9th Circ. Subchapter V Case Clarifies Commitment Periods

By **Brian Shaw and David Doyle** (July 6, 2022)

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Over two years have passed since the Small Business Reorganization Act and its seminal achievement, Subchapter V of the Bankruptcy Code, became effective.[1]

Available solely to small business debtors, Subchapter V provides a scaled down and streamlined alternative to a traditional Chapter 11 reorganization.[2]

One of the most radical changes in Subchapter V involves its standards on cramdown, or confirming a plan over the objection of a dissenting class of creditors.

Unlike in a traditional Chapter 11, the absolute priority rule does not apply in a case under Subchapter V.[3][4] A business owner may retain its equity interest in the debtor even if every impaired class of creditors rejects the plan.

For a cramdown plan to be confirmed, however, the debtor must commit its projected disposable income to funding plan payments over a period of time.[5] The shortest length of this commitment period is three years, yet it can be as long as five years.[6]

So how is the appropriate length of a commitment period decided?

In most instances, it seems obvious that the small business debtor, as the plan proponent, would propose the shortest possible commitment period — three years. And if the plan is consensual, there will likely be no issue with the three-year time period.

However, it is also not too difficult to envision a Subchapter V case in which a creditor demands that the commitment period be longer than three, and as long as five years.

Similarly, a debtor may want to extend the commitment period to five years if, during those five years, the debtor wishes to put some of its otherwise disposable income into growth-focused capital expenditures, which could result in a creditor objecting and demanding a shorter commitment period.

In those instances where there is a dispute about the appropriate commitment period, the applicable statutory language becomes relevant and provides that the commitment period is a "three-year period, or such longer period not to exceed five years as the court may fix."[7]

Until recently, there were few decisions that touched on the appropriate length of a commitment period. However, that changed in April when Legal Service Bureau Inc. v. Orange County Bail Bonds Inc. (In re: Orange County Bail Bonds Inc.), tackled the question and provided some helpful guidance on the topic of the commitment period under Section 1191(c)(2) of the Bankruptcy Code.[8]

Subchapter V Cramdown of Unsecured Creditors — Section 1191(c)(2)

In a traditional Chapter 11 bankruptcy case, the court may not confirm a plan that impairs creditors unless at least one impaired class of creditors votes to accept the plan.[9] In Subchapter V, however, a debtor may cram down its plan even if all impaired nonpriority classes vote to reject the plan, so long as the plan is fair and equitable.[10]

The meaning of fair and equitable represents a further distinction between traditional Chapter 11 cases and Subchapter V. In a traditional Chapter 11, a plan is fair and equitable to dissenting unsecured creditors only if the plan satisfies the absolute priority rule or falls within the new value corollary's limited exception to the absolute priority rule.[11][12]

However, the SBRA eliminated the absolute priority rule for small business debtors. In its place, Congress enacted Section 1191(c)(2), which permits cramdown by the debtor even when every single class of impaired creditors has rejected the plan if the debtor commits to making payments tied to its projected disposable income.

Specifically, Section 1191(c)(2) provides that a plan is fair and equitable if the plan either "commit[s] the debtor's projected disposable income [for the commitment period], or pledge[s] distributions of property having a value of at least that amount."[13]

If the debtor proceeds under subsection (A) of Section 1191(c)(2), the plain language of the statute refers to the debtor's projected, not actual, disposable income during the commitment period.

Thus, if the debtor's actual disposable income turns out lower than projected, the debtor will still be required to make the minimum projected payments unless the plan can be modified.[14] Likewise, if a debtor has a particularly profitable year, it is only required to contribute its projected disposable income as set forth in the plan.[15]

A debtor can avoid making periodic payments of disposable income by satisfying subsection (B) of Section 1191(c)(2). Under this subsection, the debtor may buy the cramdown by committing property to the plan on the effective date that has a present day value of its projected disposable income.

A debtor can satisfy subsection (B) by funding its plan with proceeds from asset sales, available cash, insider loans or capital contributions. This approach provides the debtor with the benefit of certainty regarding its discharge, as it would be otherwise tied to the debtor's successful completion of its required plan payments at the end of the commitment period.

