The Small Business Reorganization Act of 2019: Subchapter V

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On Aug. 23, 2019, the Small Business Reorganization Act of 2019 (SBRA) was signed into law and created a new Subchapter V. The general purpose of Subchapter V was to streamline the Chapter 11 bankruptcy process for small businesses and individuals engaged in business to administer their bankruptcy estate in an efficient and less costly manner.

The debt ceiling for a small business to file under Subchapter V was recently increased temporarily to $7.5 million under the Coronavirus Aid, Relief and Economic Security act of 2020 (the CARES Act). This debt ceiling increase expands access to bankruptcy relief to thousands of small businesses.

However, there is a remarkable irony between the laudable purpose of this legislation to help small businesses navigate efficiently through bankruptcy and its execution in the COVID-19 environment. One fly in the ointment is whether small business debtors can use PPP loans in bankruptcy.

By way of background, the CARES Act provided $349 billion for financing “small businesses” under the Paycheck Protection Program (PPP). Under the PPP, eligible small businesses are entitled to receive loans up to $10 million guaranteed by the Small Business Administration (SBA).

Neither the CARES Act nor the Small Business Act, however, expressly prohibits companies who have filed for bankruptcy from receiving PPP loans but this is undercut by the fact that the SBA requires that lenders use an SBA loan application form that expressly disqualifies any small business in bankruptcy. To reinforce this position the SBA promulgated an interim final rule that makes debtors ineligible to receive PPP loans.

The reason for the rule was that PPP loans to entities in bankruptcy would present an unacceptably high risk of an “unauthorized use” of funds or non-repayment of unforgiven loans. But does this make sense? Under the CARES Act, PPP loans are really not loans, but instead are treated as grants if 75% of the loan proceeds are used for payroll and the remaining 25% for rent, utilities and other operating expenses. If the borrower complies with these guidelines, the loan essentially will be forgiven. So, do small businesses that file bankruptcy really presents an unacceptably high risk of unauthorized use of funds or non-payment of unforgiven loans? One could argue to the contrary that a small business with bankruptcy court supervision and a standing trustee

is under more scrutiny than a non-debtor. Quite frankly, small businesses in bankruptcy are likely less risky.

In the interim, bankruptcy courts are actively addressing this issue. There are a number of cases percolating through the system with respect to the use of PPP loans by Chapter 11 debtors. In some cases, Chapter 11 debtors sought approval to use PPP loans for DIP financing. In other instances, the debtors filed motions to turn over the loans proceeds that had been approved but not funded. One interesting issue being raised in a number of cases is whether the SBA's position violates §525(a) of the Bankruptcy Code which in substance prohibits the government from unfairly discriminating against any entity that was or is in bankruptcy.

In this regard one court recently allowed two hospitals (Calais Regional Hospital, 19-10486), and (Penobscot Valley Hospital, 19-10034) to seek PPP loans by issuing TRO's requiring the SBA to allow each hospital to apply for PPP funding. The SBA argued it was immune from the debtor hospitals' claims for injunctive relief under the anti-injunction provision of 15 U.S.C §634(b). Judge Fagone dismissed this argument, noting that any anti-injunction language "should not be interpreted as a bar to judicial review or agency actions that exceed agency authority where the remedies would not interfere with internal agency operations." Judge Fagone further found that the SBA's refusal to extend funds to bankrupt debtors likely violated §525(a) because, in his view, the SBA is not administrating a loan program under the PPP but is rather administering a grant program.

In *In re Hidalgo County Emergency Service Foundation* (Bankr. S.D. Tex. April 25, 2020), the court issued a TRO ordering the SBA to accept debtor's PPP application, finding that the SBA position that the PPP loan applicant certify that is not involved in any bankruptcy proceeding to qualify was not required under CARES Act or Small Business Act

In *In re Village East* 20-31144 (Bankr. W.D. Ky.), the debtor initially was approved for PPP loan and then filed Chapter 11. The bank cancelled the loan based upon "material change in circumstances." The debtor moved for a turnover of the loan but the motion was denied, presumably because of the SBA interim final rule.

