Opportunities and Challenges for Small Businesses Under New Laws Enacted During the Pandemic

Zev Shechtman

Zev Shechtman is a partner at Danning, Gill, Israel & Krasnoff, a boutique Los Angeles law firm specializing in business bankruptcy, insolvency and restructuring.

The COVID-19 pandemic has resulted in the most severe economic decline since the Great Depression.[1] News accounts have predicted a "tsunami" of bankruptcy filings.[2] The increase in bankruptcy filings was not immediate, likely due to a combination of factors, including governmental financial interventions,[3] societal shutdowns due to social distancing and governmental "stay at home" orders,[4] the legal and practical inability of creditors to pursue collection,[5] and a freeze of civil litigation.[6] In fact, the number of bankruptcy filings in the United States dropped 39% from March to April 2020.[7] However, from April through July 2020, many national retail and restaurant chains, including Pier 1 Imports, J Crew, JC Penney, Ann Taylor, Chuck E. Cheese, Souplantation, and CPK, among others, filed chapter 11 bankruptcy petitions. A number of travel-related businesses, most prominently Hertz Rental Cars, filed bankruptcy petitions during that same period. Although national business bankruptcy filings started trending up in May and June 2020, the factors mentioned above are likely still playing an important role in easing financial pressures on businesses and individuals.

This article focuses on two bankruptcy topics that have been featured in recent legislation and bankruptcy cases. This article starts by addressing recent amendments to the United States Bankruptcy Code[8] utilized by small businesses seeking streamlined chapter 11 proceedings under the new subchapter V of the Bankruptcy Code. This article also addresses other statutory relief provided to debtors, for while Congress enacted revisions benefiting small business *prior* to the pandemic, the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") signed into law March 27, 2020, expanded that relief.[9] Specifically, the CARES Act expanded access to subchapter V. This article goes on to address some of the early judicial decisions regarding subchapter V.

Next, this article addresses a slew of nationwide cases addressing the Small Business Administration's (SBA) blanket denial of funds under Paycheck Protection Program ("PPP") to debtors in chapter 11 bankruptcy. A split has developed between bankruptcy courts issuing emergency injunctions against the SBA and other courts denying the same relief. The issue appears to be on track to adjudication before multiple circuit courts and, if the split persists, inevitably will result in a petition for writ of certiorari at the United States Supreme Court.

1. Subchapter V of the Bankruptcy Code and Cases Addressing Subchapter V

a. Statute

In 2019, Congress amended the United States Bankruptcy Code by enacting the Small Business Reorganization Act (the "SBRA").[10] One of the most important features of the SBRA is the creation of a new bankruptcy option for small businesses, subchapter V of chapter 11 of the Bankruptcy Code. Subchapter V is designed to streamline the chapter 11 process and remove some of the challenges for small businesses seeking to reorganize through bankruptcy.[11]

Initially, subchapter V was available to debtors with aggregate secured and unsecured debt of no more than $2,725,625.[12] However, as part of the CARES Act, enacted as an emergency response to the COVID-19 pandemic, the debt limit has been increased to $7,500,000, opening subchapter V to a broader segment of businesses.[13]

b. Major Features of Subchapter V

i. The Chapter 11 Plan Must Be Filed Within Ninety Days After the Bankruptcy Filing, and Only the Debtor May Propose a Reorganization Plan

In a typical chapter 11 bankruptcy case, the debtor has the exclusive right to file a plan of reorganization during the first 120 days of the case, and that exclusive right may be extended for up to eighteen months if the court finds "cause."[14] Once exclusivity expires, other parties may submit a plan.[15] Eliminating the costs and risk associated with plans proposed by competing parties, subchapter V provides that only the debtor may submit a plan.[16] Further, subchapter V requires that the plan be filed within ninety days after the filing of the petition, shortening the length of time the debtor will be subject to bankruptcy proceedings.[17] An extension beyond ninety days is allowed only "if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable."[18] Among other key requirements, unless all classes of creditors vote in favor of the plan, the plan must pay creditors an aggregate amount equal to the debtor's projected disposable income over a three-to-five-year period.[19]

ii. Owners May Keep Equity in Company (No Absolute Priority Rule)

