Commercial Law Newsletter

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Joint Report from the Chairs

Dear Members:

As a reminder, the ABA Business Law Section's Virtual Section Annual Meeting starts on Wednesday, September 22, 2021. There is still time to register (it is free for ABA BLS members). Both the UCC and Commercial Finance Committee have some very interesting and informative CLE programs as well as Subcommittee meetings. You can still register here: https://web.cvent.com/event/ca7ad530-c927-42be-a4cf-1c77e8ad9577/regProcessStep1. We will also be holding the Joint UCC/ComFin Virtual Reception on September 24, 4:30 – 5:30 pm central.

Please email either of us if you have any ideas for either of the Committees or wish to participate in any project, subcommittee or leadership role. The Committees have a number of projects underway. Our subcommittees and task forces are very active and always welcome input. Please do not hesitate to volunteer!

We hope you enjoy this issue, and invite you to get involved in your committee(s). We hope to see you (virtually) at the annual meeting.

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financing proposals more closely to the needs of an individual business and offer some of the benefits of traditional relationship lending. Unlike in the syndicated market, there is no syndication risk in direct lending leading to certainty of funds, as well as a speedier closing process, which is a significant advantage for a borrower in a competitive acquisition environment. Direct lenders may also be more willing to provide increased flexibility around leverage, amortization, EBITDA adjustments, and covenant limitations.

Market participants are also keeping watch on digital technologies, which they believe will be necessary to move the direct lending market forward post-pandemic. According to observers, the remote-work landscape and increased reliance on virtual mediums will lead many market participants to conduct business online, which will require investment in digital workflows and technologies.

Overall, practitioners predict the number of non-bank lenders entering the space, coupled with increased capital and economic growth, will continue to drive the market throughout the remainder of 2021.

Looking Forward

As the US economy continues to rebound, borrowers and lenders in new deals are expected to center much of their negotiations around the level of operational flexibility for borrowers in loan agreement covenant packages. Inflation is expected to remain a primary concern for loan investors throughout 2021, which may lead to increased investor demand for leveraged loans. Further COVID-19 waves caused by new variants may also have an impact on the loan market.

Lenders are also likely to watch the Biden administration closely for any tightening of regulations, which may impact certain sectors of the economy and have a knock-on effect on deal flow. Given the administration's emphasis on climate change, the sustainable-financing market is also likely to remain a popular segment within the leveraged loan market.

Market observers also expect borrowers and lenders to continue to prepare their loan documents for the discontinuation of LIBOR.

The market statistics cited in this article (unless otherwise stated) were provided by Refinitiv LPC, an LSEG business.

For a complete copy of this article published on the Practical Law website on July 22, 2021 which also includes links to recent examples of loan agreements and Expert Views from leading industry experts, see Practice Note, What's Market: 2021 Mid-Year Trends in Large Cap and Middle Market Loan Terms, Practical Law, at http://us.practicallaw.tr.com/w-030-9114.

Lenders and Small Businesses: A New Dynamic under Subchapter V of Chapter 11

by Ira L. Herman and Evan J. Zucker, Blank Rome LLP

Subchapter V of Chapter 11 of the Bankruptcy Code[1] was enacted for the stated purpose of reducing barriers to the Chapter 11 process for small businesses by streamlining the reorganization process and limiting costs.[2] When enacted in 2019,[3] the definition of "small business debtor," set forth in section 101(51D) of the Bankruptcy Code, included a debt cap of $2.5 million. In 2020, in a partial response to the COVID-19 pandemic, Congress increased the debt cap to $7.5 million in secured and unsecured non-contingent and liquidated debt.[4]

Between February 19, 2020 and September 30, 2020, more than 2,200 Subchapter V cases were filed in the United States.[5] Approximately 20% of such cases have been confirmed. This confirmation rate is no less than six times higher than the percentage for small business Chapter 11 cases that did not proceed under Subchapter V during the same period.[6] On its face, this statistic suggests that Subchapter V is working to help small to medium size businesses reorganize under Chapter 11. However, the enhanced success rate does not at all address the impact such cases have had on creditors rights and recoveries – particularly on holders of funded debt claims.

In a Subchapter V case, a number of the traditional Chapter 11 rights and remedies of secured and unsecured creditors are limited or modified. This article first identifies several of these limitations and modifications and then proposes strategies lenders may employ to enhance recoveries, when a customer becomes a debtor in a Subchapter V case.