Despite struggling to obtain PPP loans what are the good things small businesses can expect under Subchapter V? Some highlights follow.

Debtor Eligibility for and Election of Subchapter V Treatment

Eligibility for Subchapter V relief involves several criteria. First, debt must be incurred in connection with commercial or business activities. One court, however, has recently determined that a debtor is not required to be conducting business when filing its original petition. *In re Wright* 20-01035 (Bankr. D.S.C. April 27, 2020) dealing with a defunct business is enough to qualify. Second, the debt ceiling of $7.5 million must be satisfied. Third, not less than 50% of that debt must arise from commercial or business

activities. And finally, a debtor whose primary activity is to own or operate more than one real property is now eligible for Subchapter V.

In order to proceed under Subchapter V a debtor must opt in as part of its voluntary bankruptcy petition. The U.S. Trustee or other parties can object to the debtor's self-designation.

Case Administration, Retention of Professionals, Committees and Standing Trustee

The debtor generally has the powers to perform the functions of a debtor-in-possession. A 60-day mandatory conference and filing a pre-conference report by the debtor 14 days before the conference describing the efforts taken and to be taken to reach a consensual plan of reorganization is required. This conference provides the bankruptcy court with information about whether the debtor is on track to timely file its plan.

In a Subchapter V case a standing trustee is automatically appointed to "facilitate the development of a consensual plan of reorganization." The standing trustee has certain duties including being accountable for all property received, examining proofs of claim and objecting as required, opposing discharge if advisable, furnishing information about the estate and its administration and preparing and filing a final report. One very important role for the standing trustee is to collect and retain plan payments until confirmation of a plan and to make sure that the debtor makes timely payments as required under a confirmed plan.

Plan, Disclosure Statement, Property of the Estate and Confirmation

There are two ways in which a Subchapter V plan can be confirmed—consensually or through cramdown. A consensual plan is accepted by all classes of claims. A cramdown plan does not have an impaired accepting class of claims, but can be confirmed if the plan does not discriminate unfairly and is fair and equitable. The term fair and equitable has special meaning in a Subchapter V case. For example, as to each class of secured creditors the plan must satisfy the requirements of §11229(b)((2)(A) and as to other classes of creditors the plan as of the effective date must provide that (1) all of the projected disposable income of the debtor to be received will be applied to make payments under the plan, or (2) the value of property to be distributed under the plan is no less that the projected disposable income of the debtor.

No competing plans are allowed. The debtor can modify a plan before confirmation, after confirmation or even after substantial consummation if circumstances warrant such modification. The absolute priority rule does not apply and therefore equity owners can retain their interests in the debtor.

The SBRA generally eliminates the requirement of a disclosure statement. Instead, the plan must contain a brief history of the debtor's business, operations during the case, feasibility projections and a liquidation analysis.

Treatment of Claims

In a non-consensual plan, a debtor can pay administrative claims over the three- to five-year life of the plan but under a consensual plan such claims must be paid at confirmation.

Modification of a claim secured by the debtor's principal residence is permitted under Subchapter V so long as the mortgage was not used to purchase the residence and the new value received in connection with granting the security interest was used primarily in connection with the debtor's business.

By way of example, *In re Ventura*, 2020 WL 1867898 (E.D. N.Y. April 10, 2020) presents some novel issues as to whether a debtor can amend a prior petition to elect Subchapter V treatment and can strip down mortgage on her principal residence which was also used as a bed and breakfast. The court found in favor of the debtor with respect to amendment and further indicated that the debtor would have the opportunity to make a case for modification. These favorable rulings suggest that bankruptcy courts are inclined to not only apply the statute but also to follow the spirit of the statute to allow small business a reasonable chance to reorganize in Chapter 11.

Conclusion

Over time the benefits of Subchapter V should provide small business with a realistic chance to restructure debt and reorganize their business, thereby preserving enterprise value, maintaining business relationships and savings jobs.

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