The "absolute priority rule" in chapter 11 requires that owners of the debtor (i.e., the bankrupt company) contribute new value to maintain their equity in the reorganized company. That requirement is expressly eliminated from subchapter V, removing a major financial cost and risk from the reorganization process.[20]

iii. Discharge

If a plan is consensual (meaning that all classes of creditors vote in favor of the plan), the debtor will receive a discharge upon confirmation. If the plan is not consensual, the debtor's remaining debts will be discharged only if the debtor makes all its required plan payments.[21]

iv. Trustees

All subchapter V cases have a trustee, a professional fiduciary, who oversees the case.[22] The trustee's role includes investigating the business and financial affairs of the debtor, and may include distributing plan payments. The trustee also has a duty to "facilitate the development of a consensual plan of reorganization."[23] The subchapter V trustee's role is more limited than the role of a chapter 7 trustee or that of a trustee appointed in a chapter 11 case for cause. Unlike those situations, in subchapter V, the debtor stays in control of its business operations, as a "debtor in possession," unless removed for "cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor."[24]

v. No Disclosure Statement is Required Unless Ordered by the Court for Cause

In a typical chapter 11, the debtor is required to prepare a "disclosure statement" that the court reviews for adequacy of information as a preliminary step before the plan can be voted on by creditors and confirmed by the court. Preparation of the disclosure statement is one of the factors that contributes to the time and expense of a typical chapter 11 case. Subchapter V eliminates that step from the process unless ordered by the court for cause.[25]

vi. No Creditors' Committee

Creditors' committees can play an important role in chapter 11 cases.[26] The committee allows creditors to advocate collectively for the best interests of all the general unsecured creditors (or other classes of creditors or interest holders). However, the creditors' committee is also sometimes cited as a major expense that prevents small businesses from utilizing and successfully emerging from chapter 11. Subchapter V eliminates committees from the process unless expressly ordered by the court for cause.[27]

c. Cases Examining Subchapter V

Subchapter V of the Bankruptcy Code became effective on February 19, 2020. Most of the initial court decisions addressing subchapter V focused on whether a bankruptcy petition filed prior to the effective date of the SBRA could be amended to change an existing case into a subchapter V case. Those cases have broadly come down in favor of permitting amendment. Although there are

many other topics that may arise as the case law develops, for now the only other issue addressed in cases submitted for publication is the ability of subchapter V trustees to employ counsel, which is also addressed below.

i. Amending Petitions to Subchapter V

In *In re Progressive Solutions, Inc.*,[28] the debtor sought authority to amend the case to change it from a small business chapter 11 case to a subchapter V small business debtor case.[29] The case had been filed on November 21, 2018, as a small business chapter 11 case. At a hearing on February 20, 2020, the day after the SBRA became effective, the debtor requested that the petition be re-designated a subchapter V "small business debtor" petition. The court ruled that the amendment could be made at any time without leave of court pursuant to rule 1009(a) of the Federal Rules of Bankruptcy Procedure (FRBP), which provides, "[a] voluntary petition, list, schedule, or statement may be amended by the debtor as a matter of course at any time before the case is closed."[30]

In another case, *In re Moore Properties of Person County, LLC*,[31] the debtor filed a small business chapter 11 case nine days before the effective date of SBRA. A creditor immediately objected because the debtor was the owner of three real properties and its primary activity was the business of owning or operating real estate, making the debtor ineligible for designation as a "small business debtor" under the then-existing language of the applicable Bankruptcy Code provision.[32] Five days after the effective date of SBRA, the debtor filed an amended petition, changing the case to one under subchapter V. The court authorized the amendment in light of SBRA's revision to section 101(51D) of the Bankruptcy Code. That section used to say that a debtor whose primary activity is the business of owning or operating real estate is not a "small business debtor," but now the exception applies more narrowly to a debtor who operates "single asset real estate." In *In re Moore Properties of Person County, LLC*, the debtor owned three separate properties, each leased for third-party farming operations, so it was not a single-asset real estate debtor. At the time of the hearing, the "small business debtor" designation was correct, and the debtor was entitled to amend as of right under FRBP 1009.

In *In re Body Transit, Inc.*, [33] another case analyzing the question of amendment, the court agreed that the debtor had the right to amend its petition to change the case to a subchapter V case. Further, the court determined that the standard applicable to a creditor's objection to an amended petition was whether the creditor would be prejudiced by the amendment or whether the amendment had been made in bad faith. Because the objecting creditor in *In re Body Transit, Inc.* did not satisfy its burden of proof, the court overruled the objection and approved the amendment.[34]

