

BANKRUPTCY & COVID-19 WORKING GROUP

The Honorable Nancy Pelosi Speaker
House of Representatives
1236 Longworth House Office Building
Washington, DC 20515

The Honorable Mitch McConnell
Senate Majority Leader
United States Senate
317 Russell Senate Office Building
Washington DC 20510

The Honorable Kevin McCarthy
House Minority Leader
House of Representatives
2468 Rayburn House Office Building
Washington, DC 20515

The Honorable Charles Schumer
Senator Minority Leader
United States Senate
322 Hart Senate Office Building
Washington, DC 20510

May 26, 2020

Dear Sens. McConnell and Schumer, and Reps. Pelosi and McCarthy:

This proposal is intended to assist small businesses struggling to survive in the wake of the economic crisis provoked by the COVID-19 pandemic. Specifically, we propose changes to the Small Business Reorganization Act of 2019 (now subchapter V of Chapter 11) that would give debtors essential breathing room to manage their debts in the wake of the national shutdown, allowing viable debtors to reorganize and return to profitability in the near future.

We are an interdisciplinary group of scholars who study the corporate bankruptcy system and the problems associated with financial distress. We have formed a committee (the “Small Business Committee of the Bankruptcy & COVID-19 Working Group” or “Committee”)¹ to analyze the effect of the COVID-19 pandemic on small American businesses and to consider changes that might be needed to improve the ability of the bankruptcy system to cope with the crisis. While we are in the early stages of our work, and there are many issues still to cover, we write today to recommend strongly that Congress adopt temporary changes to the Bankruptcy Code that allow small business owners to delay proceedings until economic activity has been substantially restored.

¹ The Small Business Committee of the Bankruptcy & COVID-19 Working Group is one of four committees that are part of a larger group studying financial distress and COVID-19, each focused, respectively, on either (1) large corporations, (2) small businesses, (3) consumers, or (4) municipalities. The Small Business Committee includes, with institutional affiliations included for identification purposes only: Anthony Casey (University of Chicago Law School), Brook Gotberg (University of Missouri School of Law), Robin Greenwood (Harvard Business School), Benjamin Iverson (BYU Marriott School of Business), Edward Janger (Brooklyn Law School), Song Ma (Yale University School of Management), Edward Morrison (Columbia University Law School), Katherine Waldock (Georgetown University McDonough School of Business), Jialan Wang (University of Illinois Urbana-Champaign Business School), Michelle White (University of California San Diego and NBER), and Yesha Yadav (Vanderbilt University Law School). Additional members of the Working Group who agree with our recommendations are listed as additional signatories below.

We recommend an automatic six-month suspension of small business cases commenced under Subchapter V of Chapter 11 during the COVID-19 pandemic.² During this suspension, small businesses would receive the protection of the automatic stay and permission to continue operating in the ordinary course. In all other respects, the Chapter 11 case would be functionally on hold, with internal bankruptcy deadlines tolled and motions to lift the automatic stay delayed. Secured creditors would be deemed adequately protected.³ Further, obligations that would typically require payment in full prior to the confirmation of the plan, including cure amounts for assumed contracts and leases, would be eligible for amortization as part of a confirmed plan.

The overarching issue that our proposal aims to address is uncertainty about the prospects of financially distressed small businesses. Chapter 11 bankruptcy is designed to differentiate between viable and non-viable businesses, and current law is geared to perform this filtering in a functioning economy. But this differentiation will be difficult, if not impossible, in the current economic environment of artificially depressed cash flows. The problem is further complicated by possible structural changes in the U.S. economy following the pandemic. Under the current regime, standard deadlines and mandatory motions will force judges, creditors, and owners to make decisions with little indication of the long-term viability of restructuring firms. Without reform, we anticipate that a significant fraction of viable small businesses will be forced to liquidate, causing high and irreversible economic losses. Workers will lose jobs even in otherwise viable businesses. Assets will be sold at steep discounts and at effectively fire-sale valuations, pushing asset values down across Main Street. Alternatively, tight deadlines may lead to overly-optimistic restructuring plans and subsequent re-filings that will congest courts and delay future recoveries.