Finally, rather than set a fixed period during which projected disposable income must be committed to the plan, Section 1191(c)(2) provides a range: A "three-year period, or such longer period not to exceed five years as the court may fix."[16]

In re: Orange County Bail Bonds

In Orange County Bail Bonds, the Bankruptcy Appellate Panel of the Ninth Circuit highlighted the flexibility of Section 1191(c) and provided insight into how courts may apply its provisions to determine the appropriate commitment period.[17]

The debtor in Orange County was a bail bond company that entered into a bail bond agreement with a criminal defendant.[18] Global Fugitive Recovery was a skip tracer who was owed by and obtained a judgment against Orange County in the amount of

$327,000.[19]

Orange County subsequently commenced its Chapter 11 bankruptcy case, which it later converted to one under Subchapter V.[20] In its bankruptcy case, Orange County ultimately brought its third amended plan of reorganization and disclosure statement to confirmation, which committed to pay $127,000 payment to Global on its effective date.[21]

The plan further provided that Global would receive additional payments of at least $181,000 from the debtor's actual disposable income produced during a proposed five-year, post-confirmation commitment period.[22] The debtor did not, however, commit finite projected amounts, or their present value, to pay creditors under the plan.

Instead, the debtor committed its actual disposable income earned during the commitment period to make such payments.[23] Global objected to confirmation, including on the basis that the plan did not meet the fair and equitable test under Section 1191(c)(2)(A).

The bankruptcy court confirmed the plan over Global's objection, holding that the plan satisfied Section 1191(c)(2)(A).[24] In the confirmation order, however, the court added that no discharge would be entered unless the aggregate of the pro rata disposable income paid to Global over the commitment period was at least $181,000.[25]

Global appealed the confirmation order to the Ninth Circuit BAP, which affirmed, but did so on other grounds. While the BAP agreed confirmation was appropriate, it disagreed with the bankruptcy court that the plan had satisfied Section 1191(c)(2)(A).[26]

The BAP noted that the plan failed to satisfy the fair and equitable standard under Section 1191(c)(2)(A) because the plan only committed actual disposable income, not projected disposable income as required by the statute.[27] Moreover, the plan never committed to pay its actual or projected disposable income for any particular time period.

Essentially, the BAP refused to let the debtor get the benefit of Section 1191(c)(2)(A) while avoiding the required financial commitment of a sum certain over a time certain.

The BAP also noted that the requirement for Global to receive at least $180,000 from its pro rata share of the debtor's disposable income was not a confirmation requirement, but rather was merely an agreed upon between the parties condition to the debtor receiving a discharge.

As a result, the plan failed to meet Section 1191(c)(2)(A).[28]

On the other hand, because it may affirm a bankruptcy court's decision "on any ground fairly supported by the record," the BAP next considered whether the plan satisfied Section 1191(c)(2)(B).[29]

First, the BAP rejected the debtor's argument that the plan committed value greater than its five-year projection of disposable income of $490,000.[30] The plan only called for a payment on the effective date of $432,000, and nothing in the plan required the debtor to make payments beyond that amount, nor does it appear that the Orange County argued that this amount was equal to the present value of $490,000.

Further, as noted above, while the plan contained projected disposable income for three- and five-year periods, it did not commit the debtor to make such payments over a finite commitment period.

Therefore, in a twist of irony for the parties, the BAP then held that the plan satisfied the confirmation requirements set by Section 1191(c)(2)(B) based on the debtor's projected disposable income for a three-year commitment period.[31]

Specifically, the BAP held that the debtor, by committing a $432,000 payment on the effective date, was committing for payment property of a greater present value than the debtor's projected three-year disposable income of $287,000.