Finally, another court, in *In re Bello,* [35] analyzed a personal case originally filed by an individual under chapter 13. The debtor converted the case to chapter 11, and, finally, after the effective date of SBRA, the debtor amended the petition to change the case to one under subchapter V. Applying *Moore*, the court approved the amendment.[36]

ii. Employment of Professional Persons by Subchapter V Trustee

Trustees under chapters 7 and 11 have broad discretion in employing professional persons to aid them in the administration of a bankruptcy estate.[37] Trustees under chapters 12 and 13, where debtors remain in possession and continue to manage their own business affairs, tend to employ professionals in more limited situations. The bankruptcy court in *In re Penland Heating and Air Conditioning, Inc.* considered the standard for employment of attorneys by subchapter V trustees.[38] The court found that a subchapter V trustee may employ counsel. However, the court concluded, in light of the more limited role of a subchapter V trustee, like in a chapter 12 or 13 case with a debtor staying in possession, the circumstances warranting a trustee's employment of attorneys are more limited. In *In re Penland Heating and Air Conditioning, Inc.*, the subchapter V trustee was seeking to employ counsel as a matter of course, even though no particular legal need had yet arisen. The court determined that such employment was premature and denied the request to employ counsel without prejudice.[39]

2. Bankruptcy Court Decisions Regarding SBA Denial of PPP Funds to Chapter 11 Debtors

In response to the COVID-19 pandemic, Congress enacted, and the President signed into law, the CARES Act.[40] Section 1102 of the CARES Act created the Paycheck Protection Program (the "PPP").

Under the PPP, small businesses may obtain SBA-guaranteed loans to cover certain expenses, including

"payroll costs," "interest on any mortgage obligation," "rent," and "utilities." Loans issued under the PPP may be forgiven if the proceeds of the loan are used to cover allowable expenses.[41]

In two rounds of allocations, participating banks have issued hundreds of billions of dollars in PPP funds on a "first come, first serve" basis. The process has not been without challenges.[42]

For bankrupt debtors seeking PPP funds to aid their reorganizations, the process has been especially difficult due to an SBA policy against extending PPP funds to debtors. In fact, the PPP application form itself says that the loan will not be approved if the applicant answers "yes" to the following question: "Is the Applicant or any owner of the Applicant . . . presently involved in any bankruptcy?"[43]

Bankruptcy courts across the country have been presented with lawsuits challenging the SBA's policy, accompanied by emergency motions for temporary restraining orders and injunctions. The challenges are based on two separate federal statutory provisions. One argument is that the SBA's denial of PPP eligibility to bankrupt entities runs afoul of Bankruptcy Code section 525(a)'s prohibition against certain discriminatory actions by governmental entities against debtors.[44] The other argument is that the SBA's policy violates the Administrative Procedures Act,[45] because the policy is "arbitrary" and "capricious,"[46] and because the SBA exceeded its statutory authority.[47]

In one of the earliest cases addressing this issue, *In Re Hidalgo Cty. Emergency Service Foundation*,[48] a Texas bankruptcy court issued a temporary restraining order against the SBA for violating Bankruptcy Code section 525(a) and exceeding its authority when it required applicants to submit loan application forms stating that loans will be denied to bankruptcy debtors who would otherwise qualify for PPP loans. Without much analysis of the legal issues, the court issued a temporary restraining order enjoining the enforcement of the condition that PPP applicants not be "presently involved in any bankruptcy"[49] based on the urgent need for funding for the debtor, which provided emergency medical services. The SBA appealed, and the district court stayed the effect of the order and certified the appeal to the Fifth Circuit. On appeal, the Fifth Circuit reversed, vacating the temporary restraining order based on a precedent holding that "all injunctive relief directed at the SBA is absolutely prohibited."[50]

The Bankruptcy Code provides that the government may not "deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to" debtors based on discrimination against their debtor status.[51] In *In re Roman Catholic Church of Archdiocese of Santa Fe*,[52] the court evaluated whether the SBA's policy was the type of discriminatory conduct prohibited in section 525(a) of the Bankruptcy Code. The SBA argued that section 525(a) does not bar discrimination against debtors regarding loan applications, and the PPP application was expressly for a loan. The court disagreed with the SBA's argument. The court found that PPP loans fall within the ambit of "other similar grant" mentioned in section 525(a) of the Bankruptcy Code. Because a PPP loan is forgivable, the loan proceeds are primarily designed to serve as a grant or support. Further, the court found, the SBA had violated the Administrative Procedures Act, because its decision to exclude bankruptcy debtors from the PPP was "arbitrary and capricious" and exceeded the SBA's authority. The SBA's rationale was that "bankruptcy debtors 'present an unacceptably high risk for an unauthorized use of funds or non-repayment of unforgiven loans.'"[53] The court thought this argument was nonsensical, given the heightened and strict disclosures required of debtors in chapter 11.

