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Insights

CARES Act Makes Bankruptcy Changes that Benefit Small Businesses

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The stress of coronavirus may cause many small businesses owners to seek relief by reorganizing their businesses in bankruptcy. Because typical reorganization (Chapter 11 bankruptcy) can be lengthy and complicated, Congress recently enacted Subchapter 5 of the Bankruptcy Code, giving small businesses a quicker, more affordable option and an increased debt limit.

Streamlined Process

Chapter 11 involves an often lengthy court process to modify or discharge business debt through a plan of reorganization approved by the bankruptcy court. The court must approve a disclosure statement that provides detailed information about the debtor's business to assist creditors in deciding whether to accept the plan. The court then determines whether the plan meets the requirements of the Bankruptcy Code for confirmation over any objections by creditors, a process referred to as "cramdown." The confirmation hearing is often hotly contested by the debtor, secured creditors, and unsecured creditors, whose interests are frequently represented by a committee appointed by the U.S. Trustee.

While Chapter 11 worked well for large businesses such as GM, the Chapter 11 process had been criticized as being too costly and time consuming for most small business debtors. Subchapter 5 is Congress's effort to remedy that problem.

Among the advantages of Subchapter 5 to the debtor are that it need not file a disclosure statement. The plan will generally be confirmed if it meets the normal cramdown requirements of Chapter 11 with respect to secured creditors and the debtor commits all of its disposable income to the payment of creditors under the plan for a period of 3 to 5 years, as may be ordered by the court. Subchapter 5 provides an expedited process to confirm the debtor's plan, which must be filed within 90 days after the filing of the bankruptcy.

In addition, there is no committee of unsecured creditors to contend with, and the quarterly fee normally applicable to Chapter 11 is not required. As a result, Subchapter 5 provides a faster, less costly alternative than the traditional Chapter 11 bankruptcy process.

Increased Debt Limit

One major limitation on Subchapter 5, as it was originally enacted, was that the debts of the debtor must not exceed $2,725,625. Pursuant to the CARES Act, that limit has been raised to $7.5 million. However, the higher limit applies only to bankruptcies that are filed within one year after the enactment of the CARES Act.

At the end of the year, the limit will return to the lower amount of $2,725,625, plus any applicable inflation adjustment. In the interim, however, the higher debt limit will enable a much larger number of small businesses to take advantage of the less costly Subchapter 5 process.

Given the economic distress that has resulted from COVID-19, it seems likely that many small businesses will take advantage of Subchapter 5.
