Bankruptcy: The Leading Option for COVID-19 Small Business Relief

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As the country reels from the staggering economic effects of COVID-19, Congress recently overhauled the Small Business Reorganization Act (or the SBRA for short), which has only been in effect since February 2020, as part of the larger COVID-19 related CARES Act legislation. These changes may make Chapter 11 reorganization a practical reality for many smaller businesses that cannot otherwise sustain a lengthy and expensive Chapter 11.

As businesses grapple with the economic fallout from COVID-19, Congress has revised the SBRA to provide more businesses access to cheaper, streamlined, and expedient bankruptcy relief. The SBRA revised debt limit has almost tripled, meaning the SBRA is now available to not-that-small-businesses. In addition, the CARES Act opens the door for several new sources of financing for struggling businesses. As businesses are contemplating bankruptcy as a potential tool to resolve the financial problems caused by COVID-19, recent changes in the law should make reorganization through bankruptcy faster and less expensive for financially strained businesses.

1. What does the SBRA have to offer smaller businesses?

Increased debt limit

The SBRA's new debt limit has increased from $2.7 million to $7.5 million (excluding amounts owed to insiders and affiliates). For a business that may not consider itself "small," but has a debt profile up to $7.5 million, the quicker, cheaper reorganization provided by the SBRA is now a reality. This is particularly helpful to a smaller business that received a COVID-19-related loan from an insider or an affiliate, as such a loan will not be included in the SBRA debt limit. For now, these changes apply to cases filed between March 28, 2020 and March 27, 2021—but lobbying groups are currently pushing to make this change permanent.

Owners have less risk of losing ownership of their company

In a traditional Chapter 11, owners of a business cannot retain ownership of their business unless all creditors are paid in full or certain other difficult, often times impossible, requirements are met. This means the typical small business owner can be faced with a difficult dilemma, namely to either restructure the business's obligations and potentially lose ownership of the company in bankruptcy or allow creditors to take collection efforts outside of bankruptcy and maintain ownership of company that may be cannibalized by creditors. Under the SBRA, this is no longer an issue. The SBRA allows small business owners to maintain ownership of their company so long as they fairly and equitably pay creditors.

Many expensive aspects of bankruptcy have been removed

A typical Chapter 11 requires bankrupt companies to pay their lawyers to attend multiple hearings in the process to approve a plan of reorganization, pay for the lawyers of an unsecured creditors' committee, and pay fees to the United States Trustee to administer the bankruptcy case. In a smaller Chapter 11 case, such fees can make the cost of reorganization impossible for a small business to bear.Under the SBRA, these expensive aspects of bankruptcy are removed. This not only cuts down on legal costs, but also streamlines the process.

Reorganization in less time

A Chapter 11 plan can take anywhere from a few months to years to draft and negotiate, and in most situations, the creditors must approve it. Now, the SBRA requires that a plan must be filed within 90 days of the bankruptcy. Further, the SBRA provides that the debtor is the only party who can file a plan and that creditor votes are not usually necessary for approval. This prevents an onerous creditor from taking control of the bankruptcy process and reduces the time, legal fees, and other expenses typically associated with Chapter 11.

2. Additional sources of funding under the CARES Act

The CARES Act created emergency business funding programs to be overseen by the Small Business Administration. This pool of new funding includes the Specified Industry Loan Program (SILP), the Emergency Economic Injury Disaster Loan and Grant Program (EIDL), and the well-publicized Payroll Protection Program (PPP). These programs offer attractive benefits such as deferred payments, loan forgiveness, less stringent underwritten requirements, and increased availability.

The PPP program was so successful that it quickly used all its appropriated funds. While Congress may have underestimated the number of businesses seeking to take advantage of this program, it is actively finalizing a bill to offer another relief package for small businesses.

3. How do these programs help my business in bankruptcy?

When a business seeks protection under Chapter 11, it generally needs fresh, unencumbered money in order to continue operations. Colloquially called DIP financing (for debtor-in-possession financing), this financing generally comes at high interest rates and can include unfavorable terms from lenders willing to take a chance on a distressed business. The new funding programs from Congress may provide a better source of DIP financing for companies using bankruptcy as a tool to curb the effects of the pandemic. Unfortunately, companies that have filed for bankruptcy are ineligible for PPP loans, but other programs such as SILP have no restrictions and may be a saving grace for debtors in need of DIP funds. There are presently other DIP funding tools for COVID-19 impacted debtors being proposed and debated.

4. What's on the horizon?

For the foreseeable future, the coronavirus will continue to take a toll on businesses, as companies large and small are beginning to consider bankruptcy as an option. This anticipated increase in filings may overwhelm the bankruptcy court system, and for small businesses looking to get ahead of the wave, the SBRA provides an appealing, but also sensible means to fix and restructure debt without the expensive and often lengthy time process of a typical Chapter 11 case. Continued changes to the SBRA and federal lending programs are expected as Congress continues to answer the call for further economic support. Winstead strives to provide our clients with the tools and expertise needed to navigate this tumultuous time and is committed to helping our clients weather the reorganization process.

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