Going in the other direction, the court in *Schuessler v. U.S. Small Business Administration*[54] ruled that section 525(a) does not preclude the SBA from denying a PPP loan to a debtor in bankruptcy. The court reasoned that, as a "loan," the PPP money does not fall within section 525(a)'s scope. As to the arguments under the Administrative Procedures Act, the court found the SBA's arguments plausible under a highly deferential standard afforded to federal agencies. The SBA argued that excluding bankruptcy debtors from the program was part of the SBA's process of expeditiously setting standards to qualify for PPP funds. While the method was not "precise" and could have been better, that did not meet the standard necessary to invalidate the SBA's policy.[55]

Other courts ruling that the PPP monies were "loans" and therefore not within the ambit of section 525(a) have found that "'[t]he exclusion of persons involved in bankruptcy from the PPP does not conflict with the fresh start or otherwise frustrate the operation

of the Bankruptcy Code' and is 'not similar to denying a debtor a license to operate in his chosen field and thereby denying the debtor the opportunity to pursue economic betterment.'"[56]

As we go to press on this article, the SBA's policy is still being hotly litigated, and the facts on the ground continue to evolve. The original deadline for PPP funding was June 30, 2020. However, with four hours remaining and $130 billion left unspent, the Senate voted to extend the program through August 8, 2020.[57]

The legal fight between debtors and the SBA is destined to continue.[58] Unless the courts of appeal find some common ground on this issue, it appears likely that only the Supreme Court will be able to resolve the dispute.

Endnotes

1 *See* Josh Zumbrun, *Coronavirus Slump Is Worst Since Great Depression. Will It Be as Painful?*, Wall St. J. (May 10, 2020), https://www.wsj.com/articles/coronavirus-slump-is-worst-since-great-depression-will-it-be-as-painful-11589115601.

2 Michael Braga, *With Bankruptcies Surging, 2020 May Become One of the Busiest Years for Chapter 11 Filings Since the Great Recession*, USA Today (June 29, 2020), https://www.usatoday.com/story/money/2020/06/29/coronavirus-oil-industry-troubles-could-fuel-chapter-11-filings-2020/3249794001/ ("[E]xperts believe this is just the beginning of a bankruptcy tsunami that will wash over the country's largest companies this summer and then drench both smaller businesses and individuals if government stimulus money dries up.").

3 Most prominently, the Coronavirus Aid, Relief, and Economic Security Act of 2020 (Pub. L. No. 116-136, 134 Stat. 281 (2020)) (the "CARES Act"), enacted by the President on March 27, 2020.

4 *See*, *e.g.*, Cal. Exec. Order No. N-33-20 (Mar. 19, 2020), https://www.gov.ca.gov/wp-content/uploads/2020/03/3.19.20-attested-EO-N-33-20-COVID-19-HEALTH-ORDER.pdf (the "Stay at Home" order, limiting various nonessential businesses and other activities during the pandemic).

5 *See*, *e.g.*, Cal. Exec. Order No. N-37-20 (Mar. 27, 2020), https://www.gov.ca.gov/wp-content/uploads/2020/03/3.27.20-EO-N-37-20.pdf (establishing an eviction moratorium throughout California).

6 *See*, *e.g.*, News Release, Superior Court of Cal., L.A. Cty., Presiding Judge Kevin C. Brazile Issues Implementation Order to Continue All Nonemergency Matters for 30 Days Due to Coronavirus (COVID-19) Pandemic (Mar. 17, 2020), http://www.lacourt.org/newsmedia/uploads/14202033011125520NRPJORDERREIMPLEMENTATIONOFNON-EMERGENCYORDERSfinal.pdf.

7 American Bankr. Inst., Statistics, https://www.abi.org/newsroom/bankruptcy-statistics.

8 11 U.S.C. § 101 et seq. (the "Bankruptcy Code"). Unless otherwise indicated, references in this article to statutory sections are to sections of the Bankruptcy Code.

9 Pub. L. No. 116-136, 134 Stat. 281 (2020) (the "CARES Act").

10 Pub. L. No. 116-54, 133 Stat. 1079 (2019) (the "SBRA").

11 *See*, *e.g.*, Grassley & Whitehouse, et al., Statement of Senate proponents of SBRA, https://www.grassley.senate.gov/sites/default/files/documents/Bankruptcy%2C%2004-09-19%2C%20Small%20Business%20Reorganization%20Act%20Fact%20Sheet.pdf.

12 11 U.S.C. § 101(51D).

13 *See* H.R. 748, 116th Cong. § 1113 (The increase in the debt limit is scheduled to sunset after one year).

14 11 U.S.C. § 1121.

15 *Id.*

16 *Id.* § 1189(a).

17 *Id.* § 1189(b).

