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Client Alert: Enhanced Debt Relief Under the CARES Act – Leverage for Small Businesses

By Rion M. Vaughan on June 8, 2020

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To date, much of the discussion regarding the Coronavirus Aid, Relief, and Economic Stability Act (the "CARES Act") has been focused on the provisions of its Paycheck Protection Program (the "PPP"), which provides forgivable loans to small businesses based upon two and half months of their average payroll costs. The PPP has been incredibly successful in stemming the initial economic shock caused by the COVID-19 pandemic. However, now that the dust is settling, many businesses are confronting harsh realities as they attempt to adjust operations to the "new normal". The assumptions of pre-COVID business models and capital structures often don't match the post-COVID world, and the PPP is insufficient to bridge the gap.

For small businesses in this situation, the CARES Act has a remedy. The CARES Act amended the Small Business Reorganization Act of 2019 (the "SBRA") to increase the eligibility threshold for businesses filing under new subchapter V of chapter 11 of the Bankruptcy Code ("Subchapter V"), from $2,725,625.00 of debt to $7,500,000.00.

The SBRA was enacted in August 2019, and went into effect in February of 2020. The SBRA's most significant contribution to the Bankruptcy Code is contained in Subchapter V. Subchapter V provides small business debtors with significant benefits that would be unavailable in a traditional chapter 11 reorganization. When the SBRA originally went into effect, the eligibility "debt ceiling" was $2,725,625.00 – any business with debts totaling above this amount would be forced to file a traditional chapter 11 case. By essentially tripling the debt ceiling to $7,500,000.00, Congress has provided larger small businesses with significant leverage over their secured lenders and other creditors as they restructure operations for the post-COVID world. Compared to a traditional chapter 11 process, Subchapter V has significant benefits to potential debtors, including but not limited to the following:

1. Subchapter V cases are designed to be faster than traditional chapter 11s. Under Subchapter V, a debtor is required to file a plan of reorganization within 90-days of start of the case. A Subchapter V plan of reorganization does not require a separate disclosure statement to be approved by the court. In many cases, the plan deadline will arrive before the deadline by which creditors of the Subchapter V debtors must file their proofs of claim against the Debtor. While it might seem like a problem for a debtor to file a plan before they know who they are paying, Subchapter V plans require far less detail than a traditional chapter 11 plan in order to survive the confirmation process.
2. Subchapter V cases should be more affordable than traditional chapter 11s for a number of reasons. First, tighter timeframes for confirmation means less time spent for Debtor and legal counsel. Second, the disclosure requirements in Subchapter V cases are somewhat relaxed compared to a traditional chapter 11, which depending on the nature

of the business, may reduce the need to engage an outside accounting firm in the bankruptcy case. Third, Subchapter V cases do not have a committee of unsecured creditors. In a traditional chapter 11 case, a committee of unsecured creditors is appointed by the United States Trustee. The committee may then employ its own professionals, and typically does so at the Debtor's expense. In a Subchapter V case, the role of the committee is replaced by a standing Subchapter V trustee, with more strictly defined obligations than a creditors' committee in a traditional chapter 11 case. Finally, the administrative expenses of a Subchapter V case may be paid over a period of three to five years. Comparatively, in a traditional chapter 11 case, all administrative expenses must be paid upon the effective date of the plan– unless the administrative claimant agrees otherwise- or the plan may not be confirmed. This is typically a high upfront cost for small businesses with struggling cash flows, and will likely result in more confirmable cases.

3. Subchapter V cases have a lower threshold for confirmation compared to traditional chapter 11 cases. In a traditional chapter 11 case, a debtor's plan cannot be confirmed unless at least one class of creditors whose rights are "impaired" under the plan votes to accept the plan. Comparatively, a Subchapter V plan of reorganization can be confirmed even if all impaired classes of creditors vote against the plan.
4. Subchapter V equity holders may keep their equity interests in the business even when unsecured creditors are not paid in full under the plan. This is a significant departure from the "absolute priority rule" of traditional chapter 11 cases, which prohibits equity holders from retaining their interest in the debtor unless the debtor's unsecured creditors are paid in full, or – when the unsecured creditors vote to approve the plan- the equity holder contributes "new value" to the debtor. Under Subchapter V, equity holders may retain their equity interest in the debtor provided that the plan allocates all of the Debtor's "projected disposable income" to the payment of unsecured creditors during the three to five year period covered by the plan. "Disposable income" is defined as that income that is not reasonably necessary to be expended for the "continuation, preservation, or operation of the business of the debtor."

Currently, the Subchapter V provisions of the CARES Act are set to expire on March 27, 2021, after which the eligibility "debt ceiling" for a Subchapter V debtor will revert to their pre-COVID levels. That is, of course, unless Congress decides to extend this sunset provision. It is difficult to predict what will happen in the next month in the current climate, and the fate of the expanded Subchapter V eligibility is no different. Still, for the next few months, debtors may avail themselves of these enhanced protections.

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