

COVID-19: IMPACT OF THE CARES ACT ON SUBCHAPTER V REORGANIZATIONS UNDER THE BANKRUPTCY CODE

Date: 13 April 2020

U.S. Restructuring and Insolvency Alert

By: John R. Gardner, Michael J. Gearin, A. Lee Hogewood III, Margaret R. Westbrook, Emily K. Steele

On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act, Public Law No. 116-136 (the “CARES Act” or the “Act”), the stimulus package designed to mitigate the widespread economic impacts of the coronavirus (“COVID-19”). The Act includes important temporary modifications¹ to Subchapter V of the Bankruptcy Code (the “Code”), applicable to small -business debtor reorganizations.

TEMPORARY INCREASE IN DEBT LIMIT

Critically, for cases commenced under Subchapter V on or after March 27, 2020, the Act expands the eligibility of “small business debtors” to include a person engaged in commercial or business activities that has aggregate, non-contingent, liquidated, secured, and unsecured debts of not more than US\$7,500,000 (up from US\$2,725,625) by revising the definition of “small business debtor” in sections 1182 and 101(51D) of the Code.

Otherwise, the pre-CARES Act definition remains intact. Specifically, at least 50% of the debtor's aggregate debt must have arisen from its commercial or business activities, and an eligible debtor does not include any member of a group of affiliated debtors that has aggregate debt in an amount greater than US\$7,500,000, among the other limitations set forth in section 101(51D). There is, however, a technical correction to section 101(51D)(B)(iii) to except from the definition of a small business debtor any “debtor that is an affiliate of an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (11 U.S.C. § 78c).”

Since the Subchapter V-specific amendments explicitly only apply to cases commenced on or after March 27, 2020, debtors in previously filed chapter 11 cases will not be able to elect to have Subchapter V apply. Further, in order to take advantage of the higher debt limits, debtors will need to commence a case under Subchapter V within the twelve months following March 27, 2020, because the CARES Act revisions will expire one year from the date of enactment. It remains to be seen whether further increases or extensions will be granted by Congress in future legislation.

IMPACT OF CARES ACT PROVISIONS ON SUBCHAPTER V

The CARES Act revisions to Subchapter V will likely result in an uptick of new filings during the next year by debtors seeking to take advantage of the less costly reorganization options. Subchapter V offers numerous benefits for small business debtors that allows for a cheaper and quicker reorganization -- a hybrid of sorts between chapter 11 and chapter 12/13. Some of the major benefits are discussed below.

Notably, debtors are relieved of compliance with the absolute priority rule, which mandates that general unsecured creditors be paid in full before equity owners of the debtors are entitled to retain their interests. Thus, equity holders can retain their interests in the business even if the debtor does not pay all of its creditors through its plan. In contrast, non-Subchapter V chapter 11 plans cannot permit equity holders to retain their interests until general unsecured creditors are paid in full. The waiver of the absolute priority rule requirement has been the main reason for keeping the debt limits low and likely the reason for only allowing an increase temporarily.

Similar to a chapter 12 or 13 case, the small business debtor also enjoys perpetual plan exclusivity. Unlike in chapter 11 where any party in interest may, after a certain period of time, propose a plan that competes with the debtor's, in a Subchapter V case, only the debtor may propose a plan. In order to confirm its plan, a Subchapter V debtor need not obtain acceptance of an impaired voting class, removing an effective negotiating block for many creditors. Further, Subchapter V does not require that administrative claims be paid in full on the effective date of the plan, as is required in a regular chapter 11 plan. Instead, repayment of administrative claims may be spread over a period of time.

The requirement of filing a disclosure statement in conjunction with a plan of reorganization is also waived, although the plan must include a brief history of the debtor's business operations, a liquidation analysis, and projections relating to the debtor's ability to perform under the plan, thereby mitigating the impact of the lack of a disclosure statement to some degree.

However, Subchapter V debtors have less time to propose a plan, and must do so within 90 days of the petition date. In contrast, regular chapter 11 debtors have a longer window in which to file their plans. Additionally, the requisite showing for a Subchapter V debtor to obtain an extension of time to file a plan is more strenuous, and requires a showing that "the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable." 11 U.S.C. § 1189(b). To the contrary, a court may extend the deadlines in a regular chapter 11 case "for cause."

ADDENDUM

SEC. 1113. Bankruptcy.

(a) Small business debtor reorganization.—

(1) IN GENERAL.—Section 1182(1) of title 11, United States Code, is amended to read as follows:

“(1) DEBTOR.—The term 'debtor'—

“(A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning single asset real estate) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than US\$7,500,000 (excluding debts owed to 1 or more affiliates or insiders) not less than 50 percent of which arose from the commercial or business activities of the debtor; and

“(B) does not include—

“(i) any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than US\$7,500,000 (excluding debt owed to 1 or more affiliates or insiders);

“(ii) any debtor that is a corporation subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 ([15 U.S.C. 78m](#), 78o(d)); or

“(iii) any debtor that is an affiliate of an issuer, as defined in section 3 of the Securities Exchange Act of 1934 ([15 U.S.C. 78c](#)).”.

(2) APPLICABILITY OF CHAPTERS.—Section 103(i) of title 11, United States Code, is amended by striking “small business debtor” and inserting “debtor (as defined in section 1182)”.

(3) APPLICATION OF AMENDMENT.—The amendment made by paragraph (1) shall apply only with respect to cases commenced under title 11, United States Code, on or after the date of enactment of this Act.

(4) TECHNICAL CORRECTIONS.—

(A) DEFINITION OF SMALL BUSINESS DEBTOR.—Section 101(51D)(B)(iii) of title 11, United States Code, is amended to read as follows:

“(iii) any debtor that is an affiliate of an issuer (as defined in section 3 of the Securities Exchange Act of 1934 ([15 U.S.C. 78c](#))).”.

(B) UNCLAIMED PROPERTY.—Section 347(b) of title 11, United States Code, is amended by striking “1194” and inserting “1191”.

(5) SUNSET.—On the date that is 1 year after the date of enactment of this Act, section 1182(1) of title 11, United States Code, is amended to read as follows:

“(1) DEBTOR.—The term ‘debtor’ means a small business debtor.”.

FOOTNOTES

¹ The complete text of the amendments to Subchapter V is set forth in the addendum to this alert.

KEY CONTACTS



JOHN R. GARDNER
PARTNER

RALEIGH, CHARLOTTE
+1.919.743.7325
JOHN.GARDNER@KLGATES.COM



MICHAEL J. GEARIN
PARTNER

SEATTLE
+1.206.370.6666
MIKE.GEARIN@KLGATES.COM



A. LEE HOGEWOOD III
PARTNER

RALEIGH, CHARLOTTE
+1.919.743.7306
A.LEE.HOGEWOODIII@KLGATES.COM



MARGARET R. WESTBROOK
PARTNER

RALEIGH, CHARLOTTE
+1.919.743.7311
MARGARET.WESTBROOK@KLGATES.COM



EMILY K. STEELE
ASSOCIATE

RALEIGH
+1.919.743.7346
EMILY.STEELE@KLGATES.COM

This publication/newsletter is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer. Any views expressed herein are those of the author(s) and not necessarily those of the law firm's clients.