

Options for US Small Businesses in Distress in Age of COVID-19

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In the wake of the COVID-19 pandemic, more and more businesses are finding themselves in distress. According to Forbes, 30 million small businesses across the United States are experiencing financial distress, with half of those blaming the global pandemic for revenue decline. These challenges are especially felt by small businesses who may have limited access to the financial markets and investors as compared to larger companies, both public and private, and especially those whose owners have made personal guarantees on business loans. Small businesses in distress have various options available to help rehabilitate their capital structure and move toward profitable operations. These options include:

- Filing for relief under Subchapter V of the Bankruptcy Code, part of the Small Business Reorganization Act (and supercharged by the Coronavirus Aid, Relief and Economic Security (CARES) Act)
- Filing for relief under Chapter 11 of the Bankruptcy Code
- Filing for relief under Chapter 7 of the Bankruptcy Code
- Out-of-court options, including assignments for the benefit of creditors and out-of-court workouts

Any business in distress must weigh the pros and cons of each option available to it in order to determine the best path forward.

Small Business Reorganization Act: An overview

The Small Business Reorganization Act (SBRA) went into effect in February 2020 as part of recent amendments to the Bankruptcy Code and added a new Subchapter V to the code. The SBRA is codified at 11 U.S.C. § 1181 – 11 U.S.C. § 1195. The SBRA is a voluntary option for small businesses, with many advantages over pre-existing options available to small businesses, including "small business debtors" under the Bankruptcy Code pre-SBRA.

- The key provisions of the SBRA provide for significant cost savings over a typical Chapter 11 filing
 - There is no creditors' committee and therefore no associated professional fees
 - Similarly, the debtor is not obligated to pay US Trustee fees
- The process is more streamlined for the debtor
 - Plan of reorganization can be less complex
 - No requirement for a separate disclosure statement
 - Forms are available that can be used to cut down costs
- The SBRA makes it possible for equity interests to be maintained without agreement from creditors who may receive less than a full recovery on account of their claims
- The SBRA also allows for the small business debtor to modify a mortgage secured by a residence if the underlying loan was not used to acquire the residence and was used primarily in connection with the debtor's business

The SBRA: Who qualifies?

- Prior to the SBRA, "small business debtor" meant a debtor who:
 - Is engaged in commercial business activities
 - With aggregate noncontingent, liquidated debt of not more than \$2,725,625, excluding debts owed to affiliates or insiders
- Excluded from the definition were owners and operators of real property and any member of a group of affiliated debtors with aggregate debt greater than \$2,725,625

- The SBRA modified the definition of "small business debtor," and to qualify under the SBRA:
 - 50% or more of the debtors' prepetition debts must arise from the commercial or business activities of the debtor
 - Single asset real estate debtors, public companies and their affiliates are *excluded*
- For small business debtors that elect Subchapter V, the CARES Act raised the debt limit from \$2,725,625 to \$7,500,000 until March 27, 2021
- In addition to corporations (including LLCs) and partnerships, sole proprietorships may also file under Subchapter V

A small business debtor case under Subchapter V

- The debtor's election to file under Subchapter V is voluntary and the small business debtor operates in Chapter 11 as a debtor-in-possession
- No creditors' committee is appointed, unless the court orders otherwise
- A Subchapter V trustee is appointed by the US Trustee
 - The Subchapter V trustee's role is to facilitate the debtor's plan; the trustee is required to appear at hearings that concern asset sales, the value of assets subject to liens, plan confirmation and post-confirmation plan modification hearings
 - The trustee is compensated by the debtor and will usually be terminated after the plan is substantially consummated
- 60 days from entry of the order for relief, a conference is held to further the expeditious and economical resolution of the case; 14 days before the conference the debtor must file a report detailing efforts to attain a consensual plan
- The debtor has 90 days from entry of the order for relief to file a plan
 - Extensions are available for "circumstances for which the debtor should not justly be held accountable"
- Only the debtor may file a plan, and there is no deadline for plan confirmation

Contents of the Subchapter V plan

- The small business debtor's Subchapter V plan should include the following:
 - A history of the debtor's business operations
 - Liquidation analysis
 - Projections regarding the debtor's ability to make payments under the plan
 - The submission of all or a portion of the debtor's future earnings or other future income to the supervision and control of the trustee as is necessary for the execution of the plan
- Other key features of a Subchapter V plan:
 - Administrative expense claims may be paid throughout the term of the plan, rather than upon confirmation
 - For the plan to be confirmed, the requirements of Section 1129(a) must be met, *except* for the following:
 - 1129(a)(8): acceptance by each class of claims
 - 1129(a)(10): each class of claims has accepted the plan or is not impaired
 - 1129(a)(15): specific provisions for an individual debtor
 - Section 1191 dictates what it means for a plan to be fair and equitable with respect to each class of claims
 - With respect to a class of secured claims, the plan must meet the requirements of Section 1129(b)(2)(A)
 - As of the effective date of the plan,
 - The plan must provide for all of the projected disposable income of the debtor to be received in the three-year period, or such longer period not to exceed five years, to be applied toward plan payments, or
 - The value of the property to be distributed under the plan is not less than the projected disposable income of the debtor