Below, we detail the unique problems that the COVID-19 pandemic has created for small businesses that may seek relief through Chapter 11. For each problem, we propose temporary solutions that will help smooth the transition back to a robust economy.

Problem 1: If a business has impaired cash flows and there is lingering uncertainty about future recovery, it will be difficult to form a restructuring plan within currently-prescribed time frames.

Small business debtors need more time to allow economic uncertainty to decrease. We recommend the law be amended to automatically extend the following deadlines by 180 days for all small business debtors commencing cases under Subchapter V of Chapter 11:

- The 30-day deadline for a hearing on a motion to lift the automatic stay; *see* 11 U.S.C. § 362(e)
- The 30-day deadline for filing all schedules and statements of financial affairs; *see* 11 U.S.C. §§ 1116, 1187
- The 60-day deadline for a status conference; *see* 11 U.S.C § 1188(a)
- The 90-day deadline to file a plan; *see* 11 U.S.C § 1189(b)

² The definition of a small business would be that adopted by the Small Business Reorganization Act (SBRA), as amended by the CARES Act. *See* 11 U.S.C. § 101(51D); CARES Act § 1113. The same sunset provision applicable to the bankruptcy provisions of the CARES Act would also apply to these proposals.

³ See “Problem 3” below for discussion of additional protections for creditors.

- The 300-day absolute deadline to file a plan; *see* 11 U.S.C § 1121(e)(2)
- The deadline for the payment of filing fees; *see* 28 U.S.C § 1930(a)(6)(A)

We further recommend that ongoing reporting requirements be likewise suspended for 180-days. *See* 11 U.S.C. § 308.

Problem 2: Business owners need permission to use cash so that they can pay their employees and continue operating during bankruptcy. This is true whether or not a business is actually operating or, like many, shut down for an extended period as “non-essential” in a time of pandemic.

In order for a business owner in bankruptcy to meet expenses associated with the maintenance of the business as a going concern, she must first receive permission from the court. These expenditures include payments to employees and essential suppliers. Sources of financing for these expenditures typically include cash collateral and, in some cases, post-petition credit provided by external lenders.

We recommend that, for small business debtors whose deadlines have been tolled as set forth above, the following motions, if submitted, should nonetheless be heard at the outset of the case:

- Motions to pay prepetition wages and to continue paying wages and benefits in the ordinary course
- Motions to use cash collateral as necessary to continue operating in the ordinary course of business (“cash collateral motions”)
- Motions to give administrative expense priority to claims arising from essential supplier agreements (“critical vendor motions”)
- Motions to permit debtors to obtain, on a super-priority basis, any additional funds needed to maintain operations during the case (“debtor-in-possession financing motions”)

We further recommend that, for purposes of cash collateral motions, a business that remains fully or partially shut down pursuant to state order, the recommendation of health officials, or the economic realities of the moment can be considered operating in the ordinary course of business.

Problem 3: While in bankruptcy, some businesses may fail to preserve the value of assets. Courts should ensure that the value of collateral is protected while avoiding lengthy disputes during the suspension period.

While in bankruptcy, some businesses may not have proper incentives to preserve the value of assets that are pledged as collateral to secured creditors. Those creditors should have the right to ensure that their collateral is adequately protected. At the same time, systemic asset price disruptions resulting from the pandemic should not serve as justification for secured creditors to

seek relief from the automatic stay. Those relief motions may act as nuisances that entangle business owners in court battles, or, even worse, act as fuel that aggravates the fire sale of assets.

Many small business owners who are unable to pledge substantial collateral for loans instead rely on personal guarantees of their business debts. To some extent, creditors seeking judgments for those personal guarantees operate outside the bankruptcy system. However, any deadlines that are tolled for a small business case should also be tolled for an individual case that results from the enforcement of a personal guarantee of that business's debt.

