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# Case Law Update: Subchapter V and the Retroactive Effect of the SBRA and CARES Act

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# Overview of Subchapter V and CARES Act Amendments

# Overview of Subchapter V and CARES Act

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- The Small Business Reorganization Act of 2019 (“SBRA”) became effective on February 19, 2020
- The SBRA created new Subchapter V to Chapter 11 to make small business bankruptcy proceedings faster and less expensive

# Overview of Subchapter V and CARES Act

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- Key Provisions of Subchapter V:
  - › “Small business debtor”: defined to mean a person engaged in commercial or business activities with aggregate noncontingent liquidated secured and unsecured debts of not more than \$2,725,625. 11 U.S.C. § 101(51D).
    - More than 50% of debts must be from commercial or business activities of the debtor
    - Excludes single asset real estate, but expands prior definition to include businesses whose primary activity is owning or operating real estate
  - › Appointment of Subchapter V Trustee
  - › No creditors committee by presumption. § 1102(a)(3)

# Overview of Subchapter V and CARES Act

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- Key Provisions of Subchapter V (cont.)
  - › Debtor has exclusive right to file a plan. § 1189(a)
  - › Debtor must file plan within 90 days, with limited exception. § 1189(b)
    - Court may 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.”
  - › No disclosure statement required, but plan must include a short history of the debtor, a liquidation analysis, and financial projections. § 1190(1)
  - › Debtor must attempt to attain a consensual plan of reorganization. § 1188(c) (requiring report of such efforts at least 14 days before the first status conference)

# Overview of Subchapter V and CARES Act

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- Contents of Plan ( § 1190(3))
  - › Debtor may modify a mortgage on debtor’s principal residence if new value received in connection with the mortgage was:
    - Not used primarily to acquire the real property; and
    - Used primarily in connection with the small business of the debtor.
    - No other collateral
  - › Big change from existing law – § 1123(b)(5) prohibits a Chapter 11 plan from modifying the rights of mortgage holders with respect to “a security interest in real property that is the debtor’s principal residence”

# Overview of Subchapter V and CARES Act

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- Easier path to cramdown of a plan ( § 1191)
  - › No impaired accepting class required—small business debtor doesn't need any “friends”
  - › “Fair and equitable” treatment for cramdown of impaired classes that reject the plan means:
    - Secured claims: § 1129(b)(2)(A) must still be met
    - All claims: (1) plan provides that all projected “disposable income” of the debtor to be received in 3-5 year period will be applied to plan payments; (2) value of the distributions is not less than the debtor's projected disposable income.
  - › No absolute priority rule
  - › Discharge not granted until completion of cramdown plan payments. § 1192
  - › “Special Rule”: Administrative claims may be paid over time. § 1191(e)

# CARES Act Amendments to Subchapter V



# CARES Act Amendments to Subchapter V

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- CARES Act – signed into law on March 27, 2020 – House Bill 748 became public law 116-136
  - › Did not re-define “small business debtor” under § 101(51D)
  - › Instead, it redefined “debtor” under § 1182 to remove the reference to “small business debtor” and replace with a definition that is exactly the same but with a total debt cap of \$7,500,000 instead of \$2,725,625.
  - › CARES Act includes explicit provision saying the amendment to 1182’s definition of “debtor” applies only to cases commenced on or after 3/27/2020.
  - › Sunset provision reverting the definition of “debtor” under § 1182 back to “small business debtor” in one year, i.e. 3/27/2021

# Retroactive Effect of SBRA and CARES Act

# Retroactive Effect of SBRA and CARES Act

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- SBRA that went into effect on February 19, 2020, and is silent on its retroactive effect.
- Generally, bankruptcy courts are permitting pending Chapter 11 cases to be re-designated to a case under Subchapter V.
- Common considerations:
  - › Does election of Subchapter V alter or impair a vested property right?
  - › Do procedural considerations (e.g., deadlines that have passed) prevent re-designation?
  - › Is the Debtor re-designating in bad faith or would any party be unduly prejudiced by the re-designation?

