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# Restructurings in the Age of COVID-19 and the CARES Act

To mitigate the financial havoc caused by the COVID-19 pandemic, Congress swiftly passed a myriad of well-intentioned bills—and set the stage to redefine the landscape for restructurings.

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In the wake of the global COVID-19 pandemic, Congress hurriedly passed a host of economic relief bills to provide "American workers, families, and small businesses fast and direct economic assistance and to preserve jobs." The Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") was enacted in March 2020 to provide over $2 trillion in economic relief. The CARES Act included the Paycheck Protection Program ("PPP") and certain follow-on acts that injected over $650 billion for small business and their employees. Additionally, small businesses were granted the right to apply for Economic Injury Disaster Loans ("EIDL") offered by the U.S. Small Business Administration ("SBA").

While we assume lawmakers had the best intentions, the hasty implementation of such an unprecedented stimulus package has resulted in unforeseen consequences and marked inconsistencies in its application. We highlight several of these outcomes and discrepancies, including how accepting crisis funding could lead to a company becoming more distressed, how bankruptcy courts are inconsistently ruling on the ability for Chapter 11 debtors to receive PPP loans and how changes to the Bankruptcy Code altered the rights of equity holders and debtholders.

## Loan Forgiveness Out of Reach

The PPP was intended to expeditiously deliver loans to businesses affected by the pandemic, with funds becoming fully or partially forgiven if a substantial majority of the loan proceeds were utilized to fund payroll costs. On June 5, 2020, Congress passed the Paycheck Protection Flexibility Act (the "Flexibility Act") in order to ease conditions for small businesses and other PPP borrowers to qualify for full loan forgiveness by reducing the percentage required to fund payroll. Initially, businesses were required to utilize 75% of the loan in eight weeks for payroll costs at pre-pandemic staffing levels. The Flexibility Act reduced the requirement to 60% and extended the time to spend the funds to 24 weeks.

While this amendment was well-intentioned, many small businesses still may fall short of full forgiveness. If borrowers continue to operate at reduced staffing levels and do not rehire employees furloughed during the shutdown—which many cautious companies have done—they would receive no or partial, not full, loan forgiveness. By the time a distressed business receives funds, its payroll would have likely been reduced to a survival level.

Forgiveness simply will not work for companies operating on a limited basis or not at all, or for those where payroll is relatively low versus inventory and supply costs. Further, the law sets a double standard regarding repayment: PPP borrowers who received loans before June 5 will continue to be required to repay the loan within two years while those receiving loans after that date will have five years.

In the worst cases, borrowers that accept PPP funds but are unable to meet loan forgiveness requirements may end up with a heavier debt load—exactly when they can least afford it. As such, these distressed borrowers will face additional interest expenses on top of on-going cash flow distress and, in the event of bankruptcy, permanent incremental debt which will further impair equity holders.

## Borrowers and PPP Loans

Since April 2020, bankruptcy courts have wrestled with the question of whether companies in bankruptcy can access PPP loans. While there are a number of bankruptcy courts that prohibited the SBA from refusing a debtor's PPP loan application, the SBA views debtors in bankruptcy as having "an unacceptably high risk of an unauthorized use of funds or non-repayment of unforgiven loans" and determined that debtors in bankruptcy are ineligible to receive PPP loans.

At least six bankruptcy court judges have granted temporary restraining orders or injunctions prohibiting the SBA and related lending institutions from refusing a debtor's PPP loan application, two bankruptcy courts have declined to issuing any injunctive relief and on June 23, 2020, the Fifth Circuit held that an injunction issued by a bankruptcy court in Texas overstepped its bounds in issuance an injunction against the SBA based on federal law that forbids the issuance of any injunctions against the SBA administrator.

While the current round of PPP loans ended on August 8, 2020, Congress appears to be considering a new round of PPP loans and a proposed set of amendments that would permit debtors in bankruptcy to obtain PPP loans. These loans would be granted superpriority status, receiving the highest priority as administrative claims against a debtor's estate.

