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Fixing Ch. 11 For Small Biz: What SBRA Means By 'Engaged'

By **Brian Shaw and Christina Sanfelippo** (February 5, 2021, 4:44 PM EST)

On Feb. 19, 2020, Congress enacted the Small Business Reorganization Act to improve the Chapter 11 reorganization process for small business debtors. In this Expert Analysis series, bankruptcy experts reflect on ways the law has worked — and ways it hasn't — during the past year, a time of crisis for many small businesses.


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As the fallout from the pandemic continues to decimate America's small businesses, many have chosen to take advantage of the Small Business Reorganization Act, or SBRA, and Subchapter V of the Bankruptcy Code, exclusively available to "a person engaged in commercial or business activities ... [with] aggregate noncontingent liquidated secured and unsecured debts as of the date of filing ... of not more" than $2,725,62.[1]

Championed as an easier, less costly path to restructuring, due in large part to the removal of the creditors' committee and absolute priority rule from the restructuring process, it has been largely seen as a successful tool for small businesses.

But can the individual guarantors of those same businesses also avail themselves of the new benefits of the SBRA? And if so, can the individual guarantors do so through an independent filing, rather than as a concurrent filing with the small business itself?

The answer, as explained below, is not clear from either the statute or the case law. However, recent bankruptcy court decisions, as well as the impetus behind the SBRA, provide some guidance to bankruptcy practitioners looking to advise their clients on the best available options for restructuring.

SBRA Overview

The SBRA took effect on Feb. 19, 2020, and Subchapter V became available to the newly defined "small business debtor."[2]

The SBRA was enacted to improve the Chapter 11 reorganization process for small business debtors[3] that had increasingly shied away from bankruptcy — despite their desperate need for bankruptcy relief — because of its costs and administrative burdens, or the prospect of losing their business absent a large injection of new capital.

The SBRA enables small business debtors "to file bankruptcy in a timely, cost-effective manner, and hopefully allows them to remain in business."[4] The SBRA achieves this, in part, by eliminating the absolute priority rule for small business debtors, thereby allowing a debtor's owners to retain their interests in their business without the previously required injection of new capital.

Also important is the SBRA's elimination of the ability of creditors to file a competing plan of reorganization, which provides debtors in Subchapter V with a level of protection not afforded regular

Chapter 11 debtors.[5]

Not surprisingly, the SBRA has become an attractive option not only for small businesses, but also for the individual guarantors of small businesses. These individual guarantors are similarly looking to the SBRA as an attractive alternative to traditional Chapter 11 cases due, in large part, to the absence of the creditors' committee and competing plans of reorganization.

The popularity of the SBRA has inevitably led to challenges to an individual guarantor's designation as a small business debtor under Subchapter V.

So, Are They Engaged?

As noted above, to be eligible for Subchapter V, a debtor must fit within the Bankruptcy Code's new definition of "small business debtor,"[6] which is as follows:

> a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning single asset real estate) 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 $2,725,625 (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.[7]

In this definition, a "person" includes an individual, partnership or corporation.[8]

To date, the challenges leveled at a guarantor's eligibility to use Subchapter V have focused on the phrase "engaged in commercial or business activities" and have argued that a guarantor of a defunct business is not "engaged in" commercial or business activities and cannot independently qualify as a small business debtor under the SBRA.

The Majority View

The majority view is that a debtor need not be currently engaged in business for the small business designation to apply and that an individual guarantor of a small business debtor may elect to use Subchapter V even if the small business is no longer operating.

The U.S. Bankruptcy Court for the District of South Carolina was the first court to consider the issue with a decision in April 2020. In In re: Wright, the individual debtor was the sole member of an LLC as well as the part owner of a corporation.[9]

Prior to the debtor's bankruptcy filing, both of his businesses had ceased operations, filed for bankruptcy and both bankruptcy cases were dismissed.[10] More than half of the individual debtor's debts were business debts related to the defunct businesses.[11]

The court's holding was guided by the plain language of the SBRA, as well as "the specific context in which that language is used, and the broader context of the statute as a whole."[12] The Wright court acknowledged that "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" and the debtor's businesses had ceased operations.[13]

However, the Wright court also emphasized the absence of any temporal qualification in the definition of a small business debtor that qualified the term "engaged in." The court's decision ultimately turned on the fact that nothing within the SBRA, or in the language of the definition of a small business debtor, limits the application to debtors currently engaged in business or commercial activities.[14]

Also, importantly, the Wright court found that the individual debtor's act of addressing residual business debts, itself, constituted being "engaged in commercial or business activities."[15]

Two subsequent cases from the U.S. Bankruptcy Court for the Eastern District of Louisiana and the U.S. Bankruptcy Court for the Central District of California adopted the reasoning of the Wright

court in full.

