THE NEW SMALL BUSINESS BANKRUPTCY LAW---HIGHER DEBT LIMITS

Robert M. Bovarnick, Esquire
Bovarnick and Associates, LLC
rmb@rbovarnick.com
www.rbovarnick.com

I recently wrote an article about the new Subchapter 5 bankruptcy law that applies to small businesses. Under the law (known either as the "SBRA" or "Subchapter 5") for a business to qualify as a "small business" and to be able to take advantage of the expedited process, it had to have less than $2,725,625 in unsecured debt. That means that only the smallest businesses would qualify.

However, the new CARES Act is increasing that limit to **$7,500,000.00**. This is a significant move, as it will open up the doors to many, many more businesses to take advantage of the expedited bankruptcy process. As of the writing of this article, the House has not passed its version of the bill. However, assuming this provision remains in the bill (and there is every reason to believe it will), this may be a game changer for many small businesses.

This article will explain the primary differences between the way bankruptcy works for large companies, how it had worked since 2005 for small businesses and how it will work under the new law.

What is Bankruptcy?

When most people think of bankruptcy, they think of the company going out of business. This is chapter 7. What happens in a chapter 7 is a "chapter 7 trustee" is appointed by the Office of the US Trustee (part of the Department of Justice). That person takes the keys from the owner, sells all of the stuff and distributes the money as set forth in the Bankruptcy Code. Chapter 7 applies to both individuals and businesses.

There is also Chapter 11. This is reorganization. In a chapter 11, the end game is for the company to come up with a business plan (called a plan of reorganization) that describes how much it will pay existing debt and how it will operate going forward. If approved by the Court, it becomes binding on the company and all of its creditors. A company can also liquidate in chapter 11. The main difference between liquidation in chapter 7 and chapter 11 is that, in the chapter 11, the owners still run the company and they are in charge of the wind down.

The Automatic Stay

The purpose of a bankruptcy is to give the company "breathing space" to figure out its plan of reorganization. As soon as a company files for bankruptcy, the "automatic stay" goes into effect. This automatic stay does a number of things, most importantly stopping creditors from trying to get paid from the company (whether there is already a lawsuit going on or not). Also, with certain exceptions, once a bankruptcy is filed the company is not permitted to pay any of the money it owed prior to the filing of the case. So, a bankruptcy is a good way to stop paying the creditors, which can be valuable when cash is limited.

Executory Contracts and Leases

One of the things a debtor gets to do is to examine all of its contracts and decides which ones it wants to keep (called assumption) and which ones it wants to get rid of (called rejection). The standard for assumption and rejection is the debtor's business judgment. If a contract is assumed, the debtor will have to pay any arrearages (or show how they will be paid). The debtor has until the end of the case to make these decisions. With respect to leases of non-residential real property, there are different rules as to when the decision to assume or reject must be made.

The Plan of Reorganization

The plan of reorganization is the "business plan" for the company going forward. It has two primary goals. First, it advises the preexisting (prepetition) creditors how much of their claim will be paid, how it will be paid and over what time frame. Second, it describes how it intends to operate going forward. The plan will include projections going out a number of years.

A plan of reorganization divides the creditors into "classes," depending on the type of debt. For example, a bank with a secured debt (such as a mortgage) would be in one class, taxing authorities would be in another and trade debt (called general unsecured debt) is in another. There can be (and usually are) others, but this is enough to get an understanding.

A court can approve a plan one of two ways. If all of the classes agree, the plan is "consensual." If at least one class disagrees, then the plan can only be approved through something called "cram down." While there are certain standards for cram down, at its core, the company must show that the creditors are being treated "fairly and equitably."

A Brief History of Business Bankruptcy for Small Businesses

Chapter 11 is inherently time consuming and expensive. It works fairly well for large companies, such as General Motors. However, it is difficult for small businesses. To try and fix this problem, in 2005 Congress passed what is known as BAPCPA (the Bankruptcy Abuse and Consumer Protection Act of 2005). Part of this law was to streamline the process for small businesses (defined as a company with less than $2,500,000 in unsecured debt). The goal was to make the process take less than a year. While much better than it had been, it was still a long time.

Under BAPCPA, the company had to file its plan within 300 days of the beginning of the case. That means that a small business case would generally take about a year.

The Small Business Bankruptcy Reform Act

The new law streamlines this even further. The goal is to have the case over even faster (perhaps as quickly as 4 months). When the law was passed the debt limit was $2,725,625. Under the CARES Act, for **ONE YEAR** the debt limit has been increased to **$7,500,000**.

How does the SBRA work? As soon as a case is filed the Office of the United States Trustee (part of the Department of Justice) appoints a Chapter 11 Trustee (these are a group of qualified attorneys who have gone through a screening process). While they have a number of functions, one of the primary duties is to assist in the negotiation of the plan of reorganization. Since the law is new, it is uncertain as to whether the trustee will be more of an advocate or a mediator. Regardless, this will be very helpful to the company, as a neutral third party will be working with the debtor and the creditors to get them to agree on the terms of a plan.

Also, now the plan has to be filed within 90 days. While that is very fast, it means you will know very quickly whether you will be able to save your company.

If the debtor and the trustee are unsuccessful in getting the creditors to agree to the terms of the plan, the debtor can still have the plan confirmed through the cram down process. Again, the key is that the court has to find that the plan treats the creditors "fairly and equitably."

One potential down side with a plan confirmed under the cram down process is that the debtor has to provide is disposable income to the trustee for 5 years. While this may put a crimp in some things the company wants to do after bankruptcy, at least it will be out of bankruptcy and continuing to operate.

Conclusion

The increase of the debt limits is significant. It allows what, up until 2020, a viable company, to file a chapter 11 and it will have a fighting chance to remain viable. The company in bankruptcy will probably know early on whether it will be able to propose a confirmable plan. The alternative is to be defending multiple lawsuits and hope and pray that business immediately picks up. Bankruptcy will give companies protection to see if they can continue.

> The information provided in this article does not, and is not intended to, constitute legal advice; instead, all of the information and content in this article is for general informational purposes only. Information in this article may not constitute the most up-to-date legal or other information. Nothing in this article is intended to create an attorney-client relationship, which would require an engagement letter. However, if you have any questions, please feel free to email me at rmb@rbovarnick.com