

NEWS & INSIGHTS

Temporary increase in debt threshold under Subchapter 5 may provide relief for businesses amid COVID-19

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In response to the COVID-19 pandemic, the Coronavirus Aid, Relief and Economic Security (CARES) Act temporarily increased the threshold for filing a petition under Subchapter 5 of Chapter 11 of the Bankruptcy Code to \$7,500,000, effective March 27, 2020. After one year, the debt threshold will revert to \$2,725,625. Given the current economic climate and the uncertain future ahead, this temporary increase may provide businesses with an opportunity to restructure their debt as part of their financial strategy to navigate the impacts of COVID-19.

What is Subchapter 5?

When a business with sustainable income finds its debt load overwhelming, Chapter 11 provides an opportunity for the business to continue operating while reorganizing its debt. A Chapter 11 filing can be an expensive and time-consuming process, however, and often is not a practical solution for a small business. Recognizing these shortcomings, Congress enacted the Small Business Reorganization Act (SBRA), also known as Subchapter 5, on August 23, 2019. Subchapter 5, which is a new small business provision of Chapter 11, became effective on February 19, 2020.

Subchapter 5 streamlines the reorganization process by allowing a business debtor, which can be either an entity or an individual, to propose a plan to pay its debts over a period of three-to-five years. During this time, the debtor must devote its projected disposable income to paying its creditors. If it does, equity owners can retain their equity interest in the business even if unsecured creditors are not being paid in full. This recourse is not available to a Chapter 11 debtor.

Only a business with less than \$7,500,000 in non-contingent secured and unsecured debt may opt to proceed under Subchapter 5. While there is no requirement that the debtor continue to engage in the business operation, to qualify for relief under Subchapter 5, at least 50% of the debtor's pre-petition debt must be business-related. For debtors who mortgaged their residence to finance their business operations, Subchapter 5 permits the debtor to modify the mortgage by reducing the interest rate, extending the maturity date of the loan or "cramming down" the amount of the secured claim to the value of the collateral. To take advantage of this provision, the loan must have been obtained after the purchase of the residence and the loan proceeds must have been used in connection with the business. This is another strategy that is not available to a Chapter 11 debtor.

Unlike Chapter 11, a creditors' committee is not automatically formed in a Subchapter 5 proceeding, a disclosure statement is generally not required to be filed, only the debtor may file a plan and creditors do not vote on the plan. In addition, Subchapter 5 provides the debtor with an opportunity to pay administrative claims over the life of the plan as opposed to requiring that they be paid in full on the plan's effective date, as mandated in Chapter 11. While a Subchapter 5 Trustee will automatically be appointed to assist the debtor in formulating a plan and generally oversee the case, Subchapter 5 makes reorganization more accessible to small businesses by eliminating the administrative fees and various other requirements that often make filing Chapter 11 too burdensome and expensive.

Considerations for small businesses

A small business must carefully consider the timing of its Subchapter 5 filing, however, because the United States Small Business Association (SBA) has taken the position that a company that is presently in bankruptcy is ineligible for a Paycheck Protection Program (PPP) loan. Some bankruptcy courts have refused to enforce this ban, concluding that the SBA overstepped its bounds when they promulgated this rule. In addition, if a company files bankruptcy after being approved for a PPP loan, but before the loan is disbursed, the SBA has taken the position that the debtor must request cancellation of the loan.

Although Subchapter 5 provides small businesses with many benefits that make it more likely to lead to successful

reorganization, it keeps many creditor protections intact, including:

- The “best interest of creditors” requirement that the debtor’s plan provides creditors with at least the amount they would receive if the debtor were liquidated
- Requiring that the debtor cure defaults and provide adequate assurance of future performance to assume an executory contract or lease
- Allowing a secured creditor to take advantage of any post-confirmation increase in the value of its collateral by electing to have the entire value of its claim remain secured
- A secured creditor’s right to “adequate protection”
- A supplier’s right to an administrative expense claim for goods delivered to the debtor within 20 days of the bankruptcy filing

Creditors should make use of these provisions to protect their interests and ensure that they are receiving optimal treatment under the debtor’s proposed Subchapter 5 reorganization plan.

Seek legal counsel

Businesses who may be facing financial difficulties amid the COVID-19 pandemic should consider contacting legal counsel to discuss their options. An experienced debtors’ and creditors’ rights/bankruptcy attorney can provide an evaluation and make recommendations concerning collection advice, bankruptcy solutions or alternatives to bankruptcy, such as workouts with creditors, negotiating payment terms and strategies for asset protection.

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