MOLAWYERSMEDIA.COM Part of the BRIDGETOWER MEDIA network AUGUST 7, 2020

Missouri Lawyers WEEKLY
MOLAWYERSMEDIA.COM
EXPERTLY FOCUSED. WIDELY ACCLAIMED. NATIONAL & STATE AWARD WINNER FOR NEWS, PHOTOS & DESIGN

Understanding the Impact of the CARES Act on Bankruptcy

By George Basharis and Kevin Checkett

Faced with an emerging economic catastrophe, Congress enacted the Coronavirus Aid, Relief, and Economic Security Act to provide emergency assistance and health care response for individuals, families, and businesses affected by the COVID-19 pandemic. Among the many provisions of the CARES Act are requirements that aim to lessen the economic impact of COVID-19 on small businesses. For example, the Paycheck Protection Program provides cash flow assistance through federally guaranteed loans to employers who maintain their payroll, and the Economic Injury Disaster Loan program offers economic relief to businesses experiencing temporary revenue losses. The CARES Act also makes some significant changes to the U.S. Bankruptcy Code that affect debt restructuring and participation in federal relief programs.

Small business bankruptcies

Prior to the enactment of the CARES Act and the COVID-19 pandemic, the Small Business Reorganization Act of 2019 created a new type of Chapter 11 bankruptcy case, effective Feb. 19, 2020, under subchapter V of the Bankruptcy Code for small businesses with debts under a specified threshold. The purpose of the new subchapter was to streamline small business reorganization cases by eliminating disclosure statements, scheduling a status conference, relaxing confirmation requirements and appointing a supervisory trustee to assist in crafting a plan. The Missouri subchapter V trustees in the Eastern District are Seth A. Albin and Stephen Coffin, and in the Western District are G. Matt Barberich, Robbin Messerli and Norman E. Rouse.

Under the SBRA, small businesses, including sole proprietors, qualify for a subchapter V case if their aggregate secured and unsecured debts do not exceed $2,725,625, and at least half of those debts are commercial or business. The CARES Act expands the scope of the subchapter V small business remedy by temporarily raising the debt threshold to $7,500,000 for cases filed after March 27, 2020, the effective date of the act. Conversion to subchapter V from another chapter or from a standard Chapter 11 case may be possible for cases filed before March 27, 2020. However, the higher threshold will revert to the original limit of $2,725,625 on March 21, 2021, absent an extension by Congress.

Payroll loans

PPP loans to small businesses were part of the more than $2 trillion aid package authorized under the CARES Act. Although they are characterized as loans by the act, PPP loans may be fully forgiven if at least 75 percent of the funds are used for payroll. A recent amendment to the PPP reduced the payroll requirement to 60 percent and extended the time in which to use the PPP funds. Moreover, a business owner who is unable to maintain the required staffing levels, or otherwise satisfy the requirements for loan forgiveness through the program, may avoid repayment by filing for bankruptcy under subchapter V or any other chapter of the Bankruptcy Code. PPP loans are unsecured obligations and a court-approved repayment plan will require only a fraction of the loan be repaid. However, the Small Business Administration, which administers the program, will deny PPP loans to companies already in bankruptcy.

In April, the SBA adopted an interim rule denying approval of PPP loans for applicants "presently involved in any bankruptcy." According to the SBA, bankrupt companies "would present an unacceptably high risk for an unauthorized use of funds or non-repayment of unforgiven loans." Moreover, applicants have an affirmative duty to notify lenders if they file for bankruptcy before loan funds are disbursed and are required to request cancellation of their applications.

The CARES Act does not exclude debtors in bankruptcy cases from receiving PPP funds, and debtors have been challenging the SBA's rulemaking authority to exclude them from the program. Bankruptcy courts have so far reached different conclusions on whether the SBA has the authority to deny PPP funds to bankrupt debtors. Courts ruling in favor of debtors have found that the SBA exceeded its rulemaking authority by disqualifying debtors from the program, that the agency's interim rules are arbitrary and capricious because they improperly impose a creditworthiness test to PPP loan applications, or that the SBA's rejection of debtor applications violates Bankruptcy Code Sec. 525(a), which prohibits the government from denying among other entitlements "grants" on account of bankruptcy.

On the other hand, courts ruling against debtors have determined that they lack the constitutional authority to address the boundaries of the SBA's rulemaking powers, the SBA acted within its statutory authority, or the agency's policy to reject debtors does not violate the Bankruptcy Code because PPP loans are not "grants" within the meaning of Sec. 525(a). In addition, the U.S. Court of Appeals for the Fifth Circuit recently determined that the Small Business Act prevents courts from compelling the SBA to make PPP loans to debtors.