18 *Id.*

19 *Id.* § 1191(c)(2)(A).

20 *Id.* § 1181(a).

21 *Id.* § 1192.

22 *Id.* § 1183.

23 *Id.* § 1183(b)(7).

24 *Id.*§ 1185.

25 *Id.* § 1181(b).

26 *See id.* §§ 1102-1103.

27 *Id.* § 1181(a).

28 *In re* Progressive Sols., Inc., No. 8:18-BK-14277-SC, 2020 WL 975464 (Bankr. C.D. Cal. Feb. 21, 2020).

29 Lest there be confusion, a "small business case" is a small business chapter 11 case that is not a "subchapter V" case. 11 U.S.C. § 101(51C).

30 Fed. R. Bankr. P. 1009(a).

31 *In re* Moore Props. of Pers. Cty., LLC, No. 20-80081, 2020 WL 995544 (Bankr. M.D.N.C. Feb. 28, 2020).

32 11 U.S.C. § 101(51D).

33 *In re* Body Transit, Inc., 613 B.R. 400 (Bankr. E.D. Pa. 2020).

34 *Id.* at 409.

35 *In re* Bello, 613 B.R. 894 (Bankr. E.D. Mich. 2020).

36 *Id.* at 896.

37 11 U.S.C. § 327 ("trustee, with court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons").

38 *In re* Penland Heating and Air Conditioning, Inc., No. 20-01795-5-DMW, 2020 WL 3124585, at *2 (Bankr. E.D.N.C. June 11, 2020).

39 *Id.* ("If during the case the Trustee identifies a specific need for the employment of an attorney or other professional, then the court will consider another request.").

40 Coronavirus Aid, Relief, and Economic Security Act of 2020, Pub. L. No. 116-136, 134 Stat. 281 (2020).

41 *See* CARES Act § 1106(b); 15 U.S.C. § 9005(b).

42 *See*, *e.g.*, Stacy Cowley et al., *Small-Business Loan Program, Chaotic from Start, Gets 2nd Round*, N.Y. Times (Apr. 26, 2020), https://www.nytimes.com/2020/04/26/business/ppp-small-business-loans.html.

43 Paycheck Protection Program, Borrower Application Form Revised June 12, 2020, https://www.sba.gov/sites/default/files/2020-06/PPP%20Borrower%20Application%20Form%20%28Revised%20June%2012%202020%29-Fillable-508.pdf.

44 11 U.S.C. § 525(a).

45 5 U.S.C. §§ 500 et seq.

46 *Id.* § 706.

47 *Id.* § 706(2)(C).

48 *In re* Hidalgo Cty. Emergency Serv. Found., No. 19-20497, 2020 WL 2029252, at *1–2 (Bankr. S.D. Tex. Apr. 25, 2020).

49 *Id*. at *3.

50 *In re* Hidalgo Cty. Emergency Serv. Found., No. 20-40368, 2020 WL 3411190, at *1 (5th Cir. June 22, 2020)

51 11 U.S.C. § 525(a).

52 *In re* Roman Catholic Church of Archdiocese of Santa Fe, No. 18-13027 T11, 2020 WL 2096113, at *8 (Bankr. D.N.M. May 1, 2020).

53 *Id*.

54 Schuessler v. U.S. Small Bus. Admin., No. AP 20-02065-BHL, 2020 WL 2621186, at *9 (Bankr. E.D. Wis. May 22, 2020).

55 *Id*.

56 The Diocese of Rochester v. U.S. Small Bus. Admin., No. 6:20-CV-06243 EAW, 2020 WL 3071603, at *9–10 (W.D.N.Y. June 10, 2020) (quoting *In re* Penobscot Valley Hosp., Nos. 20-1005, 20-1006, 2020 WL 3032939, at *14 (Bankr. D. Me. June 3, 2020)). *See also In re* Henry Anesthesia Assocs. LLC, No. 19-64159-LRC, 2020 WL 3002124, at *7 (Bankr. N.D. Ga. June 4, 2020) (pointedly observing that by its policy the SBA "has discriminated against debtors solely based on their status as debtors in bankruptcy. However, the Court must conclude that this form of discrimination is not one of those prohibited by § 525(a).").

57 S. 4116, 116th Cong. (2020).

58 Alex Wolf, *Virus Aid Continues to Elude Bankrupt Companies as Deadline Hits*, Bloomberg L. (June 30, 2020), https://news.bloomberglaw.com/bankruptcy-law/virus-aid-continues-to-elude-bankrupt-companies-as-deadline-hits ("Despite the PPP application window closing, a tangled web of federal lawsuits and appeals will likely continue into the future.").