A. SUBCHAPTER V LIMITATIONS ON LENDER RIGHTS

1. The Elimination of the Absolute Priority Rule and Certain Voting Rights

Subchapter V eliminates the "absolute priority rule," meaning that a Subchapter V debtor may retain its property, even if it does not pay its creditors in full. Moreover, Subchapter V, eliminates the traditional Chapter 11 confirmation requirement of acceptance by an impaired class of creditors. However, the concept of acceptance by an impaired class does not disappear entirely in a Subchapter V case, rather acceptance of the Subchapter V plan by the voting classes of creditors[7] may be beneficial to a debtor – providing creditors with some leverage as they negotiate with a Debtor. How so? Confirming a consensual plan under Subchapter V has at least two significant benefits for the debtor: (a) an earlier discharge and (b) the right to keep post-petition property outside of the bankruptcy estate. On the other hand, in exchange for the elimination of the traditional confirmation requirement of acceptance by an impaired class of creditors (*i.e.*, a non-consensual plan), all of a debtor's projected disposable income for a three to five years period must be paid to creditors, and the debtor does not receive a discharge until the completion of its plan payments.

2. Payment of Administrative Expense Claims Can Affect Plan Length

In order to confirm a reorganization plan in a traditional Chapter 11 case, a debtor (or plan proponent) is required to pay in full all of its administrative expenses – that is, all of the post-petition expenses that "are actual and necessary costs and expenses of preserving the estate." 11 U.S.C. § 503. In a Subchapter V case, if the plan is nonconsensual, a debtor is not required to pay administrative claims at confirmation (unless otherwise agreed) – it can stretch them out over the life of the plan (*i.e.*, three to five years). This treatment of administrative expenses in Subchapter V cases, significantly changes the debtor/creditor dynamic from the dynamic that exists in traditional Chapter 11 cases. For example, where a debtor has incurred substantial administrative expenses, it may find itself in a totally counterintuitive position - preferring a contested plan confirmation to a consensual plan confirmation, since it can stretch out the payment of administrative expenses. On the other hand, distressed investors (claims traders) with holdings consisting of unsecured claims or equity interests still will want to limit administrative claims, since such expenses will be paid in full ahead of their claims and interests.

3. A Subjective Projected Disposable Income Test and Limitations on Post-Confirmation Modification

To confirm a non-consensual Subchapter V plan, a debtor must demonstrate that it is providing "all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix." 11 U.S.C. § 1191(c). After confirmation of a Subchapter V plan, only the debtor may modify the plan if the projections turn out to be incorrect. 11 U.S.C. § 1193. Thus, in a Subchapter V case, if the debtor's business improves significantly after confirmation during the term of the plan or the debtor's projections prove to have been overly pessimistic, there is no provision in Subchapter V permitting a lender to request modification of the plan to increase payments to match the post confirmation income being generated by the debtor. However, if the post-confirmation income stream is less than projected at confirmation, the debtor can request a modification of the plan under Subchapter V, even though the plan has been substantially consummated. 11 U.S.C. § 1193(c). This is different than in a traditional Chapter 11. In a typical corporate Chapter 11 case, a confirmed plan may be modified by the plan proponent or reorganized debtor at any time after confirmation, but before substantial consummation of the plan. 11 U.S.C. § 1127(b). And, with respect to traditional individual Chapter 11 debtors who seek to modify a confirmed plan, there is a more level playing field post-confirmation, as with regard to individual Chapter 11 debtors "the plan may be modified at any time after confirmation of the plan but before the completion of payments under the plan, whether or not the plan has been substantially consummated, upon request of the debtor, the trustee, the United States trustee, or the holder of an allowed unsecured claim." 11 U.S.C. § 1127(e).

4. Modification of Mortgages on the Debtor's Principal Residence

In the traditional Chapter 11 case, the plan may not modify the rights of creditors holding a claim secured solely by an interest in a debtor's principal residence. This anti-modification rule generally prevents debtors from "stripping down" a loan or, in other words, voiding a creditor's lien to the extent the debt secured by a principle residence is less than the value of the residence. This is lender protection is eliminated in Subchapter V cases.

When a debtor seeks to confirm a traditional Chapter 11 plan over the objection of a secured creditor, the plan must "not discriminate unfairly" and be "fair and equitable" with respect to each class of creditors that voted against the plan. 11 U.S.C. § 112(b). Generally, a traditional Chapter 11 plan is "fair and equitable" with respect to the treatment of a secured claim if the plan either (a) provides for the retention by the holder of the claim of the liens securing the claim and the payment to the holder of deferred cash payments totaling at least the allowable amount of the claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in the property securing the liens, (b) provides for the sale of the property securing the liens, free and clear of the liens, with the liens to attach to the proceeds of such sale, and the treatment of such liens, or (c) the plan provides for the realization by the holder of the secured claim of the "indubitable equivalent" of such claim. 11 U.S.C. §§ 1129(b) & 1191(c)(1). Subchapter V does not change the "fair and equitable' standard, but it does change the general rule under section 1123(b)(5), by authorizing a debtor to modify the rights of certain holders of claims secured only by a mortgage lien in a debtor's principal residence, when the proceeds of the relevant mortgage were used primarily in connection with such debtor's business. 11 U.S.C. § 1190(3). Specially, section 1190(3) provides that a plan, "notwithstanding section 1123(b)(5) of this title, may modify the rights of the holder of a claim secured only by a security interest in real property that is the principal residence of the debtor if the new value received in connection with the granting of the security interest was (a) not used primarily to acquire the real property; and (b) used primarily in connection with the small business of the debtor." 11 U.S.C. § 1190(3). Thus, if a mortgage is not a purchase money mortgage and was used to finance a business enterprise, then a debtor may be able to modify that mortgage by confirming a Subchapter V plan.

