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New Small Business Reorganization Act of 2019 May Permit "Small Business Debtors" to Modify Their Residential Mortgages

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The Small Business Reorganization Act of 2019 ("SBRA") (11 U.S.C. §§ 1181-1195), signed into law in August 2019, went into effect on February 19, 2020. SBRA will apply in any chapter 11 case where the debtors, either an individual or a business, is a "small business debtor" and elects to opt-in to the newly-created Subchapter V. Under the newly revised definition in the Bankruptcy Code, a "small business debtor" is a debtor engaged in commercial or business activities with no more than $2,725,625 in aggregate secured and unsecured debts, at least one-half of which debts arose from commercial or business activities of the debtor. 11 U.S.C. § 101(51D).

In general, SBRA aims to streamline existing bankruptcy procedures for small business debtors in order to increase such debtors' ability to successfully reorganize. To achieve that goal, the SBRA, among other things, increases small business debtors' ability to negotiate a successful reorganization plan (*see* 11 U.S.C. §§ 1189-1191), reduces procedural burdens and costs, and provides increased oversight, including appointment of trustee and a mandatory initial status conference "to further the expeditious and economical resolution of" the case. 11 U.S.C. § 1188(a).

One new SBRA provision may be of particular interest to our lender clients. Newly-adopted section 1190(3) of the Bankruptcy Code permits "small business debtors" to modify, under certain circumstances, a mortgage secured by a residence. Specifically, the new section provides:

> A plan filed under this subchapter—
>
> (3) notwithstanding section 1123(b)(5) of [the Bankruptcy Code], 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—
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> (A) not used primarily to acquire the real property; and
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> (B) used primarily in connection with the small business of the debtor.

11 U.S.C. § 1190(3).

Readers of our recent client alert (*Bonnie Pollack Recently Obtained a Favorable Decision on Behalf of Secured Lender in Chapter 11 Bankruptcy Case*) will recall that section 1123(b)(5) of the Bankruptcy Code (the so-called "anti-modification provision") prevents a debtor from modifying a mortgage on the debtor's principal residence where the mortgage lien is secured by the debtor's principal residence. *See* 11 U.S.C. § 1123(b)(5) (allowing a chapter 11 plan that "modif[ies] the rights of holders of secured claims, *other than a claim secured only by a security interest in real property that is the debtor's principal residence*, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claim.") (emphasis added). As we discussed in that prior alert, courts have recently found that this section applies to "principal residences" as well as mixed-use properties (*i.e.*, a property which is the debtor "principal residence" *and* has a commercial/business use).

Under the new SBRA provision, the mortgage on the principal residence of the "small business debtor" may be modified if the underlying loan was used primarily in connection with the debtor's small business and not to acquire the residence. As such, while the anti-modification provisions in section 1123(b)(5) of the Bankruptcy Code (in chapter 11 cases) and section 1322(b)(2) of the Bankruptcy Code (in chapter 13 cases) still protect purchase money mortgage lenders from modification of their rights, the new SBRA eliminates similar protections in chapter 11 cases for lenders holding collateral mortgages related to loans made to debtor's small business. Lenders should also be mindful of this new provision when refinancing loans. The new provision may impact situations where the cash taken out as part of the refinance is "primarily" used for debtor's small business. Application of the new section 1190(3) of the Bankruptcy Code to refinancing situations, including the question of whether the term "primarily" as used in the statute simply means more than 50%, will likely be tested in future cases. We will provide alerts on these issues as the parties and courts begin to grapple with these new provisions.

Please note that this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and recipient. If you have questions regarding these provisions, or any other aspect of bankruptcy law, please contact Bonnie Pollack.

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