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(Not-So) Small Business Reorganization Act: CARES Act Expands SBRA Eligibility

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On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") went into effect. While coverage of the CARES Act has focused primarily on tax relief and provisions to extend loans and other forms of assistance to impacted businesses and individuals, the law also temporarily expanded eligibility for companies seeking bankruptcy protection under the recently enacted Small Business Reorganization Act of 2019 ("SBRA"). As described below, the SBRA encourages small businesses to more frequently use chapter 11 by making certain debtor-friendly changes to the rules that would ordinarily govern the chapter 11 process. Combined with temporarily increased access to the SBRA and the anticipated downturn in the economy, it is important for lenders to distressed small businesses to understand the basic provisions of the SBRA.

SBRA Background and Expanded Eligibility

The SBRA, which went into effect on February 19, 2020, was designed to address concerns that the traditional chapter 11 process is too expensive and time-consuming for most small businesses. While nominally available to businesses of all sizes, the traditional chapter 11 process is a better fit for larger distressed companies.

To make chapter 11 more viable for small businesses, Congress passed the SBRA. Prior to passage of the CARES Act, a small business could have no more than $2,725,625 of noncontingent, liquidated debt—at least 50 percent of which must arise from "commercial or business activities"—to qualify for SBRA relief. Cases filed under the SBRA are referred to as "Subchapter 5" cases. Barely a month after the SBRA went into effect, Congress increased this debt limit to $7,500,000 to expand access to the SBRA amid growing concerns about the economy as a result of COVID-19 and the economic impact of governmental measures

designed to counteract the pandemic. This expanded eligibility is subject to a sunset clause, however, and absent further extension by Congress, a business with noncontingent, liquidated debts between $2,725,625 and $7.5 million will only be eligible for SBRA relief until March 27, 2021. Further, a small business already in a pending chapter 11 case as of March 27, 2020 cannot convert to a Subchapter 5 to take advantage of the increased debt limit.

Key Provisions of the SBRA

The SBRA introduces a number of changes to streamline chapter 11 for eligible small business debtors. While a full review of all changes in the SBRA is beyond the scope of this alert, those changes include the following:

Elimination of the Absolute Priority Rule. Under the Absolute Priority Rule, an owner of a bankrupt business generally cannot retain his or her equity interest unless all creditor classes vote to accept the plan of reorganization or are otherwise paid in full. Consequently, equity holders wishing to "retain" an equity stake in the reorganized business typically need to provide "new value" (almost always, additional capital) into the business. The rapidly deteriorating and uncertain economic environment may discourage or inhibit equity holders from investing new capital into their businesses.

The SBRA eliminates the Absolute Priority Rule. Instead, the debtor may retain ownership of the business even if unsecured creditors are not paid in full, so long as the plan provides for the payment of all of the business's projected "disposable income" over a three-year period or "such longer period not to exceed five years as the court may fix…"

Faster Time to Confirmation and More Control. In a traditional chapter 11 proceeding, a debtor has the exclusive right to file a plan of reorganization for the first 120 days of the case. Bankruptcy courts frequently extend this "exclusivity period" for debtors. Furthermore, a plan proponent must also obtain the bankruptcy court's approval of a "disclosure statement"—a document that sets forth, among other things, the history of the debtor, the events to date in the debtor's chapter 11 proceeding and the key terms of the plan—all prior to soliciting any votes on the plan. As a result of these considerations (and more), it may be many months—if not a year or more—before a plan is confirmed in a non-SBRA chapter 11 case.

Under the SBRA, however, only a debtor may propose a plan, and the debtor must, absent "circumstances for which the debtor should not justly be held accountable," do so within 90 days of filing for bankruptcy. Therefore, a chapter 11 plan is much more likely to be filed and confirmed within a reasonable amount of time in an SBRA case.

No Mandatory Creditor Support. A chapter 11 plan normally requires at least one class of "impaired" creditors (*i.e.*, creditors whose rights are being altered or modified in any manner) vote to accept the plan of reorganization if any class of creditors votes to reject the plan. The SBRA eliminates this requirement, and, a plan that otherwise satisfies the confirmation

requirements may be confirmed without any creditor support.

No Creditors' Committee. In most chapter 11 cases, a committee of creditors holding unsecured claims (frequently referred to as a "UCC") is appointed. The debtor often expends significant resources providing diligence and discovery materials to the UCC, further complicating and slowing down the reorganization process. In a Subchapter 5 case, the bankruptcy court may only appoint a UCC "for cause." While the precise meaning of cause will be developed through case law, commentators are unanimous that a UCC should be the exception—not the rule—in SBRA proceedings.

Conclusion

The COVID-19 pandemic has dramatically increased the likelihood of a severe and/or sustained economic downturn, which may be felt most severely by small businesses that lack the resources to withstand a sustained decrease in economic activity. Based on that pressure and the increased eligibility of up to $7.5 million in debt allowed by the CARES Act, we anticipate that many small business debtors will seek relief under the SBRA in the coming months. During these difficult times, it is important for financially distressed companies considering bankruptcy protection—and their creditors—to familiarize themselves with their rights under the SBRA and the streamlined chapter 11 process.

If you have any questions about the CARES Act and SBRA proceedings, please contact any member of the Creditors' Rights & Bankruptcy team.