017 & 3017.1. A disclosure statement is a statement filed by a debtor, or other party that has proposed a plan, that describes the contents of the plan. *See* 11 U.S.C. § 1125.

[11] *See In re Wright*, No. CV 20-01035-HB, 2020 WL 2193240, at *3 n.6 (Bankr. D.S.C. Apr. 27, 2020) (noting small business debtors' difficulties in reorganizing even after BAPCPA) (citing Report from the House Committee on the Judiciary (Report No. 116-54)).

[12] For a more extensive overview of these differences, *see In re Seven Stars on the Hudson Corp.*, 618 B.R. 333, 340 (Bankr. S.D. Fla. 2020).

[13] 11 U.S.C. § 1183(b)(7). In a small business case, a trustee (who would displace management) is only appointed upon a showing of fraud, mismanagement, or similar proof.

[14] *See, e.g.*, 11 U.S.C. § 1189(b) (requiring debtor to file a plan "not later than 90 days after the order for relief under this chapter," and only allowing the court to extend the time to file a plan "if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable").

[15] 11 U.S.C. §§ 1181(a), 1191(b).

[16] 11 U.S.C. § 1191(b).

[17] 11 U.S.C. § 1189(a).

[18] 11 U.S.C. § 1191(b).

[19] 28 U.S.C. § 1930(a)(6)(A).

[20] 11 U.S.C. § 1191(e).

[21] *See* 11 U.S.C. § 1182(1) (providing qualifications to be subchapter V debtor); *In re RS Air, LLC*, 638 B.R. 403, 409 (B.A.P. 9th Cir. 2022) (noting that the SBRA "as originally enacted defined the debtor under § 101(51D), in the same way as a small business debtor who does not elect to proceed under subchapter V").

[22] *See RS Air, LLC*, 638 B.R. at 409 (noting that the SBRA "as originally enacted defined the debtor under 11 U.S.C. § 101(51D), in the same way as a small business debtor who does not elect to proceed under subchapter V") (citing Pub. L. No. 116-136, 134 Stat. 281 (Mar. 27, 2020)).

[23] *See id*. (citing Pub. L. No. 117-5 (Mar. 27, 2021) (the "COVID-19 Bankruptcy Relief Extension Act of 2021") and Pub. L. No. 117-151 (S. 3823) (June 21, 2022) (the "Bankruptcy Threshold Adjustment and Technical Corrections Act")).

[24] 11 U.S.C. § 1102(a)(1). In practice, the UST will fulfill this duty by analyzing the need for such a committee and, where appropriate, appoint such committee, or otherwise inform the Court that the UST was unable to do so.

[25] *Id*.

[26] 11 U.S.C. § 1102(a)(2).

[27] 11 U.S.C. § 1102(a)(3).

[28] *See In re Bonert*, 619 B.R. 248, 254 (Bankr. C.D. Cal. 2020) ("[T]he Court will provide the Committee an opportunity to show cause why it should be permitted to continue in existence after the Debtors' Subchapter V election takes effect."). In subsequent briefing, the subchapter V trustee argued that his role and the role of a committee would be duplicative. In light of the subchapter V trustee's brief, the committee did not oppose disbandment, and the court entered an order disbanding the creditors' committee. *See In re Bonert*, Case No. 2:19-bk-20836-ER (Bankr. C.D. Cal.), Docket Nos. 277 (June 18, 2020) (subchapter V trustee's brief), 278 (June 19, 2020) (creditors' committee's statement that it did not object to disbandment) & 287 (July 10, 2020) (order disbanding the committee).

[29] 11 U.S.C. § 1103(c).

[30] 11 U.S.C. § 1103(c)(1).

[31] 11 U.S.C. § 1103(c)(2).

[32] 11 U.S.C. § 1103(c)(3).

[33] 11 U.S.C. § 1103(c)(4).

[34] *See, e.g.*, *In re Roman Cath. Diocese of Harrisburg*, 640 B.R. 59, 67 (Bankr. M.D. Pa. 2022) (citing *Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 553 (3d Cir. 2003)); *In re Roman Cath. Bishop of Great Falls, Montana*, 584 B.R. 335, 338 (Bankr. D. Mont. 2018) (citing *In re Valley Park, Inc.*, 217 B.R. 864, 866 (Bankr. D. Mont. 1998)); *In re Dzierzawski*, 518 B.R. 415, 417–19 (Bankr. E.D. Mich. 2014) (discussing Sixth Circuit cases).

[35] 11 U.S.C. § 1103(a).

[36] 11 U.S.C. §§ 330(a), 503(b).

[37] 11 U.S.C. § 1102(a)(3).

[38] *Id.*

[39] Case No. 1:22-bk-10165-BLS (Bankr. D. Del.), Docket Nos. 130 (April 20, 2022) (motion) & 175 (May 2, 2022) (reply brief).

[40] Case No. 1:22-bk-10165-BLS (Bankr. D. Del.), Docket Nos. 133 (April 20, 2022) (objection to motion to shorten time) & 171 (April 30, 2022) (opposition brief).

[41] Case No. 1:22-bk-10165-BLS (Bankr. D. Del.), Docket No. 241 (June 7, 2022).

[42] Case No. 1:22-bk-10165-BLS (Bankr. D. Del.), Docket No. 251 (June 23, 2022).

[43] *In re Albrechts Ohio Inns, Inc.*, 152 B.R. 496, 502 (Bankr. S.D. Ohio 1993).

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