# Retroactive Effect of SBRA and CARES Act

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- *In re Progressive Solutions, Inc., Debtor.*, 8:18-BK-14277-SC, 2020 WL 975464, at \*1 (Bankr. C.D. Cal. Feb. 21, 2020)
  - › Chapter 11 debtor filed “Motion for Order Authorizing Amendment of Chapter 11 petition regarding Subchapter V Election and Extension of Plan Deadline.”
  - › Court considered the due process concerns with re-designating a pending case to a Subchapter V case.
    - Inquired whether any creditors or parties in interest had any vested rights that would be disturbed by re-designation.
    - Creditors and US Trustee could not identify any such vested rights.
  - › US Trustee raised procedural and timing issues related to the IDI, 341 meeting, status conferece report, status conference, and plan filing deadlines.
    - The court rejected these concerns as a reason for denying re-designation, pointing out that nothing in Subchapter V prohibits the Court from altering these deadlines.
  - › Court concluded there is no legal reason to deny a Chapter 11 debtor’s motion to authorize amended petition under Subchapter V.
  - › But the Court denied the Motion, holding no legal requirement to have the Court grant leave to amend the petition or schedules under Rule 1009.

# Retroactive Effect of SBRA and CARES Act

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- *In re: Moore Properties of Pers. County, LLC, Debtor.*, 20-80081, 2020 WL 995544, at \*1 (Bankr. M.D.N.C. Feb. 28, 2020)
  - › Chapter 11 case filed on 2/10/2020; amended petition on 2/24/2020 to elect Subchapter V (5 days after SBRA effective date)
  - › Objection to debtor's designation as small business debtor before SBRA effective date.
  - › Court addressed (1) whether debtor with a case pending on the effective date of SBRA may elect to proceed under Subchapter V; and (2) whether a debtor who did not meet the definition of a small business debtor on the petition date, is eligible to proceed under Subchapter V when it now meets the definition under the SBRA?

# Retroactive Effect of SBRA and CARES Act

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- *In re: Moore Properties of Pers. County, LLC, Debtor.*, 20-80081, 2020 WL 995544, at \*1 (Bankr. M.D.N.C. Feb. 28, 2020)
  - › Court analyzed canons of construction set forth in Supreme Court precedent
  - › Court should apply law in effect at the time it renders its decision, but there is a presumption against retroactively applying laws, especially where application of new laws to pending cases would “defeat vested traditional property interests” (*Landgraf v. USI Film Products*, 511 U.S. 244 (1994); *U.S. v. Sec. Indus. Bank*, 459 U.S. 70 (1982))

# Retroactive Effect of SBRA and CARES Act

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- *In re: Moore Properties of Pers. County, LLC, Debtor.*, 20-80081, 2020 WL 995544, at \*1 (Bankr. M.D.N.C. Feb. 28, 2020)
  - › Two potential aspects that could defeat creditor’s vested property right:
    1. Anti-modification exception for a principal residence, which didn’t apply because debtor was not an individual
      - Footnote 14: Court stated that even if 1190(3) applied, the remedy was not to prohibit Debtor from utilizing Subchapter V, but instead to restrict availability of 1190(3).
    2. Alteration of fair and equitable requirements under 1129(b), but:
      - a. Removal of impaired accepting class requirement does not defeat vested property rights
      - b. Subchapter V replaces the absolute priority rule with the disposable income requirement—the requirement that future income and earnings must be submitted to Trustee “as is necessary for the execution of the plan”
      - c. AND this alteration of confirmation requirements, alone, does not amount to an impermissible retroactive taking—but it may in cases that have been pending in chapter 11 for longer.

# Retroactive Effect of SBRA and CARES Act

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- *In re: Moore Properties of Pers. County, LLC, Debtor.*, 20-80081, 2020 WL 995544, at \*1 (Bankr. M.D.N.C. Feb. 28, 2020)
  - › Question 2: Whether a debtor who did not meet the definition of a small business debtor on the petition date, is eligible to proceed under Subchapter V when it now meets the definition under the SBRA?
  - › Court held that the debtor’s designation as small business debtor controls until the Court determines that it is incorrect, and as of the date the Court reviewed the debtor’s designation, the debtor met the new definition of “small business debtor.”
  - › Debtor benefited from the expanded definition of “small business debtor”
    - Pre-SBRA: excluded “a person whose primary activity is the business of owning or operating real property or activities incidental thereto.”
    - Post-SBRA: excludes “a person whose primary activity is the business of owning single asset real estate.”