5. **Guarantees**

Subchapter V does not change the law concerning obligations of non-debtor related parties, including guarantors. It neither changes the scope of the automatic stay nor expands the scope of a discharge. Thus, a lender's rights against a guarantor under Subchapter V are just like the lender's rights against a guarantor in a traditional Chapter 11 case. Absent an injunction extending the automatic stay to a non-debtor guarantor, the automatic stay in a Subchapter V case does not protect a guarantor, and, similarly, confirmation of a Subchapter V plan does not serve a to release a guarantor, without an appropriate showing under the applicable law regarding a non-debtor release included in a plan of reorganization.

Given certain perceived advantages of Subchapter V for a debtor, an individual guarantor may want to file a Subchapter V case to deal with personal liabilities arising out of guarantees or other obligations related to a failed business. A split of authority exists on whether an individual, who guarantees a business debt, qualifies for Subchapter V relief, as the issue has been argued, the individual at issue has not "engaged in commercial or business activities" where the business giving rise to the debts is no longer operating. In *In re Wright*, 2020 WL 2193240 (Bankr. D. S.C. 2020), the court held that nothing in the definition limits the scope of Subchapter V eligibility to a debtor currently engaged in business and ruled that an individual who guaranteed debts of two limited liability companies that were no longer operating could proceed in a Subchapter V case. *Accord, In re Bonert,* 619 B.R. 248, 255 (Bankr. C.D. Cal. 2020); *see In re Blanchard*, 2020 WL 4032411 (Bankr. E.D. La., 2020). Other courts have reached a contrary outcome and concluded that a debtor must currently be engaged in business to be eligible for Subchapter V relief. *See In re Thurmon,* 625 B.R. 417 (Bankr. W.D. Mo., Dec. 8, 2020). In *Thurmon*, the court reasoned, "[t]he plain meaning of 'engaged in' means to be actively and currently involved. In § 1182(a)(1)(A) of the Bankruptcy Code, 'engaged in' is written not in the past or future but in the present tense."

B. **CREDITOR STRATEGIES**

1. **Objecting to a Debtor's Eligibility**

Given the benefits provided to a debtor (at the expense of creditors) under Subchapter V, a lender should be aware of potential strategies a debtor may employ to satisfy the eligibility requirements of Subchapter V and how to challenge a debtor that employs such strategies. For example, a debtor might attempt to assign debts to non-affiliate insiders, might characterize debts as contingent or nonliquidated, without an appropriate evidentiary foundation, or negotiate with friendly creditors to reduce or pay their claims, pre-bankruptcy, to qualify for the "small business" debt limit. A lender could be well served to strategically object to a debtor's Subchapter V election, if it suspects gamesmanship concerning eligibility and is concerned about the cram-down provisions available to Subchapter V debtors. Interim Bankruptcy Rule 1020(b) provides that a creditor has until 30 days after the conclusion of the meeting of creditors held under 11 U.S.C. § 341(a) to object to the Subchapter V election. Filing and sustaining such an objection, however, can be a costly endeavor and often will require discovery due the fact intensive nature of the inquiry. Finally, because Subchapter V requires a plan to be filed within 90 days of the commencement of the case, the prosecution of an objection regarding eligibility can at least play an important role in plan negotiation because of the risk to a debtor that it will be disqualified for Subchapter V.

