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IN THIS ISSUE

Bankruptcy Law

Bankruptcy in the Bluegrass

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In 1832, a young man from just outside of Hodgenville, Ky., signed a promissory note for a 50% stake in a small general store in Illinois.[1] The business struggled financially, and a mortgage foreclosure was initiated against the store. [2] As creditors sought judgments, the business "winked out" within two years.[3] After his insolvency, the LaRue County native was still being dunned for his debts 25 years later.[4] Eventually he repaid all of his creditors back and went on to become a lawyer helping individuals file bankruptcy.[5] The debtor-turned-bankruptcy attorney--Abraham Lincoln--went on to become arguably this nation's greatest President and best known attorney.[6]

The U.S. Constitution (Article 1, Section 8, Clause 4) authorizes Congress to enact "uniform Laws on the subject of Bankruptcies throughout the United States."[7] Congress first exercised this authority in 1800, and bankruptcy law has evolved since Lincoln's day to create the safety net millions of Americans and businesses rely upon in times of financial distress.[8] In 2021, not as many individuals and businesses turned to bankruptcy as one might expect. However, that is likely to soon change. Fortunately, as events drive fluctuations in bankruptcy filings, there are thankfully new tools available to respond to the challenges.

BANKRUPTCY FILINGS PLUNGED TO LOWEST NUMBER SINCE 1985.

On March 6, 2020, as the COVID-19 global pandemic reached Kentucky, Governor Andy Beshear declared a state of emergency pursuant to Executive Order.[9] Less than a week later, the World Health Organization declared the COVID-19 coronavirus outbreak a pandemic.[10] Subsequently, all 120 counties in Kentucky declared a state of emergency.[11]

In the ensuing days and weeks, the Governor and the Kentucky Cabinet for Health and Family Services issued stay-at-home orders and mandatory closures of all public-facing businesses that encourage public congregation, including gyms, entertainment and recreational facilities, and theaters. Many forecasted a tidal wave of bankruptcy filings.[12]

However, personal and business bankruptcy filings plummeted nearly 30% for the 12-month period ending September 30, 2021.[13] The number of filings was the lowest in a 12-month period since 1985.[14] Consumer bankruptcy filings, which amounted to approximately 96% of bankruptcies, decreased 29%.[15] Business bankruptcies declined 28%.[16] Chapter 7 bankruptcies were 24% lower; Chapter 11 cases were 31% lower; and Chapter 13s dropped by 39%.[17] In his 2021 Year-End Report on the Federal Judiciary, U.S. Supreme Court Chief Justice John G. Roberts, Jr., attributed the reduction primarily to the COVID-19 pandemic in the form of decreased personal expenditures resulting from state lock-down orders, new and increased government benefit payments, and moratoriums on certain foreclosures and evictions.[18]

FORECLOSURES (THE SEED OF MANY BANKRUPTCIES) CAME TO A HALT UNDER THE CARES ACT AND CONSUMER FINANCIAL PROTECTION BUREAU RULES.

Behind every good bankruptcy, you can usually find a foreclosure. Many circumstances can lead to a bankruptcy filing, however, research suggests that homeowners who file Chapter 13 are usually

seeking to save their home from foreclosure.[19] Foreclosures declined significantly during the pandemic because Congress injected an unprecedented amount of money into the economy and promulgated federal moratoria that prohibited foreclosures.[20] In response to the COVID-19 pandemic, business closures and loss of employment, Congress enacted a $2.2 trillion legislative package under the Coronavirus Aid, Relief and Economic Security Act (CARES Act) on March 27, 2020.[21] Under the CARES Act, borrowers hit hard by the pandemic and having trouble making their mortgage payments were provided with protection from foreclosure with a foreclosure moratorium, which ended July 31, 2021, subject to certain conditions.[22] Borrowers with government backed mortgage loans, which make up about 75% of all mortgages, were also able to use the CARES Act to temporarily stop making their monthly mortgage payments, also known as a forbearance.[23] The U.S. Government Accountability Office found "many single-family mortgage borrowers who missed payments during the pandemic used the expanded mortgage forbearance provision in the CARES Act."[24]

As certain CARES Act protections and federal foreclosure moratoria phased out, the Consumer Financial Protection Bureau (CFPB) amended the federal mortgage servicing regulations effective August 31, 2021.[25] The driving force behind the CFPB's actions was to "help protect mortgage borrowers from unwelcome surprises as they exit forbearance."[26] The CFPB Acting Director Dave Uejio argued an "unchecked wave of foreclosures" would drain billions of dollars in wealth from communities hardest hit by the pandemic and would "risk destabilizing the housing market for all consumers."[27]

