Recent Changes in the Bankruptcy Code for Small Businesses in Era of COVID-19

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No business wants to end up in bankruptcy court. However, when faced with insurmountable financial difficulties, it may be the best or only option. Chapter 11 is the chapter of the Bankruptcy Code that allows a business entity to continue operating under existing management while restructuring its debts and paying them off over time. The linchpin of Chapter 11 is the debtor's plan of reorganization, which must be approved by its creditors and the Bankruptcy Court. Chapter 11 differs markedly from Chapter 7, in which the debtor's business operations are typically shut down and its assets liquidated by a court-appointed bankruptcy trustee, with any net proceeds going to creditors.

Chapter 11 requires the preparation of a reorganization plan and entails a drawn-out process to obtain plan approval from creditors and the Bankruptcy Court. This plan approval process alone presents a significant obstacle to small businesses seeking to reorganize under Chapter 11 because it can be costly and time consuming. The complexity of Chapter 11 may serve as a deterrent to some small businesses and has created a perception that it is geared towards large, highly complex businesses.

Congress recently enacted significant changes to Chapter 11 that streamline the process for small businesses and may make it a more viable option for distressed small businesses. The first set of changes were made in February 2020, while the second set were made in March as part of the massive federal response to the coronavirus pandemic. While a full discussion of all the changes recently effected by these statutes is beyond the scope of this bulletin, some of the significant changes are discussed in turn below.

The Small Business Reorganization Act

Effective February 2020, Congress enacted the Small Business Reorganization Act ("SBRA"), which added a new Subchapter V to Chapter 11 of the U.S. Bankruptcy Code that is specific to small businesses. The SBRA, also referred to as "Subchapter V," created special rules for small businesses seeking to restructure their debts through a Chapter 11 bankruptcy. It was enacted to address the already-existing issues of Chapter 11 (*i.e.,* pre-COVID-19) that have historically prevented some small businesses from taking advantage of the protection afforded by Chapter

11. The core provisions of the SBRA - discussed below - make it easier for small businesses to reorganize by increasing the debtors' ability to negotiate a successful reorganization plan and retain control of its business, and reducing unnecessary procedural burdens and costs, while somewhat increasing oversight.

The Coronavirus Aid, Relief, and. Economic Security Act

One month after the enactment of the SBRA, Congress passed theCoronavirus Aid, Relief, and Economic Security Act ("CARES Act") in response to the rapid spread of COVID-19, which is intended to provide a broad range of relief to individuals and businesses adversely affected by the COVID-19 pandemic. The financial fallout from government-mandated lockdowns may lead to an increase in bankruptcy filings. Among the different forms of relief offered under the CARES Act are temporary amendments to the recently enacted SBRA, again specifically targeted to small business debtors. These provisions are designed to further alleviate the burdens faced by small businesses that may file Chapter 11 bankruptcy in the wake of COVID-19.

Small Business Bankruptcy under the SBRA and CARES Act

While certain provisions of both the SBRA and CARES Act make it easier for small businesses to file Chapter 11 bankruptcy (*e.g.,* by making it more streamlined and giving the debtor more control), other aspects may make it more difficult to file for Chapter 11. Among the key changes effected by the SBRA and CARES Act pertaining to small business reorganizations are:

1. The SBRA eliminates potential competing plans by creditors by permitting only the debtor to file a plan of reorganization, which will prevent contested hearings by creditors that could otherwise increase the costs and duration of the proceeding. However, the SBRA also shortens the time period for the debtor to file its plan to 90 days (as opposed to 120 days for other Chapter 11 debtors);
2. The SBRA eliminates the requirement for a disclosure statement (the detailed, court-approved disclosure that must be made to creditors in connection with a proposed reorganization plan);
3. The SBRA makes it easier for a small business to obtain approval of its reorganization plan over creditors' objections by permitting a bankruptcy court to approve a plan even without creditor support as long as it is "fair and equitable" and does not "discriminate unfairly" against classes of creditors;
4. Under the SBRA, the standard that a plan be "fair and equitable" is relatively low, requiring only that the plan provide that all projected business disposable income for three to five years will be used for making payments under the plan;
5. The SBRA allows a small business debtor to modify the rights of a creditor who has a security interest in the debtor's principal residence, as long as the loan secured by the principal residence was not used to acquire the residence but was used in connection with the debtor's business;

6. Under the SBRA, a trustee will be appointed by the Bankruptcy Court to provide general oversight and ensure that the debtor remains on track with its reorganization plan. This is a significant change from a typical Chapter 11, in which a trustee is appointed only on motion of a creditor where certain conditions are met;
7. The SBRA eliminates the quarterly fees that must be paid to the United States Trustee based on disbursements under Chapter 11, which could result in a substantial cost reduction depending on the amount of the debtor's disbursements during each quarter;
8. The CARES Act temporarily triples (from $2,725,625 to $7,500,000) the maximum amount of debt a small business can have to be eligible for filing Chapter 11 under Subchapter V. However, this increase applies only to cases filed *after* the CARES Act and expires after one year, at which point the debt limit will revert to $2,725,625.
9. Federal COVID-19-related emergency relief payments provided to small businesses under the CARES Act are excluded from the definitions of the debtor's "current monthly income" and "disposable income" as it relates to court approval of the debtor's payments under the reorganization plan.

Key Considerations

Given the infancy of the SBRA and CARES Act, it is important to keep in mind the lack of any legal precedent interpreting or applying these new laws. As with most new legislation, it is impossible to predict how courts will ultimately interpret and apply them. It may be the case that courts initially apply these new laws narrowly, for the very reason that they are so new and the courts lack the experience and understanding of the laws that may otherwise persuade a judge to expand its interpretation and apply them more broadly.

Second, while many of the provisions in the SBRA and CARES Act provide more control and flexibility to the small business debtor, certain aspects limit this freedom, such as the mandatory appointment of a trustee to each small business debtor filing under Chapter 11. Therefore, tied to the additional freedom afforded to small businesses is also somewhat more oversight.

Third, it is important to note that the changes established under the CARES Act, including the debt threshold and exemption of federal payments from income, will come to an end within one year. However, the unrelated SBRA will remain in effect, as it was established prior to and independent of the COVID-19 pandemic.

Stone Pigman's Bankruptcy Practice Group is ready to assist the firm's clients on matters involving bankruptcy and creditor's rights.