



SMALL BUSINESSES FEELING THE EFFECTS OF COVID-19 SHOULD BE AWARE OF THE NEWLY ARRIVED SMALL BUSINESS REORGANIZATION ACT OF 2019

March 18, 2020

Updated Post on March 25 at 12:15 PM

On Sunday, March 22, 2020, the National Bankruptcy Conference (NBC), an advisory group of bankruptcy judges, lawyers and scholars, wrote several top congressional leaders acknowledging that current bankruptcy laws were not equipped to handle the effect of the coronavirus pandemic on small businesses and consumers. The NBC requested several changes to current law including the increase of the current debt limitation under the SBRA from \$2,725,625 to \$7,500,000 because it would give relief to “many thousands of small businesses in desperate circumstances to the benefit of their owners, creditors, suppliers, customers, employees and the entire economy.”

Posted: March 18 at 1:30 PM

With businesses across the country facing shutdowns — either mandatory or de facto because of social distancing due to COVID-19 — the likelihood of bankruptcy among them will increase. Small businesses, such as restaurants, bars, entertainment facilities and hotels, may be particularly hard-hit. But a recent change in the law makes the remedy of bankruptcy far less difficult for them than in years past.

With little fanfare, the Small Business Reorganization Act of 2019 (SBRA), appearing in Subchapter V of Chapter 11, was signed into law on August 23, 2019 and went into effect on February 19. The SBRA was intended to streamline the restructuring process for small businesses, defined as those with non-contingent liquidated secured and unsecured debts not exceeding \$2,725,625.

Under the prior law, equity owners were unable to retain their ownership interests in a reorganized debtor without paying creditors in full unless those creditors consented or the equity owner paid 'new value' to the debtor for the new equity interests. Known as the 'absolute priority rule,' this sometimes led to the loss of the equity or even the failure of Chapter 11 cases. But now, if the debtor commits to pay creditors all of its projected disposable income over 3 to 5 years and pays secured creditors the value of their collateral, the SBRA eliminates the application of the 'absolute priority' in 'small business' cases. This permits equity owners to retain their ownership interests without paying creditors in full, increases the likelihood of a successful reorganization and decreases the likelihood of creditors receiving substantial payment.

The SBRA also removes several requirements that typically drove up the costs of a Chapter 11, including:

- The possibility of a creditors' committee, except in unusual cases. Instead, a 'standing trustee' is appointed to oversee the plan process.
- The need for a disclosure statement and process for approving it. Instead, it requires filing a plan of reorganization within 90 days of bankruptcy filing, and it provides that only the debtor may file a plan of reorganization.

In short, the SBRA lowers costs, simplifies the plan confirmation process and provides more certainty to equity owners looking to protect their investment from creditors. It also arrives at an opportune time for small business owners.

Chapter 11 is ideal for those businesses that represent a profitable business model but, because of economic or other circumstances, suffer from a temporary loss of cash flow. Before now, its costs and delays could outweigh its benefits. But Subchapter V and the SBRA make the benefits of Chapter 11 more affordable and accessible to 'small business' owners. Likewise, creditors should be aware of an increased use of the SBRA and the potential for decreased payouts and less leverage in Chapter 11 proceedings.

Businesses with \$2,725,625 in debt made up only 42% of 2019 bankruptcy filings. In light of the coronavirus pandemic and its effect on the economy, many commentators are now calling for at least a temporary increase of the debt limitation to \$10,000,000, which would increase eligibility to 59% of past filers. So even if your small business now exceeds the maximum debt limitation, be aware that Congress could be increasing that limitation in the near term as part of coronavirus relief legislation.

If you have questions or would like to discuss further, please contact Russell Mills.

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