COVID-19: The Small Business Reorganization Act and CARES Act

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We are living in unprecedented times, with businesses across all industries reporting cash shortages and fear of failure as result of the broad shutdowns caused by the COVID-19 pandemic. Of particular concern to Americans, as voiced widely on social media, is the financial health and the future of their favorite main street businesses. Americans are openly asking what will become of their local coffee shop, the indie bookstore down the street, or neighborhood restaurant.

Main street businesses are more than a concept, or a place, or the products they sell. 99% of American businesses are small businesses, and nearly 48% of U.S. workforce is employed by a small business. Indeed, main street businesses are the people behind them, and when small and medium-sized businesses fail, they lose a lot more than their balance sheet.

Unfortunately, when main street businesses have turned to chapter 11 of the Bankruptcy Code to reorganize and try to save their business in the past, they have found a broken system. Prior amendments to the Bankruptcy Code aimed at helping main street businesses have failed. For instance, the 2005 amendments to the Bankruptcy Code imposed unrealistic deadlines for most small businesses and contained provisions, such as the absolute priority rule, that facilitated the demise of those businesses before they had an opportunity for success.

However, in what appears to be an incredibly well-timed turn of events, the Small Business Reorganization Act (SBRA) of 2019, also known as subchapter V of Chapter 11 of the Bankruptcy Code, went into effect February 19, 2020. The SBRA provides main street businesses with a streamlined approach to restructuring their debts, with the aim of reducing liquidations and saving jobs.

Moreover, the Coronavirus Aid, Relief and Economic Security Act, or CARES Act, passed by Congress and signed into law by President Trump on March 27, 2020, contains additional provisions to help struggling main street businesses. Specifically, the CARES Act significantly amends the newly enacted SBRA to include a larger swath of potential debtors.

With this new toolbox, and a dearth of reported case law interpreting the SBRA, courts should be in a position to help small business debtors more than ever before.

Does Subchapter V of Chapter 11 Apply to Your Business?

New subchapter V of Chapter 11 is devoted to small business debtors and its value is in its efficiency and low cost. Subchapter V of chapter 11 is voluntary and optional; only the debtor may elect to have the subchapter apply to it. The provisions apply broadly to most commercial enterprises, including real estate operations, although it does not include single asset real estate businesses.

The provisions of the SBRA are available to a small business, which prior to the passage of the CARES Act was defined as a business having no more than $2,725,625 in secured and unsecured debt.

However, the CARES Act amends the SBRA to increase the eligibility threshold for businesses filing under subchapter V of chapter 11 from $2,725,625 of debt to $7,500,000. The eligibility threshold would return to $2,725,625 after one year.

The SBRA Provides for a Quicker Resolution

The goal of any debtor in a chapter 11 case is to obtain a plan that restructures and, ideally, reduces debt. However, a traditional chapter 11 plan mandates procedures and timing that are costly for a small business debtor. The SBRA changes that in the following ways:

- The SBRA does away with the disclosure statement. This saves a small business debtor considerable time and money in not having to circulate to creditors and get a disclosure statement approved by the court. For those who are unfamiliar with the disclosure statement process in a traditional chapter 11, the process is often fraught with creditor objections, which increases both the time and expense involved with approval.
- There are no committees of unsecured creditors under the SBRA. This is beneficial to a small business debtor because it saves them expense — creditors' committees are paid for by the debtor in a traditional chapter 11— and prevents creditors from leveraging their interests against those of the debtor.
- The SRBA contemplates the appointment of an "estate neutral" trustee, meaning a trustee that doesn't operate the business. Importantly, the small business debtor remains in control of the bankruptcy as debtor-in-possession. But unlike a traditional chapter 11, a subchapter V trustee is required to help the debtor make a plan of reorganization, which should benefit the small business debtor. A subchapter V trustee will also benefit the debtor in reviewing and objecting to claims, ensuring the debtor is making plan payments and, in some cases, making adequate protection payments.

The SBRA Provides for a More Affordable Path for Main Street Debtors

Under the traditional provisions of chapter 11, a debtor has 120 days to propose a plan. During this 120-day period, money is being drawn out of the estate in the form of attorneys' fees, US Trustee quarterly fees, and the expense of a creditors' committee, among other costs.

In contrast, under the SBRA, a debtor has 90 days to file a plan, which limits attorneys' fees. And, importantly, there are no US Trustee quarterly fees in a SBRA case, which can be a significant cost savings for the debtor. Further, a debtor can stretch the payment of administrative expense claims out over the term of their plan, which may be anywhere from three to five years.

The SBRA'S Flexibility Makes It More Effective for Main Street Debtors

The SBRA may be more effective than a traditional chapter 11 case. Under the SBRA, only the debtor may file a plan and only the debtor may modify the plan. And there is more flexibility in the plan process; while a plan must be filed within the first 90 days, it may also be modified any time before the effective date of confirmation.

Perhaps most importantly for small and mid-size business owners, who have not worked their entire lives to lose their businesses at the end of a chapter 11 case, there is a mechanism under the SBRA allowing existing owners of the debtor to retain their equity over the objection of a class of unsecured creditors.

In contrast, in a traditional chapter 11, existing owners of the debtor can only retain their equity over the objection of unsecured creditors only if all creditors are paid in full or if the existing owners provide additional funding or other consideration.

Under the SBRA, owners can retain equity in their business if they commit all disposable income of the debtor to pay creditors over a three-to-five-year period. And interestingly, there may be ways to cramdown unsecured creditors if a debtor is able to pay the value of the debtor's projected disposable income over three-to-five years in a lump sum, perhaps presenting opportunities for exit financing that get the debtor out of bankruptcy even sooner.

These are unquestionably difficult times for small and mid-size businesses alike. However, the SBRA, in combination with the CARES Act, may provide a valuable tool in the toolbox for distressed main street businesses negotiating with creditors both in and outside of bankruptcy.

Bailey Glasser stands ready to help small businesses struggling with overwhelming debts resulting from the COVID-19 pandemic.

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