The BAP noted that, under Section 1191(c)(2)(B), the minimum commitment period was three years.[32] And while the bankruptcy court used its discretion to set a five-year commitment period to satisfy Section 1191(c)(2)(A), the BAP held that the record "does not indicate that the bankruptcy court set a longer commitment period" than three years for purposes of Section 1191(c)(2)(B).[33]

Of course, this was in part because no time period was committed to by the debtor. Accordingly, the plan satisfied Section 1191(c)(2)(B) by committing $432,000 on the effective date of the plan — more than the debtor's projected disposable income for the minimum three-year period — and the debtor actually benefited from its omission.

Conclusion

So, what does this early decision on the Section 1191(c)(2) and the length of a commitment period teach us?

First, creditors should review and confirm that the language of a proposed Subchapter V plan properly mimics the language in Section 1191(c)(2) — including utilizing the debtor's projected disposable income for distributions, rather than actual, and setting forth a finite commitment period of between three and five years.

As Global learned, a debtor's failure to do so correctly can adversely affect creditors too.

Second, do not assume that the debtor wants the shortest possible commitment period and the creditors want the longest period, because it translates into more money. In the context of a consensual plan, a debtor may want to spread payments out over five years in order to use capital expenditures to expand and strengthen the business.

In contrast, creditors may be willing to forego two extra years of payments for a little more certainty, and less risk of time.

Third, as a debtor, remember your baseline economic commitment to achieve cramdown — which is the debtor's projected disposable income for a period of three years, not to exceed five years after confirmation — because it is this baseline against which all of your negotiations with creditors for a consensual plan will be based. This baseline establishes what a debtor would be able to force the creditors to take.

So, while not the intent of the debtor in Orange County, when the BAP reversed the bankruptcy court and held the plan with the longer commitment period failed to comply with Section 1191(c)(2)(A), the BAP went right to that baseline minimum and determined that while the plan failed to comply with Section 1191(c)(2)(A), it complied with and would be confirmed under Section 1191(c)(2)(B) — to the apparent benefit to the debtor.

And finally, while one case does not constitute a trend, the BAP's decision to fall back on a three-year commitment period rather than a five-year period when none was identified under Section 1191(c)(2)(B) in the plan is consistent with the common view that three years is the norm and a longer commitment period is for more extraordinary circumstances.

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[1] Small Business Reorganization Act of 2019, PL 116-54, August 23, 2019, 133 Stat 1079.

[2] 11 U.S.C. § 101(51D).

[3] 11 U.S.C. § 1129(b)(2).

[4] Compare 11 U.S.C. § 1129(b)(2)(A)(B) with 11 U.S.C. § 1191(c)(2).

[5] 11 U.S.C. § 1191(c)(2)(A), (B).

[6] Id.

[7] Id.

[8] Legal Service Bureau, Inc. v. Orange Cnty. Bail Bonds, Inc. (In re Orange Cnty. Bail Bonds, Inc.), 638 B.R. 137 (B.A.P. 9th Cir. 2022).

[9] 11 U.S.C. § 1129(a)(8).

[10] 11 U.S.C. § 1191(b).

[11] See 11 U.S.C. § 1129(b)(2)(B).

[12] See, e.g., Bank of America Nat. Trust and Sav. Ass'n. v. 203 N. LaSalle St. Partn., 526 U.S. 434 (1999)

[13] Orange Cnty. Bail Bonds, 638 B.R. at 146.

[14] See, e.g., 8 Collier on Bankruptcy ¶ 1191.04 (16th 2022) ("If the debtor's actual disposable income turns out to be less than the projected disposable income, unless the plan can be modified, the debtor must still pay the minimum amount. If, on the other hand, the actual disposable income turns out to be greater than the projected disposable income, unless the plan specifically provides otherwise, the additional income need not be applied to the plan.").

[15] See id.

[16] 11 U.S.C. § 1191(c)(2)(A), (B).

[17] Orange Cnty. Bail Bonds, 638 B.R. at 146.

[18] Id. at 142.

[19] Id.

[20] Id.

[21] Id. at 146.

[22] Id. at 145.

[23] Id.

[24] Id. at 145.

[25] Id.

[26] Id. at 146.

[27] Id.

[28] Id.

[29] Id. at 147.

[30] Id. at 146.

[31] Id.

[32] Id.

[33] Id.