"Disposable income" is defined as income received by the debtor that is not reasonably necessary to be expended for (1) the maintenance or support of the debtor or a dependent of the debtor, (2) a domestic support obligation that first becomes payable after the date of the filing of the petition, or (3) the payment of expenditures necessary for the continuation, preservation or operation of the debtor's business

- The debtor will be able to make all payments under the plan, or

- There is a reasonable likelihood that the debtor will be able to do so, and
- the plan provides appropriate remedies (which may include the liquidation of nonexempt assets) to protect holders of claims or interest in the event plan payments are not made

Subchapter V plan compared to Chapter 11 plan

Some of the key differences between a Subchapter V plan and a traditional Chapter 11 plan include the following:

Subchapter V plan	Traditional Chapter 11 plan
Debtor must file a plan within 90 days, and there are no competing plans	Debtor has 120 days to file a plan before its "exclusive period" expires, which time can be extended by the court; after expiration of the debtor's exclusive period, other parties in interest may file a competing plan
No disclosure statement requirement	Section 1125 requires that a debtor provide in a disclosure statement "adequate information" of the debtor's business that would allow a hypothetical investor to make an informed judgment about the plan
Absolute priority rule does not apply and the equity holders may retain their interests even absent payment in full to all creditors, with no "new value" requirement	Absolute priority rule applies and equity interests are not retained over the objection of unsecured creditors that are not paid in full without "new value" being provided
Administrative expense claims may be paid over the term of the plan	Administrative expense claims must be paid on the effective date of the plan, unless the claim holder agrees to other treatment
The plan must provide for the liquidation of nonexempt assets in the event that plan payments are not made	The debtor can amend its plan before it's substantially consummated, if the plan is substantially consummated, the bankruptcy court can use its discretion to permit liquidation under Chapter 11, or convert to Chapter 7

Discharge granted only after all plan payments are made (meaning the debtor may wait three to five years and complete all plan payments before receiving a discharge)

The debtor receives a discharge of its debts upon plan confirmation

Other options

Chapter 7

- Instead of reorganizing under Chapter 11 or Subchapter V, a debtor can liquidate its assets under Chapter 7 of the Bankruptcy Code, and the proceeds of the liquidation will be used to pay the debtor's creditors
- The Chapter 7 Trustee
 - Under Chapter 7, a trustee is appointed and takes control of the company's assets
 - Directors and officers no longer have decision-making authority over the company and its assets
 - The Chapter 7 trustee does not operate the business
 - Instead, the trustee is tasked with liquidating company assets, and any remaining employees will be terminated
- The Chapter 7 filing will trigger the automatic stay, preventing secured creditors from foreclosing on the company's assets and preventing other creditors from pursuing or continuing lawsuits
- Note that the Chapter 7 trustee would have standing to pursue claims on behalf of the company, including those for breach of fiduciary duty against the company's directors and officers

Assignment for the benefit of creditors, or “ABC”

- An ABC is an insolvency proceeding governed by state law instead of federal law, through which the company enters into a formal assignment agreement with the assignee, who is a fiduciary to creditors and tasked with liquidating the company's assets for their benefit
- Creditors receive notice of the assignment and submit claims to the assignee
- An ABC leaves open the possibility of a buyer purchasing the debtor's assets, if one is identified the assignee can close an asset sale after the assignment is made

Other considerations

- Although a discharge under Subchapter V will provide relief to the debtor of business debts, to the extent the owners have any personal liabilities or guarantees, they will remain on the hook
 - In addition, the debtor is still responsible for paying sales tax and other taxes, employee-related obligations, including wages, and required insurance, and the debtor's D&Os could face personal liability if certain of these obligations go unpaid
 - The SBRA made changes to preferences as well, requiring that the debtor exercise reasonable due diligence, "taking into account a party's known or reasonably knowable affirmative defenses" before filing a preference lawsuit
 - If the preference claim is for less than \$25,000, the suit must be brought in the federal district where the defendant resides
- Debtors filing for relief under Subchapter V or Chapter 11 may not be able to receive any relief under the Paycheck Protection Program (PPP)
 - Courts around the country have come out differently on this issue, with no circuit court yet weighing in
 - Some courts have issued temporary restraining orders compelling the Small Business Administration to act on a PPP loan application without considering the applicant's bankruptcy status, others have deferred to the SBA's rules prohibiting the granting of PPP loans to debtors, and other courts have granted the debtor's request to dismiss the case for the purpose of pursuing PPP funding
- There may be state specific relief that can be afforded to small businesses through executive orders that have been executed during the pandemic

- For example, in New York, Governor Andrew Cuomo signed an executive order providing for a moratorium on evictions for commercial tenants through August 20
 - Although these tenants do remain liable for rent payments during this time, the moratorium at least provides limited relief to tenants who are unable to make their rent payments at present
 - Whether there will be any further related relief to address the hardship that tenants may face once the moratorium is lifted and landlords attempt to collect past rent, is presently unknown
 - In the interim, tenants and landlords can engage in negotiations to restructure the terms of their leases to give tenants some relief to pay amounts due over time, or otherwise extend the term of the lease

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