The Small Business Reorganization Act of 2019 and the Individual Debtor

by Michael Traison and Michael Kwiatkowski

Small businesses are often owned by one or two individuals and the debts of such businesses are often guaranteed by the owners and their spouses. Our lender and small business clients have asked whether the owners of small businesses and small business individual guarantors are also entitled to file petitions under the newly enacted Small Business Reorganization Act of 2019 (SBRA). 11 U.S.C. §§ 1181-1195 (2019).

Cases dealing with interpretation of Bankruptcy Code provisions focus our attention upon the historic origins of the bankruptcy court in chancery, which itself originated in the church, as a means of dealing with equity issues not easily reduced to simple arithmetic calculations or established legal principles. The equitable nature of the bankruptcy court has contracted over the years as legislation has increasingly defined its powers. Yet still, the bankruptcy judge can be more flexible in dealing with practical business issues because the principal purpose of the Bankruptcy Code remains granting "a fresh start to the honest but unfortunate debtor." *Marrama v. Citizens Bank of Mass*., 549 U.S. 365, 367 (2007) (quotation marks and citation omitted).

The SBRA was signed into law in August 2019 and became effective on February 19, 2020. We have issued several legal alerts discussing this new law. As more cases are filed, courts are increasingly issuing more decisions and the application of the law continues to develop. Most recently, a decision of a bankruptcy court in Louisiana focuses our attention on several aspects of the application of these provisions, including the ability to convert a case from a standard Chapter 11 case to a Chapter 11 case under the SBRA, and the ability of individuals to qualify under the SBRA provisions of Subchapter V of chapter 11 of the United States Bankruptcy Code.

The timing of the enactment of the SBRA was fortuitous, as it became effective just as many small businesses began to suffer from the economic impact of the COVID-19 pandemic. While the existing chapter 11 reorganization provisions may be effective, the process is expensive, and thus may be beyond the reach of many small businesses. The original terms of the SBRA capped the total amount of debts (secured and unsecured) for a "small business" to qualify under the SBRA to approximately $2.7 million. With the enactment of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) in late March 2020 in response to the COVID-19 pandemic, the debt limit for eligibility was increased, for one year, to $7.5 million, enabling many more businesses to take advantage of the SBRA.

In the recent case out of Louisiana, *In re Andrew Blanchard and Christine Blanchard*, No. 19-12440, 2020 WL 4032411 (Bankr. E.D. La. July 16, 2020), two individual debtors filed their joint petition under existing provision of chapter 11 in early September 2019. 2020 WL 4032411 at *1. The debtors were sole owners of several businesses and personally guaranteed the businesses' debts. *Id*. at *2.

After the US Trustee sought to convert the case to chapter 7 in April 2020, the debtors amended their petition in order to proceed under the SBRA. Id. at *1. The US Trustee and a creditor opposed debtors' re-designation to an SBRA case. *Id*. The two main issues were (i) whether these individual debtors as owners and guarantors of business debts (for non-debtor businesses) qualified to be debtors under the SBRA which requires that a debtor be "engaged in commercial or business activities," and (ii) whether the delay resulting from the re-designation under SBRA and the need to reset certain deadlines under the SBRA prevented the court from allowing the debtors to proceed under the SBRA. *Id.* at 1.

Focusing on the first issue, the creditor argued that "an individual debtor with debt resulting from the individual debtor's guarantee of commercial or business loan to a separate entity in which the individual debtor has a controlling interest does not qualify the individual debtor to be a debtor under the SBRA," and that "for such an individual debtor to qualify under the SBRA, the separate legal entity must also be a debtor, of which the individual debtor may be an affiliate under § 1182(1)(A)." *Id.* at *1. As the bankruptcy court pointed out, the objecting creditor interpreted the statutory language to "require a debtor to be *currently* engaged in commercial or business activities." *Id.* at *2 (emphasis added).

Rejecting this interpretation, the court relied on *In re Wright*, No. 20-01035-HB, 2020 WL 2193240 (Bankr. D.S.C. Apr. 27, 2020), which found that "'[a]lthough the brief legislative history of the SBRA indicates it was intended to improve the ability of small businesses to reorganize and ultimately remain in business, nothing therein, **or in the language of the**

definition of a small business debtor, limits application to debtors currently engaged in business or commercial activities'." *Id*. at *2 (*quoting In re Wright*, No. 20-01035-HB, 2020 WL 2193240, *3 (Bankr. D.S.C. Apr. 27, 2020) (emphasis in the original). Thus, the bankruptcy court found that the debtors qualified as small business debtors under the SBRA because "a majority of the Debtors' debts stem from operation of both currently operating businesses and non-operating businesses, and those debts do not exceed the SBRA's debt limit." *Id.* The fact that some of the debtors' business may have been defunct did not deprive the debtor from qualifying as "engaged in commercial or business activities."

As to the procedural argument regarding the practicality and scheduling issues associated with an SBRA designation of a pending case, the bankruptcy court dismissed that argument, finding that "'there are no bases in law or rules to prohibit a resetting or rescheduling of these procedural matters'." *Id*. at *3 (*quoting In re Progressive Solutions, Inc.*, No. 18-BK-14277, 2020 WL 975464, at *5 (Bankr. C.D. Cal. Feb. 21, 2020)). Lastly, in response to US Trustee's argument that debtors' re-designation under the SBRA may impact vested rights of creditors, the court pointed out that no such creditors have asserted such prejudice. *Id*.

A number of significant conclusions may be drawn from this decision. Substantively, bankruptcy courts may permit distressed debtors to take advantage of the provisions of SBRA, even where the underlying business debt is based on the debtor's personal guaranty for debts of a defunct business. Procedurally, considerations of potential delays are unlikely to be sufficient for the court to deny a debtor the opportunity to re-designate its chapter 11 case as an SBRA case. These are important considerations in light of the current economic times and the increasing popularity of the SBRA as a potential option for bankruptcy filers. According to the American Bankruptcy Institute, over 630 debtors have taken advantage of the new law since its enactment in February 2020 (see Subchapter V Case Statistic Tables available at https://www.abi.org/sbra).

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