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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Small Biz Bankruptcy Rules Come Just In Time For Many

By **Vince Sullivan**

Law360 (April 24, 2020, 3:31 PM EDT) -- Changes in the rules governing small business bankruptcies came at a fortuitous time earlier this year and could provide an easier path to reorganization as many more companies are likely to become insolvent due to the continued effects of the COVID-19 outbreak.

In effect since mid-February, the Small Business Restructuring Act makes Chapter 11 proceedings faster, cheaper and more efficient for companies that come to court with debt loads below a new statutory cap — just in time for them to navigate the financial turmoil resulting from the coronavirus pandemic, according to bankruptcy professionals.

While the new process hasn't been widely used over the past two months, according to Matt Ferris, a restructuring partner with Haynes & Boone LLP, that will likely change as more and more businesses tip into bankruptcy.

"It's going to open the door for many more parties to access a potential restructuring," Ferris told Law360. "The timing was kind of incredible, frankly."

Passed by Congress in August 2019 and enacted in February, the SBRA created a new Subchapter V of Chapter 11 of the federal Bankruptcy Code that streamlines the reorganization process for debtors with less than $2,725,625 of debt by eliminating disclosure and solicitation obligations and tightening case deadlines to ensure a quick trip through the process.

The Coronavirus Aid, Relief and Economic Security Act that passed in late March in response to the crisis raised that debt cap to $7.5 million in an effort to help companies struggling in light of widespread business shutdowns enacted to stem the spread of the disease.

The CARES Act also included a $349 billion fund to provide Paycheck Protection Program grants and loans to small businesses, with the money being made available for those companies to cover their payroll, lease, mortgage and utility obligations. The fund approved more than 1.6 million loans through nearly 5,000 lending organizations, exhausting its original appropriation by April 16.

The Senate approved another $250 billion in funding for the PPP loan program on April 21, and the entire $484 billion aid package was overwhelmingly approved by the House of Representatives two days later.

These protections, however, may not provide the lifeline for small businesses it was designed to save.

According to the Small Business Administration, which is administering the PPP, the median amount of the loans granted is about $200,000, but Alex Grishman, also of Haynes & Boone, said some businesses are left in an impossible situation where the money isn't helpful.

He said the terms of the loan program allow for the forgiveness of the entire amount if at least 75% is used to cover payroll expenses. The rub is that many of the businesses that applied are subject to mandatory shutdown orders and don't have any payroll at the moment. If the money isn't used for the intended purposes, it converts into a low-interest loan that needs to be repaid.

Increased unemployment benefits are making a return to work in a potentially dangerous environment a less attractive option for rank-and-file employees, Grishman said, and small businesses like independent restaurants and auto service stations are finding it difficult to use the PPP money for its intended purposes.

"It's making it difficult for everyone from the local mechanic to the restaurant chain to attract back the workers they need for that eight-week period to make the PPP portion of the CARES Act work correctly," he said. "It does have a beneficial aspect — it's just for many businesses, it's not going to be a solution that's going to keep them out of failure."

The funds were appropriated with the intention of bridging the gap through the crisis over the next eight to 10 weeks, but Grishman said the money could end up just delaying the inevitable collapse of many of these businesses.

"It's yet to be seen if it's going to save a lot of these businesses or if it's just going to push it down the road eight to 10 weeks," he said of the PPP.

What happens if a company receives a disbursement under the PPP but subsequently falls into bankruptcy is a question without an answer at this point in the crisis. When applying for the funds, a company has to confirm it is not already a debtor in a bankruptcy proceeding, but Julia Frost-Davies, a restructuring partner with Morgan Lewis & Bockius LLP, said there isn't anything stopping a company from filing after receiving the money.

In that event, she surmises that any PPP loans would be treated as junior to any existing secured debt.

"The loans are unsecured, so my assumption is they would be treated as unsecured debt in a bankruptcy in accordance with the priority scheme," Frost-Davies told Law360.

She predicted there will be some tricky factual issues to navigate in the event a PPP recipient files a Chapter 11 petition, an event which is very likely to occur given the widespread nature of the economic troubles facing virtually every industry.

"It does seem to me that the purpose of the loans is to try to give a business a pathway to success, but not all of them are going to succeed," she said.

Kristen Campana, also of Morgan Lewis, said most companies are viewing the PPP loans as equity infusions, just with the federal government acting as the silent sponsor of the capital injection. In a bankruptcy, a company should be able to have the loans forgiven if it meets all the criteria for forgiveness in the program and no repayment will be needed.

In the event it doesn't meet the forgiveness criteria, it would become an unsecured obligation with a 1% interest rate and a six-month deferral of payments in accordance with the program's regulations, Campana predicted

As these companies tip into bankruptcy, the Subchapter V rules are going to provide a better path to reorganization than was previously available to small businesses, even if the PPP payments weren't enough to keep them afloat. The cheaper, faster and more efficient process will allow companies that previously couldn't have financed a Chapter 11 case to have a fighting chance to emerge.

Larger, more traditional Chapter 11 cases — especially among retailers who filed before the COVID-19 crisis — have floundered in recent weeks with some converting to straight Chapter 7 liquidations because their revenue evaporated with the stay-at-home and shelter-in-place orders enacted across the country, Frost-Davies said. The new rules should help smaller debtors avoid that fate.

"I think we're seeing administrative insolvency and conversion in cases that might have had a fighting chance in a different environment," she said. "To the extent Subchapter V can alleviate some of those costs for the smaller more fragile businesses that can't afford it, it gives them a much better opportunity."

While some companies have been moving into bankruptcy because of the pandemic and its related financial challenges, there has not yet been a glut of cases flooding into court, and Ferris said that is likely because of an understanding among lenders and borrowers that parties are taking a wait-and-see approach.

"There hasn't been just a complete wave of bankruptcy yet because I think people want to give this time to see how bad this is potentially going to be," he said. "I don't know that anyone wants to accelerate that … If this continues for an extreme period of time, I think all bets are off."

--Editing by Philip Shea and Kelly Duncan.