We recommend that, for small business debtors whose deadlines have been tolled as set forth above, the Bankruptcy Code be amended, to give the court the additional power to:

- Suspend motions for relief of stay until the end of the 180-day period
- Hear any motions for adequate protection brought by secured creditors and set amounts for adequate protection without relying on a motion for relief of stay
- Apply the 180-day tolling of deadlines to any individual Chapter 7, Chapter 11, or Chapter 13 cases that arise as a result of a judgment associated with a personal guarantee of any business debt that is part of the original small business case

Problem 4: Small businesses may have accumulated significant unpaid obligations prior to bankruptcy that, under normal circumstances, would be due immediately following a bankruptcy filing, and which would prove onerous to any plan of reorganization.

Given the current crisis, small businesses may enter bankruptcy with unprecedented levels of unpaid lease and mortgage obligations. Small businesses in the current environment are unlikely to have the resources to make these payments up front, and may struggle to make the payments at all.

For small business debtors whose deadlines have been tolled as set forth above, we recommend the following changes to alleviate the pressure of these obligations:

- The prompt cure provision for unpaid executory contracts or lease obligations be temporarily relaxed so that small business owners can negotiate and amortize these payments over the life of a confirmed plan; *see* 11 U.S.C § 365(b)
- For secured obligations for which the value of the collateral exceeds the value of the debt, interest accumulated between March 13, 2020⁴ and the date of the bankruptcy filing be treated as “unmatured” and therefore disallowed; *see* 11 U.S.C §§ 502(b)(2); 506(b)

Problem 5: Small businesses may not be able to make lease payments while the effects of COVID-19 persist.

For many small businesses, it will be critical for the maintenance of ongoing operations that they remain in the same commercial space. However, they may not be able to perform under

⁴ March 13, 2020 was the date of the national emergency proclamation concerning COVID-19.

lease agreements that were executed prior to the pandemic. Debtors need time to restore cash flows before these leases can be fully renegotiated. However, landlords should be entitled to assurance that the value of their property will be reasonably protected during the pendency of the bankruptcy case and that missed rent payments will not be readily extinguished upon confirmation of a plan.

We recommend that, for small business debtors whose deadlines have been tolled as set forth above, the following changes should be made to the Bankruptcy Code:

- Allow debtors 210 days to assume or reject leases; *see* 11 U.S.C § 365(d)(4)(A)
- Suspend the requirement that the debtor perform its obligations under unexpired leases of nonresidential real property within 60 days after the order for relief, provided that the court finds that the debtor is continuing to experience a material financial hardship due, directly or indirectly, to the COVID-19 pandemic;⁵ *see* 11 U.S.C. § 365(d)(3)

In addition, we recommend that the following motions (if submitted) should be heard promptly:

- Motions for the payment of utilities, insurance premia, and maintenance agreements
- Motions for the adequate protection of nonresidential commercial property, provided that landlords present evidence of significant diminution of value

Problem 6: Even with the option to defer proceedings, courts may be flooded with cases as the economy stabilizes.

We anticipate a dramatic increase in bankruptcy filings in the near future, as unpaid debts accumulate and lenders begin collection efforts. Although bankruptcy filings are currently down, we expect that a wave is coming. More filings require more resources from the bankruptcy system.

We propose the following solutions:

- Appoint additional bankruptcy judges, even if only on a temporary basis
- Select additional SBRA subchapter V trustees, even if only on a temporary basis

Notwithstanding any of the recommendations made above, we believe that courts should have the flexibility to dismiss any case for which a global settlement among parties is reached. Any case that is not dismissed by the end of the 180-day deferral period should proceed according to the rules of the Code as modified by the SBRA.

We look forward to discussing these recommendations with you.

Sincerely,

⁵ *See* In re Pier 1 Imports, Inc., No. 20-30805 (KRH), 2020 WL 2374539, (Bankr. E.D. Va. May 10, 2020)

/s/ Brook Gotberg

Brook Gotberg, Chair

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