The new rules required mortgage servicers to redouble their efforts to work to prevent avoidable foreclosures by allowing eligible borrowers to move missed payments to the end of the mortgage, commonly called "deferral," as well as being able to lower their monthly mortgage payments through loan modifications, or sell their homes where sufficient equity exists.[28]

The CFPB recognized that in some situations a foreclosure is unavoidable and allowed a foreclosure to start if the borrower did the following: abandoned the property; was more than 120 days behind on the mortgage before March 1, 2020; was more than 120 days behind on mortgage payments and had not responded to specific required outreach from the mortgage servicer for 90 days; or had been evaluated for all non-foreclosure options, to no avail.[29] One-hundred twenty days from the August 31, 2021 effective date of the federal mortgage servicing regulations was December 29, 2021, which is one reason foreclosures filings have now started to increase.[30]

BANKRUPTCY DEBTORS IMPACTED BY COVID-19 PERMITTED TO STAY IN BANKRUPTCY TWO TO FOUR YEARS LONGER.

The CARES Act also contained changes to the Bankruptcy Code. One significant change is a new provision that allows a Chapter 13 plan confirmed before March 27, 2021 to be modified if "the debtor is experiencing or has experienced a material financial hardship due, directly or indirectly, to the coronavirus disease."[31] Chapter 13 Plans are permitted by law to last three – five years. However, the CARES Act bankruptcy plan modifications allow for an extension of plan payments for up to seven total years. Although the plan modifications originally had to be filed by Mach 27, 2021, the COVID-19 Bankruptcy Relief Extension Act of 2021 extended the deadline to file a modification to March 27, 2022.[32]

IN 2021, KENTUCKIANS FILED MORE BANKRUPTCIES *PER CAPITA* THAN 44 OTHER STATES AND COULD REACH THE TOP FIVE AS VICTIMS OF TORNADOES IN KENTUCKY ARE LIKELY TO TURN TO BANKRUPTCY.

Bankruptcy filings in 2021 were down overall across the United States, however, more Kentuckians filed bankruptcy *per capita* than in 44 other states.[33] Kentucky's *per capita* share rose even though Kentucky is only the 26th most populous state.[34] Kentucky's new rank of 6th in the country displaced its former 9th place ranking in 2020.[35]

The storms of recent months may lead to even more filings. On December 10 and 11, 2021, a powerful severe weather system generating tornadoes and strong straight-line winds ripped through the Commonwealth of Kentucky, causing death and injury, flash flooding, and damage to infrastructure and properties.[36] Initial damage estimates of $18 billion "in total damage and economic loss" make it the costliest tornado outbreak in U.S. history.[37] Research shows that many disaster victims eventually turn to bankruptcy for help.[38] One study, which analyzed bankruptcy filing rates after a major hurricane, reveals bankruptcy filings are typically about 50% higher in states that have suffered a direct hit.[39] The study concludes bankruptcy filings drastically increase in the second and third year following a natural disaster, as most survivors are not focused on their financial affairs immediately after such disaster.[40]

Data shows that the location of a natural disaster can also have significant impact on the need to file for bankruptcy.[41] For example, when the damage occurs in regions where there are many low-cost homes, FEMA payments are lower, and corresponding bankruptcy filings are higher.[42] The highest increase in bankruptcy filings in decades occurred when Hurricane Elena hit Mississippi in 1985, resulting in a 71.8% bankruptcy-filing increase in the following three years. [43]

One might ask, how do you provide the paperwork necessary to file a bankruptcy when your house was destroyed by a tornado? In the past, the U.S. Trustee Program, the component of the Department of Justice responsible for overseeing the administration of bankruptcy cases, has issued relaxed bankruptcy enforcement guidelines to take into account the hardships experienced by victims of natural disasters.[44] For example, after the 2005 hurricanes ravaged the Gulf Coast region, U.S. Trustees did not file enforcement motions against debtors unable to produce documents and temporarily waived

statutory requirements for credit counseling for bankruptcy filers in Louisiana and the Southern District of Mississippi due to the effects of Hurricane Katrina.[45] For small businesses, U.S. Trustees did not take enforcement actions against filers who, as a result of the Gulf Coast natural disasters, could not reasonably have been expected to perform statutory duties such as attending an initial debtor interview or file financial reports.

