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COVID-19: How Chapter 7, Chapter 11, and Chapter 13 Bankruptcies are Impacted by the CARES Act

Chapter 11

In February 2020, the Small Business Reorganization Act (SBRA) became effective, creating a new cost-effective method for small businesses to re-organize under the bankruptcy code. The SBRA created a new subchapter under Chapter 11 of the bankruptcy code that is commonly referred to as “Subchapter 5.” Subchapter 5 aims to give businesses with debts that are under a certain threshold a faster and less expensive option for reorganizing under a Chapter 11 bankruptcy. Legal commentators had long lamented that Chapter 11's high costs and complexities make it too difficult for small businesses to successfully reorganize.

While Subchapter 5 reorganization is supposed to be faster and less expensive than a traditional Chapter 11 bankruptcy re-organization, it was originally limited to businesses with debts of $2,725,624 or less. On March 27, 2020, the President signed into law the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) to mitigate the widespread economic effects of COVID-19. The CARES Act expands the definition to include businesses with debts up to $7.5 million. Therefore, businesses with debts of $7.5 million or less will now qualify to file cases under Subchapter 5. This change in the debt limit applies only to cases filed after the CARES Act became effective on March 27, 2020, and is in effect for one year after the CARES Act took effect. After the one-year deadline expires, the debt limit for cases under Subchapter 5 will return to $2,725,625 and “sunset,” absent an extension by Congress. The debt counted includes the aggregated noncontingent, liquidated, secured and unsecured debt, excluding insider and affiliate debt. This expansion should allow more businesses to use the streamlined bankruptcy re-organization provisions.

Chapter 7 and Chapter 13

The CARES Act also modified Chapters 7 and 13 of the bankruptcy code, ensuring that income received as a result of the CARES Act is excluded from income under Chapter 7, as well as the calculation of disposable income under Chapter 13. The Act also allows modification to Chapter 13 approved plans if the modification is a result of material financial hardship due to COVID-19. These provisions “sunset” as well one year after the CARES Act’s enactment.

Specifically, the CARES Act modifies the definition of “current monthly income” in the bankruptcy code to expressly exclude payments made under federal law relating to the national emergency declared by the President under the National Emergencies Act with respect to COVID-19. The CARES Act also states that any payments made to individuals under federal law relating to the COVID-19 pandemic do not constitute “disposable income” required to be committed to a Chapter 13 debtor’s plan. The amended definition of “disposable income” should benefit both current Chapter 13 debtors who did not have confirmed plans as of the date of enactment of the CARES Act, as well as future Chapter 13 debtors.

The CARES Act also permits current chapter 13 debtors with plans confirmed as of the date of enactment of the CARES Act to seek modifications of their plan due to COVID-19-related hardships. Specifically, the CARES Act permits a debtor to modify a confirmed plan, after notice and a hearing, if such debtor is experiencing a "material financial hardship" due, "directly or indirectly," to the COVID-19 pandemic. Under the CARES Act, a plan also may be modified to extend the plan period up to seven years after the first payment under the original confirmed plan became due. The CARES Act also grants bankruptcy courts the ability to approve these modifications upon request of a debtor.

The CARES Act, however, does not define the scope of an "indirect" hardship arising from the COVID-19 pandemic or what type of proof will be required of a debtor to show indirect hardship. Given the hardships of COVID-19, it is likely that many debtors with confirmed plans will meet the qualifications for "material financial hardship" directly or indirectly arising from the COVID-19 pandemic, but how broadly bankruptcy courts will interpret these standards is yet to be determined.

It is expected that the plan modification provision permitted by the CARES Act will cause debtors to include requests for deferred payments on various types of consumer debt, such as mortgage loans, auto loans, credit cards, and student loans. Although payments may be deferred, there does not presently appear to be any reason why a Chapter 13 creditor would be relieved of its obligation to file timely notices to creditors pursuant to federal bankruptcy rules in the event of a future payment change, since the rule does not carve out any exception for forbearance agreements or similar types of deferred payment agreements.