In In re: Bonert in June 2020, the California bankruptcy court found the SBRA to apply to individual debtors where the majority of the individual debtors' liabilities were business debts stemming from guarantees in connection with their prior operation of a bakery.[16]

Similarly, in July 2020, the Bankruptcy Court for the Eastern District of Louisiana in In re: Blanchard allowed individual debtors to proceed under the SBRA because the majority of the individual debtors' debts stemmed from their guarantees of commercial loans to both currently operating businesses and nonoperating businesses.[17]

The Minority View

In contrast, in December 2020, the U.S. Bankruptcy Court for the Western District of Missouri concluded that the majority view renders the phrase "engaged in commercial or business activities" superfluous. In In re: Thurmon, the individual debtors had ceased operating their business and sold the business's assets months before filing their bankruptcy case, the filing of which was driven by residual business debt.

While the Thurmon court acknowledged the unanimous holding by prior courts, it took issue with the majority's "blank slate" approach to interpreting the SBRA. The more appropriate approach, according to the Thurmon court, was to look at the plain meaning of "engaged in" and prior interpretations of existing provisions of the Bankruptcy Code using similar "engaged in" language.[18]

The Thurmon court implicitly rejected the majority view position that the term "engaged in" contained no qualification, and instead found that it was plainly in the present tense — not in the past or future tense.[19] Moreover, the court held that the plain meaning of "engaged in" means to be actively and currently involved.[20]

Thus, the Thurmon court concluded that "to add the word 'currently' to the phrase 'engaged in' would be redundant, because the currency of the involvement or activeness is inherent in the idea of being 'engaged in' something."[21]

The court found support for its interpretation of "engaged in" in early Chapter 12 case law. Specifically, the court looked to case law from the U.S. Court of Appeals for the Eighth Circuit wherein it examined whether a corporation qualified as a "family farmer" and "compared the active role required to 'conduct' a farming operation with being 'engaged in' a farming operation, observing that both phrases require an active role in the operation."[22]

Ultimately, the Thurmon court reasoned that "if Congress had intended to make all debtors with business debts below the debt cap eligible for subchapter V small business relief regardless of whether the business was still operating, it could have done so."[23]

Conclusion

The SBRA is still a new law, and the cases interpreting it are still few. While there is currently a majority view on the issue of whether or not a debtor must be currently engaged in business for the small business designation to apply, an individual guarantor's ability to use Subchapter V is still an open question in most courtrooms.

That being said, we believe that the majority view is the correct one for a few reasons.

First, while the term "engaged in" is indeed present tense in a vacuum, it can and is often easily qualified, and in the context of its use in Section 101(51D), is arguably ambiguous.

Second, and as correctly noted by the Wright court, the act of addressing residual business debts, in and of itself, constitutes being "engaged in commercial or business activities."[24]

Finally, the minority view's reliance on case law interpreting eligibility under Chapter 12 is arguably flawed.

The relevant Chapter 12 eligibility provisions of the Bankruptcy Code are based, in part, on the nature and sources of that debtor's annual income for the year or years leading up to the petition date. This naturally renders a context in which it rationally appears that, to be an eligible family farmer, a debtor must currently be farming and generating income.

In contrast, the single provision defining a small business debtor only focused on the nature of the debtor's debts and contains no mention of nor qualifications based on sources of income or income at all.

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[1] 11 U.S.C. § 101(51D). The Coronavirus Aid, Relief, and Economic Security Act, enacted on March 27, 2020, increased the eligibility limit for small businesses looking to file under SBRA's subchapter V from $2,725,625 of debt to $7,500,000. The threshold is set to return to $2,725,625 after one year and the expiration date has yet to be extended. See CARES Act; Pub. L. No. 116-136, 134 Stat. 281 (2020).

[2] Pub. L. No. 116-54, 133 Stat. 1079 (2019) (temporarily amended by Pub. L. No. 116-136, 134 Stat. 281 (2020)).

[3] H.R. REP. NO. 116-171.

[4] Id.

[5] 11 U.S.C. § 1189(a).

[6] Notably, whether a person that qualifies as a small business debtor under 11 U.S.C. § 101(51D) avails itself of Subchapter V is entirely a permissive choice that lies with the debtor.

[7] 11 U.S.C. § 101(51D).

[8] 11 U.S.C. § 101(41).

[9] In re Wright, No. CV 20-01035-HB, 2020 WL 2193240, at *2 (Bankr. D.S.C. Apr. 27, 2020).

[10] Id.

[11] Id.

[12] Id.

[13] Id. at *3.

[14] Id.

[15] Id.

[16] In re Bonert, No. 2:19-bk-20836-ER Chapter: 11, 2020 Bankr. LEXIS 1783 (Bankr. C.D. Cal. June 3, 2020)

[17] In re Blanchard, No. 19-12440, 2020 WL 4032411, at *1-*2 (Bankr. E.D. La. July 16, 2020).

[18] In re Thurmon, No. 20-41400-CAN11, 2020 WL 7249555, at *3 (Bankr. W.D. Mo. Dec. 8, 2020).

[19] Id. at *4.

[20] Id.

[21] Id.

[22] Id.

[23] Id. at *5.

[24] Wright, 2020 WL 2193240, at *3.