SUBCHAPTER V: A NEW TYPE OF BANKRUPTCY MAY PROVIDE RELIEF TO KENTUCKY SMALL BUSINESSES.

The Small Business Reorganization Act of 2019 (SBRA)[46] took effect in February 2020, less than a month before then President, Donald J. Trump, proclaimed the COVID-19 pandemic a national emergency.[47] The SBRA added a new subchapter V to Chapter 11 of the U.S. Bankruptcy Code, which many Kentucky businesses may elect to use in 2022. Congress recognizes that small businesses, typically family-owned businesses, startups, and other entrepreneurial ventures "form the backbone of the American economy."[48] According to the Small Business Administration Office of Advocacy, approximately 20% of small businesses survive the first year, but by the five-year mark only 50% are still in business and by the 10-year mark only one-third survive.[49] We should note that these statistics are generalized and do not factor in Kentucky businesses at specific risk of closure after the 2021 tornados or based on the COVID-19 pandemic.

Chapter 11 of the U.S. Bankruptcy Code is a well-known form of bankruptcy relief that is typically used by businesses to reorganize their financial affairs, while giving the business a "financial breathing spell" from most creditor collection efforts.[50] In general, the Chapter 11 process requires the debtor to propose a plan of reorganization pursuant to which the debtor commits to repay its creditors.[51] The plan is voted upon by the debtor's creditors and the bankruptcy court must make certain findings (e.g., the plan was proposed in good faith and it complies with specified payment priorities).[52] The appointment of a case trustee is a rarity in a Chapter 11 case, and there are often delays in the formulation and confirmation of a plan.[53]

While most Chapter 11 business cases are filed by small, not big, business debtors, Congress found that small business debtors are often "the least likely to reorganize successfully."[54] In response to that concern, Subchapter V was created to allow certain distressed small businesses to file a streamlined Chapter 11 case with the goal to make small business bankruptcies faster, cheaper, and more likely to succeed.[55] Under the SBRA, small business debtors, defined as debtors with less than $2,725,625 in noncontingent liquidated debts that also meet other criteria, may elect to have their case administered under Subchapter V. The $2,725,625 threshold debt amount was temporarily increased, twice, to $7.5 million for cases filed between March 27, 2020, and March 27, 2022.[56]

SBRA's key provisions, which resemble Chapter 13 Bankruptcy cases in some ways, seek: to increase a debtor's ability to negotiate a successful reorganization while retaining control of the business; to reduce "unnecessary procedural burdens and costs" by eliminating the creditors' committee and disclosure statement requirements for the plan of reorganization; and to increase oversight and ensure quick reorganizations.[57] Under SBRA, a Subchapter V Trustee is appointed to the case, whose purpose is to exercise appropriate business and professional judgment to promote the expeditious administration of the case and facilitate a consensual plan.[58]

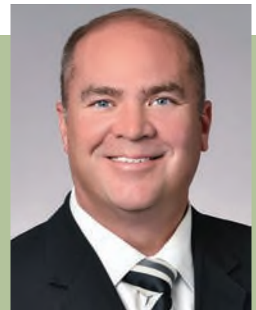
The major changes to Chapter 11 made by SBRA for small business cases in which the debtor elects to proceed under Subchapter V are:

- A trustee is appointed in every case tasked primarily with facilitating a consensual plan.
- The court conducts a mandatory status conference within the first 60 days of the case.
- There is no required disclosure statement for the plan of reorganization or mandatory unsecured creditors' committee, unless the court orders otherwise.
- Only the debtor may file a plan, but it must do so within 90 days of the petition date.
- Plans may be confirmed consensually or non-consensually (often referred to as a "cramdown" plan), each of which leads to different results for trustee retention, modification requirements, and timing of discharge.
- Debtors are not required to pay quarterly fees to the U.S. Trustee. [59]

BLACK SWAN EVENT BANKRUPTCIES

As the twin black swan events of COVID-19 and the Kentucky Tornadoes continue to playout over the months and years to come, there is a certainty that Kentuckians will need bankruptcy relief and representation to overcome these hard times. All roads in Kentucky point to increased consumer and small businesses bankruptcy filings and a growing need for Subchapter V and the other bankruptcy tools. B&B

ABOUT THE AUTHORS



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