While this amendment would allow debtors previously denied PPP loans to reapply, it may also create issues with the availability of more traditional forms of debtor-in-possession financing and negotiating use of cash collateral with pre-existing lenders who typically demand to squarely be in the first priority of administrative creditor as a form of "adequate protection" for the use of collateral.

As a result, debtors that would like to access cash collateral and additional forms of DIP financing may be faced with a choice to either only seek the PPP loan or stay with a more traditional form of cash collateral use and DIP financing. Finally, traditional lenders who extended credit will need to vigilantly monitor the debtors' use of such PPP loan proceeds to ensure that the PPP loan will be forgiven during the bankruptcy case so that their loan's adequate protection claims have first priority.

Further, the CARES Act has provided an incentive for a greater range of smaller business to utilize Subchapter V in an attempt to discharge their pre-existing debts. While a traditional Chapter 11 case prioritizes creditor recoveries over the ability for an equity owner to hold on to their ownership stake, Subchapter V specifically allows for equity holders to maintain their ownership while modifying or discharging the contractual obligations owed to creditors. It remains to be seen whether this realignment in favor of business owners leaves creditors in a better position, because their customers have a better chance for survival, or will become a significant leverage point in favor of struggling business who may be dissipating assets—leading to lower creditor recoveries overall.

**Novel Bankruptcy Precedents**

Recent pandemic legislation has exposed winners and losers in certain industries. For commercial real estate landlords, for example, the CARES Act has introduced unusual burdens while tenants have been widely supported. From March through July 2020, evictions were suspended for millions of properties across America. While rental income was constrained, landlords were still on the hook for fixed expenses such as mortgages, maintenance, management fees and taxes. The CARES Act does little in the way of providing direct relief for commercial property owners whose mortgages are held by non-federally backed or non-traditional lenders.

Many jurisdictions have extended even friendlier laws to commercial tenants. Washington DC and other states have allowed commercial tenants to defer rent. New York, North Carolina and Nevada temporarily prohibited evictions of some or all commercial tenants. Parts of California have frozen or limited rent increases and banned late charges and the state proposed legislation that would allow tenants to terminate leases. The New Jersey legislature passed a bill that excused tenants from paying rent. However, the governor vetoed the bill.

Recent bankruptcy court decisions provide continued victories for tenants at the expense of landlords. The Bankruptcy Code provides that a debtor/tenant is supposed to pay rent on a timely basis after an initial 60-day period, even if it has been delinquent with rent payments prior to filing. In May, however, the bankruptcy court granted Pier 1's request to defer making regular rent payments on a timely basis, citing that doing so "would not decrease the value of any Lessor's interest" in their property, since insurance and utilities were being paid.

One could argue the opposite: if Pier 1 cannot pay its deferred rents in a few months as promised, a highly likely scenario given plummeting retail demand, then the landlord may never recoup rent at the stated rate and be permanently impaired. As such, we may continue to see bankruptcy courts defer rental obligations which have, until now, long been upheld by courts post-filing.

Other bankruptcy rulings could be setting important precedents. On June 3, 2020, the U.S. Bankruptcy Court for the Northern District of Illinois issued one of the first decisions to apply a force majeure clause to a commercial tenant's rent obligations in the wake of the governor's shutdown mandate. Pursuant to an Illinois executive order, restaurant operations for Hitz Restaurant Group, the tenant debtor, were limited to curbside pickup. The court concluded that the force majeure clause in the parties' contract supported a 75% reduction in rent. Some legal commentary has highlighted that force majeure may now be the opportunity for tenants to defer rent that had no relief outside of a formal bankruptcy proceeding.

**Conclusion**

As COVID-19 continues to stress many segments of our economy, our legislators and judges are creating laws that are intended to improve the chances of corporate rehabilitation. In the process, however, we will likely continue to see courts grapple with the consistent application of this legislation.

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