

## New Subchapter V May be the Bankruptcy Lifeline Small Businesses Need to Survive COVID-19

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When the Small Business Reorganization Act (SBRA) was signed into law in August 2019 and slated to go effective in February 2020, no one could have foreseen that, by March 2020, the U.S. economy would grind to a halt as a result of a global pandemic. The financial consequences of COVID-19 have hit small businesses especially hard. The SBRA – commonly known as Subchapter V, referring to new Subchapter V of Chapter 11 of the Bankruptcy Code – may provide a much-needed lifeline to small businesses struggling to survive this crisis. With Subchapter V elections likely to surge during and after the pandemic, lenders and other creditors should know how the SBRA alters the normal Chapter 11 landscape to which they may be accustomed.

Arguably, the SBRA was long overdue. Many financially distressed small businesses have consulted a bankruptcy lawyer only to learn that, ironically, they are too poor to reorganize under Chapter 11. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) promised to streamline Chapter 11 for small businesses, for example, by allowing a one-step plan solicitation and confirmation process. However, BAPCPA imposed increased reporting requirements and other procedural burdens that many felt outweighed the benefits for small businesses.

Subchapter V retains some components of BAPCPA, including one-step confirmation, while adding new features intended to make Chapter 11 more accessible for small businesses. Highlights of Subchapter V include:

- Normally, only a business debtor with non-contingent, secured and unsecured debt less than \$2,725,625 may elect Subchapter V treatment. (One key caveat: entities that derive substantially all of their income from operating a single real property are ineligible for Subchapter V.) While most “mom & pop” businesses fall within these debt parameters, many small businesses that could benefit from the SBRA exceed this modest threshold. Some cynics have speculated that, for borrowers on the cusp, lenders may extend additional credit to disqualify the borrower from a Subchapter V election. On the flipside, since the limit applies to “non-contingent” debt, desperate or unscrupulous debtors could potentially circumvent the limit by characterizing legitimate debts as contingent or disputed. Even before the COVID-19 crisis, the National Bankruptcy Conference and others in the restructuring industry advocated raising the cap. On March 27, 2020, Congress increased the cap to \$7,500,000 for the next year as part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, in the hope that the higher cap will benefit not only small business owners, but also their creditors, suppliers, customers, employees, and the overall economy.
- Much like a Chapter 13 case for individuals with regular monthly income, Subchapter V allows a debtor to spread its debt over 3 to 5 years, during which time the debtor must devote its projected disposable income to paying creditors. In many cases, this model benefits both debtors (by allowing them to spread payments over time) and creditors (by allowing them a meaningful recovery from debtors who may not have much money on hand but have a realistic expectation of income over time). In a traditional Chapter 11 case, administrative expenses must be paid at plan confirmation; under Subchapter V, they may be paid over the life of the plan. Debts are not discharged until the debtor completes all of its plan payments.
- In order to keep cases moving quickly, theoretically conserving administrative costs, a Subchapter V debtor must normally file its plan of reorganization within 90 days after entering bankruptcy. However, the Bankruptcy Court may extend this deadline “if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable.” Obviously, in the COVID-19 environment, courts are likely to grant extensions liberally.

- Normally, a Chapter 11 trustee is appointed only for cause, such as fraud or gross mismanagement, and seizes control of the debtor's operations. Under Subchapter V, a trustee is automatically appointed, but the debtor retains control of its assets and operations. Creditors' committees – a staple in traditional Chapter 11 cases – are formed only for cause in Subchapter V cases. Although Subchapter V trustees have authority to investigate the debtor's financial affairs, their primary function is to facilitate a consensual plan among the debtor and its creditors, almost like a mediator would facilitate a settlement in litigation. The involvement of an impartial third-party may increase the likelihood of a fair and equitable resolution among the debtor and its creditors, and may be particularly useful for a small business whose creditors are unwilling to make reasonable concessions in light of the impending financial crisis. Under the supervision of the Department of Justice, approximately 250 Subchapter V trustees – mostly attorneys and accountants – were selected out of over 3,000 applicants. Most Subchapter V trustees had recently received their first case assignments when the COVID-19 pandemic hit.
- Subchapter V also cushions small business owners from certain adverse personal consequences that might otherwise disincentivize a Chapter 11 filing. For example, if the debtor's principal used his or her primary residence as security for a loan to fund the small business, the debtor's plan may modify the loan. Additionally, Subchapter V eliminates the so-called "new value rule," which normally requires equity holders to provide "new value" if they want to retain their equity interest in the business.

Unprecedented in living memory, the COVID-19 pandemic may force even small businesses that were on fundamentally sound footing just a few weeks ago to explore the full panoply of options, including Subchapter V. Normally, businesses of any size are ill-advised to enter Chapter 11 without a well-planned exit strategy; this crisis may be the exception. Subchapter V may allow small businesses to responsibly pause their obligations for long enough to negotiate with lenders, landlords, and other creditors (who are being inundated with similar requests) and – hopefully – to resume normal operations once the immediate health peril subsides. However, small businesses should carefully consider the timing of a Subchapter V filing: the Borrower Application Form promulgated by the U.S. Small Business Administration indicates that applicants presently subject to a bankruptcy proceeding are ineligible for the Paycheck Protection Program (PPP). Subchapter V filings will likely surge once PPP funds run out, particularly among businesses who find themselves unable to meet the loan forgiveness criteria.

If you have questions or would like additional information, please contact Amy Vulpio ([vulpioa@whiteandwilliams.com](mailto:vulpioa@whiteandwilliams.com); 215.864.6250) or another member of the Financial Restructuring and Bankruptcy Group.

As we continue to monitor the novel coronavirus (COVID-19), White and Williams lawyers are working collaboratively to stay current on developments and counsel clients through the various legal and business issues that may arise across a variety of sectors. Read all of the updates [here](#).

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