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Distressed Investors' Unexpected Tool: Understanding the Small Business Reorganization Act and Changes Related to the CARES Act

Article By:

Patrick M. Birney

Leslie J. Levinson

Endicott (Kit) Peabody, IV

In what seems like in the blink of an eye, a once robust economy quickly evaporated, leaving many small businesses with little to no revenue and depleted cash reserves. While many businesses are facing financial distress, the federal government has sought to ease some of the burdens on distressed small businesses with several initiatives bundled within the CARES Act. While much has been made of the Paycheck Protection Program (PPP), Congress also increased the debt limit under the Small Business Reorganization Act (SBRA),[1] a new subchapter of the Bankruptcy Code's Chapter 11 reorganization provisions. The SBRA is intended to streamline the bankruptcy reorganization process for small-business debtors by eliminating certain disclosure requirements while simultaneously tightening case deadlines to make the trip through the bankruptcy process as quick as possible. This article will summarize the SBRA and highlight opportunities distressed company investors may have given the streamlined bankruptcy process enacted by the SBRA.

It is almost a certainty that as a direct result of the COVID-19 pandemic, restructuring activity for small-business debtors will increase dramatically for the foreseeable future. Many restructurings begin with an out-of-court workout which, if unsuccessful, are followed by a Chapter 11 filing culminating in the sale of the debtors' assets. Prior to the enactment of the SBRA, the bankruptcy reorganization process was seemingly out of reach for the small-business debtor because of the cost and time involved. The primary intent of the SBRA is to provide small-business debtors with a more cost-effective and efficient bankruptcy reorganization process, which may culminate in a true reorganization versus a liquidation.

To be eligible to take advantage of SBRA, among other things, (i) at least 50 percent of the small-businesses debt must have arisen from commercial or business activity, and (ii) the total debt cap for the small-business must not exceed $7.5 million. It should be noted that the CARES (Coronavirus Aid, Relief and Economic Security) Act increased the debt cap to $7.5 million from $2,725,625[2]. The benefit of the increase in the debt cap by the CARES Act is that small-businesses that could not have previously taken advantage of SBRA can now do so.

Some of the key provisions and operating philosophy of the SBRA to think about if considering a bankruptcy reorganization are as follows:

- **Increasing the Debtors' Ability to Negotiate a Successful Reorganization and Retain Control of the Business.**

- Only the small-business debtor may file a plan under the SBRA.

- The owner of the small-business debtor may retain a stake in the company so long as the plan does not discriminate unfairly, and is fair and equitable with respect to each class of claims or interests.

- If a trustee or a holder of an unsecured claim objects to the plan, the court cannot approve the plan unless the plan provides that all the small-business debtor's projected disposable income to be received during the plan will be applied to make payments under the plan for a period of three-to-five years.

- **Reducing Unnecessary Procedural Burdens and Costs.**

- Unless the court for cause orders otherwise, an official committee of unsecured creditors will not be appointed and a disclosure statement will not be required.

- **Increasing Oversight and Ensuring Quick Reorganization.**

- **A standing trustee would be appointed in every small-business debtor case to perform duties similar to those performed by a Chapter 12 or Chapter 13 trustee and help ensure the reorganization stays on track.**

- **The small-business debtor must file a plan within 90 days of commencement, which may be extended under limited circumstances.**

The SBRA, as amended, provides small businesses with an additional avenue of relief under the Bankruptcy Code, one not previously available. It may also present an opportunity for investors who focus on distressed investing. Opportunities may include purchasing existing debt below par in tandem with providing debtor in possession financing as a loan-to-own strategy. In tandem with the small business debtor, the SBRA may also provide the distressed investor with an opportunity to obtain assets free and clear of liens, claims and interests through a Bankruptcy Code process focused exclusively on an expedited and cost-efficient sale process, generally unavailable in the past. The SBRA may also provide distressed investors with a mechanism to acquire new equity in a reorganized, de-levered small-business debtor.

Given the economic uncertainty in todays "new normal," the filing of more bankruptcies is all but certain, and the SBRA is an attractive option for small-business debtors because of its debtor-friendly provisions described above. In addition, it is also likely to become a tool more widely used by distressed-company investors in the lower mid-market space as familiarity with the SBRA becomes more widely appreciated.

ENDNOTES

[1] While the SBRA was signed by President Trump on August 23, 2019, it did not go into effect until February 19, 2020.

[2] The debt cap will be decreased back to $2,725,625 in March 2021, pursuant to the terms of the CARES Act.

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