2. **Leveraging a Lender's Section 1111(b) Secured Creditor Elections**

Under section 506(a) of the Bankruptcy Code, a secured claim held by a lender is limited to the value of its collateral, while the lender is left with a general unsecured claim for all amounts outstanding that are in excess of that value. Section 1111(b) of the Bankruptcy Code provides that an under-secured creditor can avoid the effect of Section 506(a) and elect to have the full amount of the outstanding indebtedness as being fully secured at the time in the future when the collateral is to be liquidation, despite the fact that the actual value assigned to the collateral at confirmation is less than the amount outstanding at confirmation. The election can be quite important to a lender that believes the value of its collateral is temporarily depressed or undervalued (*e.g.*, due to the COVID-19 pandemic or other causes). Absent the exercise of the 1111(b) election, the operation of Section 506(a) will result in the under-secured lender receiving (a) the net present value of its collateral on the secured portion of its claim, and (b) a *pro rata* share of distributions under the plan on account of its unsecured deficiency claim. By exercising the right of election, the lender's lien remains, the amount secured by the lien remains intact and the lender will receive an income stream equal to the present value of the collateral. The payments made will be applied to the amount of the claim secured by the lien. Thus, if the lender's collateral is worth $1 million and the amount secured by the lien is $2 million, for the lien to be satisfied, the lender will have to receive $2 million of payments over time, while the present value of such payments must be (at least) $1 million. In this example, if the lender has been paid $1 million dollars over time after confirmation of a plan, and the debtor wants to sell the property, it will have to pay the lender the amount remaining due on account of the lien or $1 million.

Traditionally, in deciding when to make an election, an under secured creditor must consider the practical effects of not making such election – *i.e.*, that its claim would be bifurcated, with it retains the ability debtor to vote as both a secured creditor and unsecured creditor on a debtor's Chapter 11 plan. And, because a debtor is required to have at least one accepting impaired consenting class, a lender may hold a blocking position. The analysis, however, changes in a Subchapter V case because a debtor is not required to have an impaired accepting class as a condition of confirmation.

There is, however, an exception to a lender's 1111(b) election right. Under the so-called "inconsequential value exception" to the 1111(b) election right, "[a] class of claims may not elect the application of paragraph (2) of this subsection if—(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value. . . ." 11 U.S.C. § 1111(b)(1)(B)(i). The term "inconsequential" is not defined in the Bankruptcy Code. Courts have used different approaches in analyzing the "inconsequential value exception." Some courts compare the value of the asserted secured interest with the overall value of the collateralized asset to determine whether the lien is of "inconsequential" value. Other courts compare the value of the security interest to the total dollar amount of the underlying secured claim. And, in the context of a Subchapter V case, there is a dispute as to whether a court should consider the fact that the case is one under Subchapter V in determining whether the lien is of inconsequential value. *Compare In re Body Transit, Inc.*, 2020 WL 4574907 (E.D. Penn. August 7, 2020) *with In re VP Williams Trans, LLC*, Case No. 20-10521 (MEW), 5-9 (Bankr. S.D.N.Y. Sep. 29, 2020).

In *Body Transit*, the Court found that the purposes underlying Subchapter V influenced its determination of whether the value at issue was "inconsequential." And, since the purpose of Subchapter V was to permit a small business to satisfy unsecured portions of claims by paying their projected disposable income for three to five years, and that this favored a lenient interpretation of the definition of "inconsequential" and section 1111(b). The Court, in *VP Williams Trans*, however, rejected such considering stating:

> But I do not see how that should have any bearing on the interpretation of section 1111(b). Congress also desired to foster other forms of chapter 11 reorganizations, but section 1111(b) applies in all chapter 11 cases, including subchapter V. If section 1111(b) was supposed to give way in a subchapter V case, or to have a different application in such a case, that was for Congress to say, and Congress did not do so. Furthermore, while it is true that Congress desired to foster reorganizations under subchapter V when a small business debtor agrees to devote its projected disposable income to payments under the plan, that is only one of the tests that must be applied. See 11 U.S.C. § 1191(c).

3. Investigate Debtor's Financial Projection to Minimize Cramdown Risk and/or Negotiate a Consensual Plan

Determining the amount of a debtor's disposable income will be critical to either negotiating (and accepting) a consensual plan or forming the basis for opposing confirmation of a non-consensual plan. "Disposable income" for the purposed of Subchapter V means "the income that is received by the debtor and that is not reasonably necessary to be expended . . . (2) for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor." 11 U.S.C. § 1191(2). As set forth above, a debtor will have the incentive to "lowball" its projected revenues and to maximize its projected expenses. That is particularly true in the current macro-economic environment, as the economic recovery from the COVID-19 pandemic continues at an unpredictable pace. Given the informational disparity concerning what a debtor knows about its finances and what a creditor may know, a creditor may choose to employ the contested proceeding discovery rules or examinations, under Fed. R. Bankr. P. 2004, to investigate the validity of the Debtor's projected disposable income. A word of caution: this will have to be done expeditiously, due to the relatively short amount of time available for a lender to act in the context of a Subchapter V case to contest plan confirmation.

C. CONCLUSION

While Subchapter V provides many benefits to a small business debtor, lenders and other creditors are not left without options. A lender will be well served by acting decisively and taking certain steps available to it under the new statutory scheme to protect its interests and maximize its recovery. However, because of the streamlined reorganization process now available to small businesses under Subchapter V, the old admonition, "if you snooze you lose" is truer than ever.