# Retroactive Effect of SBRA and CARES Act

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- *In re Body Transit, Inc.*, BR 20-10014 ELF, 2020 WL 1486784 (Bankr. E.D. Pa. Mar. 24, 2020)
  - › Creditor argued that granting the debtor Subchapter V status would infringe on its right to seek appointment of a Chapter 11 trustee who could propose a plan, since § 1189(a) provides that only a debtor may file a plan.
  - › Court held that, in general, Subchapter V does not impair the vested property interests of creditors, and therefore no concerns with retroactive application of the new law.
  - › **Standard:** an objection to the debtor's election to proceed under Subchapter V in a pending case should be sustained if the election was made in bad faith or would unduly prejudice a party.
    - Requires a particularized showing based on the present circumstances of this case; can't be hypothetical concerns
  - › Court agreed with *Progressive Solutions* that, procedurally, a debtor has the right to amend its petition to elect Subchapter V, and the case will proceed under Subchapter V until there's an objection sustained by the Court.

# Retroactive Effect of SBRA and CARES Act

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- *In re: Deirdre Ventura, Debtor.*, 8-18-77193-REG, 2020 WL 1867898 (Bankr. E.D.N.Y. Apr. 10, 2020)
  - › Individual debtor owns and operates a bed and breakfast business at her principal residence.
  - › After the case was pending over 15 months, the Debtor amended her petition (at the Court’s suggestion) after an adjournment of the February 26th confirmation hearing on a creditor plan (shortly after SBRA effective date).
  - › UST and secured creditor filed objections to the amended petition and debtor’s designation under Subchapter V.
  - › Secured creditor argued (1) it had vested rights in the case because it had a pending plan that was set for confirmation (i.e., due process concerns); (2) debtor doesn’t fit definition of “small business debtor”; (3) debtor should be judicially estopped from amending her petition; and (4) mortgage cannot be modified under § 1190(3).

# Retroactive Effect of SBRA and CARES Act

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- *In re: Deirdre Ventura, Debtor.*, 8-18-77193-REG, 2020 WL 1867898 (Bankr. E.D.N.Y. Apr. 10, 2020)
  - › “SBRA is silent as to whether it applies to pending cases”
  - › Court agreed with the previous cases that generally there is no taking or retroactivity concerns with applying SBRA to a pending case.
  - › Court found the secured creditor’s argument re “vested rights resulting from the progress made in the Debtor’s case” misplaced.
    - Question is: whether designation of the debtor as a Subchapter V debtor will impair the secured creditor’s rights *as they existed prior to the effective date of the SBRA*.
  - › But does retroactive application of § 1190(3) defeat vested property interests? Court says “no” under the unique facts of the case.
    - Mortgagee’s debt was previously discharged in prior bankruptcy case, so mortgagee could only look to value of the property. Therefore, bifurcation of the secured claim under 1190(3) will not deprive the secured creditor of any rights retained under state law.
    - But the Court also suggests the answer would be the same even if no prior discharge of personal liability.

# Retroactive Effect of SBRA and CARES Act

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- *In re: Deirdre Ventura, Debtor.*, 8-18-77193-REG, 2020 WL 1867898 (Bankr. E.D.N.Y. Apr. 10, 2020)
  - › Is Mortgagee unduly prejudiced based on history of case? No:
    - “The Court will not penalize the Debtor because after careful analysis by Congress the law has been amended to address the needs of debtors that engage in the type of business she operates. These types of debtors who are willing to risk everything to start and maintain their own businesses should not be penalized, rather, they should be applauded. Gregory will retain many of the rights it had at the inception of the case, any delay caused by this ruling is not sufficiently prejudicial to Gregory, given the current economic conditions.”
  - › Does the debtor qualify as a “small business debtor”? Yes:
    - Question was whether more than 50% of debtor’s debts arose from commercial or business activities.
    - Court found that even though the property was the debtor’s primary residence, the primary purpose of the property is to own and operate a bed and breakfast.