The other bankruptcy question related to PPP loans is whether the funds are property of a debtor's bankruptcy estate and therefore subject to the claims of its creditors. Although PPP loans might be excluded from the means test as "payments made under Federal law relating to" the pandemic, there is no exemption in the Bankruptcy Code or any state law to shield the funds from the claims of creditors. Nonetheless, to the extent the loans will be forgiven if used for specified purposes other than funding a repayment plan in bankruptcy, a debtor is likely to be allowed to use the funds to pay payroll, rent and utilities, effectively placing PPP funds beyond the reach of creditors.

Exclusion of benefits from means testing

The CARES Act amends the Bankruptcy Code to exclude from a debtor's "current monthly income" COVID-19-related payments made under federal law. Current monthly income is used in the means-test calculation to determine a consumer debtor's eligibility to file a Chapter 7 bankruptcy case. It also is used to determine the repayment period in Chapter 13 cases. Further, an amendment to Chapter 13 reinforces that COVID-19-related financial assistance payments are not to be counted as disposable income for purposes of plan confirmation and payments to creditors.

Ordinarily, assets such as financial assistance from the government are included in a debtor's bankruptcy estate and are subject to the claims of creditors unless they are exempt under state or federal law. The CARES Act does not exclude or exempt stimulus payments from creditor claims in bankruptcy, and only one state so far has enacted an exemption to specifically protect consumer COVID-19 stimulus payments in bankruptcy proceedings. Despite the dearth of statutory protections, the U.S. Trustee's office, which has oversight over bankruptcy cases, has indicated that it does not expect Chapter 7 trustees to administer stimulus payments given the modest amount of the rebates, the applicability of existing state and federal exemptions, non-debtor spouse interests in the payments and the cost to the estate of recovering and administering stimulus payments.

The debtor also may protect stimulus payments by claiming a property exemption in the funds that is not specifically tied to pandemic financial relief; for example, by using existing state public assistance, tax credit, wild card or other property exemption. In addition, trustees should factor stimulus payments in the liquidation analysis only in cases filed after the effective date of the CARES Act and should notify the U.S. Trustee before taking any action to recover stimulus payments or objecting to a Chapter 13 plan based on the treatment of stimulus payments.

Plan modifications

The CARES Act creates a new provision in the Bankruptcy Code that allows a Chapter 13 plan that was confirmed before the effective date of the act to be modified if "the debtor is experiencing or has experienced a material financial hardship due, directly or indirectly, to the coronavirus disease." The modification may include extension of plan payments for up to 84 months from the date the first payment under the confirmed plan was due. Modifications must be requested no later than March 27, 2021, and may provide for the payment of post-confirmation defaults and unpaid installments from any mortgage or other loan forbearances. Additionally, an attempt to modify is a prerequisite to obtaining a hardship discharge prior to completing all payments under a confirmed plan. Cases confirmed after the effective date of the act are limited to a maximum repayment period of 60 months.

Conclusion

The CARES Act opens the door to new bankruptcy options for financially distressed small businesses under Chapter 11. The SBRA created subchapter V to address longstanding concerns that standard Chapter 11 cases are too time-consuming, complex and costly for successful small business reorganizations. Congress originally made subchapter V available to small businesses with relatively modest debt levels. The CARES Act nearly triples the debt threshold for the rest of 2020 and into early 2021. Timing is crucial for small businesses that intend to apply for PPP loans as the SBA restricts participation in the program for bankruptcy debtors. Finally, the act enhances bankruptcy relief for individuals by authorizing the modification of confirmed Chapter 13 plans by debtors who are affected by financial hardship as a result of the outbreak. Most of the amendments to the Bankruptcy Code will sunset automatically on March 27, 2021 — one year following enactment of the act — although Congress can extend the changes if the economic fallout from this crisis continues or deepens.

George Basharis is a business analyst with Stretto. He is a licensed attorney and author with comprehensive knowledge of bankruptcy laws and rules of practice. Kevin Checkett is a shareholder at Checkett & Pauly in Carthage. He has practiced law for 43 years in southwest Missouri, focusing on bankruptcy, lender liability, estates, receiverships and other areas of business and commerce.

Reprinted with permission from Missouri Lawyers Media, 319 North Fourth Street, Fifth Floor, St. Louis, MO 63102. Not for digital distribution. © 2020