CARES Act to Impact Small Business Bankruptcy

The $2 trillion economic stimulus package is on its way to businesses and individuals across the U.S. Officially named the Coronavirus Aid, Relief and Economic Security Act (CARES Act), President Trump signed the act into law at the end of March to help those being impacted by the outbreak of COVID-19.

The CARES Act modifies the newly implemented Small Business Reorganization Act (SBRA), which was passed to help those with smaller debts and with small businesses go through what could be a very expensive process in Chapter 11 bankruptcy. As it was originally passed, the SBRA threshold to file under Subchapter V of the Chapter 11 Bankruptcy Code was roughly $2.7 million of debt. The CARES Act raises that threshold to $7.5 million, allowing the potential for more small businesses to file under the plan should they struggle during the pandemic. The dollar amount increase lasts for one year. However, there is the fear in the credit community the increase has the potential of sticking around longer or growing in dollar amount.

This increase gives smaller businesses the opportunity to file Chapter 11 bankruptcy that wouldn't have had the chance under the lower threshold. "Absent this increase in the debt ceiling, many small businesses that are financially distressed due to the COVID-19 environment could fall through the cracks—too big for the more efficient and cost-effective SBRA Chapter 11 process, yet too small to afford or survive a traditional Chapter 11 which is more expensive and less efficient," said Jason Torf, partner with Ice Miller LLP. "As a result, without the increase, many companies that exceed the lower debt ceiling under SBRA but fall under the higher ceiling under the CARES Act could end up failing without any reasonable prospect of using bankruptcy to reorganize," he said.

"This, in turn, is good for creditors, in my view. Where the alternative is a customer's liquidation, it is better for the customer to have a viable option to reorganize which, if successful, creates the opportunity for the supplier to preserve the ongoing business relationship going forward. In addition, the prospect of recovery on prepetition claims often is better in a successful reorganization than in a liquidation. This is a win-win for creditors," Torf added.

However, there are risks for creditors. "Many creditors are themselves small businesses and this could very easily have a snowball effect," said Val Venable, CCE, CICP. "I've sat on creditors' committees and seen otherwise solvent companies become insolvent due to a preference action or even just the act of the debtor's automatic stay eliminating the cash flow from the creditor," Venable said. "They in turn had no other option but to themselves file an insolvency action or have their bank foreclose and force them out of business. The larger the pool of exceptions, the more this will become a deep hole."