# Retroactive Effect of SBRA and CARES Act

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- *In re: Deirdre Ventura, Debtor.*, 8-18-77193-REG, 2020 WL 1867898 (Bankr. E.D.N.Y. Apr. 10, 2020)
  - › Is the Debtor entitled to utilize § 1190(3)?
    - Debtor and creditor agreed that success of a Subchapter V plan hinges on application of § 1190(3).
    - Court framed the question under § 1190(3)(A) as whether the mortgage proceeds were used primarily to purchase the Debtor's residence, i.e., whether the "primary purpose of the mortgage was to acquire the debtor's residence."
    - Finding it possible for the Debtor to utilize § 1190(3), the Court set an evidentiary hearing to determine its application, using the following factors:
      - Were the mortgage proceeds used primarily to further the debtor's business interests;
      - Is the property an integral part of the debtor's business;
      - The degree to which the specific property is necessary to run the business;
      - Do customers need to enter the property to utilize the business; and
      - Does the business utilize employees and other businesses in the area to run its operations.

# Retroactive Effect of SBRA and CARES Act

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- Did the *Ventura* Court interpret § 1190(3) correctly?
- No dispute that the loan proceeds were used to acquire the debtor's real property. And § 1190(3)(A) requires that the mortgage loan proceeds are “not used primarily to acquire the real property.”
- How does the Court square these two things?
  - › Court makes a slick move by stating that the phrase “real property” in § 1109(3)(A) refers back to the phrase “real property that is the principal residence of the debtor” in the body of § 1190(3), and then framing the question of the applicability of § 1190(3)(A) as “whether the mortgage proceeds were used primarily to purchase the debtor's residence, instead of just the ‘real property.’”

# Retroactive Effect of SBRA and CARES Act

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- Can a debtor in a case pending as of 3/27/2020 take advantage of the new, temporary definition of “debtor” under the CARES Act?
  - CARES Act redefined “debtor” under section 1182 to remove the reference to “small business debtor” and replace with a definition that is exactly the same but with a total debt cap of \$7,500,000 instead of \$2,725,625.
  - CARES Act includes an explicit provision saying the amendment to 1182’s definition of debtor only applies to cases commenced on or after 3/27/2020.
  - Therefore, debtors with cases pending on 3/27/2020 cannot take advantage of the new \$7.5MM debt cap.
    - › BUT, the CARES Act retained the old definition of small business debtor in 101(51D) with a debt cap of \$2,725,625 so that pending cases may still be converted to Subchapter V upon the filing of an amended petition with an appropriate election.

# Retroactive Effect of SBRA and CARES Act

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- Can a debtor that is not conducting business on the petition date qualify for Subchapter V status?
  - › *In re Wright*, 20-01035 (Bankr. D.S.C. April 27, 2020)
  - › Owner of two businesses that liquidated in Chapter 11 filed personally on February 28, 2020
  - › Elected Subchapter V status based on personal guarantees of the business debt (56% of all debts)
  - › US Trustee moved to strike Subchapter V designation, arguing debtor was not “a person engaged in commercial or business activity” because the companies were liquidated.
  - › Court held the owner qualified on his own because he was “engaged in commercial or business activities” by addressing residual business debt and otherwise meeting the requirements under § 101(51D).



Can a Chapter 13 debtor  
convert to a Subchapter V case?

# Can a chapter 13 debtor to convert to Subchapter V?

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- Section 1307(d) allows conversion to chapter 11 before confirmation but only if debtor may be a debtor under chapter 11
  - › Business debts must exceed 50% of the debtor's debts
  - › May not be allowed to convert if total debts exceed \$2,725,625 (or \$7,500,000)
- SBRA designed Subchapter V to act more like a chapter 13, and made chapter 11 easier and cheaper to use for small business debtors previously unable to afford a chapter 11 process
- Useful for small business debtors with debts between the chapter 13 debt limits and the small business debtor debt limits

# Any Questions?



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