Client ALERT

The New CARES Act Provides Temporary Debt Limit Increase for "Small Businesses" to Restructure Debts Under Subchapter V of Chapter 11 (among other amendments to the Bankruptcy Code)

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First, what is Subchapter V? The *Small Business Reorganization Act of 2019* (the "SBRA"), which became effective on February 19, 2020, amended Chapter 11 of the United States Bankruptcy Code[1] by adding a completely new Subchapter V. Under the SBRA, eligible debtors (individuals and business entities) can restructure their debts and obligations through a Chapter 11 plan approved by the bankruptcy court under Subchapter V. The goal is to promote small business reorganization while reducing the time and expenses generally associated with a typical Chapter 11 reorganization. The SBRA originally used the "small business debtor" definition under the Bankruptcy Code that requires the following:

(i) the debtor to be engaged in commercial or business activities (excluding a debtor whose primary activity is the business of owning single asset real estate);

(ii) the debtor to have aggregate non-contingent liquidated secured and unsecured debts in an amount no more than $2,725,625.00 (not including debts owed to affiliates or insiders); and

(iii) at least 50% of the prepetition debts must be from commercial or business activities.

Amendment to the SBRA/ Subchapter V:

The new *Coronavirus Aid, Relief, and Economic Security Act* (the "CARES Act"), signed into law on March 27, 2020, amended the SBRA to increase the debt limit from 2,725,625.00 to $7,500,000.00 for eligible debtors that elect to restructure their financial affairs under Subchapter V of the Bankruptcy Code. As a result, more businesses will qualify for relief under Subchapter V. This amendment will apply to petitions filed after the enactment of the CARES Act, but the increased debt limit is set to return to $2,725,625.00 after one (1) year.

Key Tradeoffs for Debtors and Creditors Under Subchapter V:

As mentioned above, Subchapter V provides an easier path for debtors to confirm a Chapter 11 plan. Some of the confirmation requirements in a typical Chapter 11 case do not apply to a Subchapter V case which will greatly benefit the Subchapter V debtor. For example, current ownership of the business can be preserved even if unsecured creditors are not being paid in full (in a typical Chapter 11 case, unsecured creditors must be paid in full before owners are permitted to retain their equity interests, subject to certain limited exceptions).

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[1] Title 11 of the United States Code, 11 U.S.C. §§ 101 et seq. (the "Bankruptcy Code").

However, for the Chapter 11 plan to be confirmed under Subchapter V it is still required that such plan be "fair and equitable" to creditors. This "fair and equitable" condition requires that the total amount of the debtor's "projected disposable income" (defined under the Bankruptcy Code) be contributed to the plan or set the floor for the minimum value of the property to be distributed under the plan should not be less than the debtor's projected disposable income. In addition, the Subchapter V debtor should be ready to move quickly and file the proposed Chapter 11 plan within 90 days of the petition.

Other Amendments to the Bankruptcy Code Under the CARES Act:

The CARES Act excludes from the definition of "small business debtor" under the Bankruptcy Code any debtor that is an affiliate of an issuer (as defined in section 3 of the Securities Exchange Act of 1934). [2]

There are other amendments to the Bankruptcy Code that would benefit consumer debtors. First, the exclusion of COVID-19 related payments from the definition of "current monthly income," and the definition of "disposable income" for Chapter 13 cases. Second, the option for an individual Chapter 13 debtor to modify a previously confirmed plan in the event of a material financial hardship due to the COVID-19 pandemic. Such provisions also expire within a year of the CARES Act being enacted.

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[2] The definition of "small business debtor" under the Bankruptcy Code also does NOT apply to (i) any member of a group of affiliated debtors that does not meet the debt limit requirement, and (ii) a debtor that is a corporation subject to certain reporting requirements under the Securities Exchange Act of 1934.