

'Small Business' Bankruptcies: What You Need to Know about Subchapter V of Chapter 11

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The Small Business Reorganization Act of 2019 (SBRA), which became effective in February 2020, created a new subchapter within Chapter 11 of the Bankruptcy Code—Subchapter V, bringing with it sweeping changes to the way Chapter 11 bankruptcies are conducted for qualifying small businesses.

The new law was particularly timely, as the COVID-19 crisis hit the American economy about a month after its effective date. As a result of the pandemic's economic impact, Congress expanded the law's reach in March 2020, nearly tripling the maximum debt threshold for businesses to qualify for Subchapter V treatment and thereby granting access to tens of thousands of additional potential debtors.

As the economic impact of the pandemic endures, Subchapter V will likely be used to a greater degree by small businesses in Chapter 11 bankruptcies, which—as many bankruptcy professionals and attorneys in the commercial lending, leasing, and equipment finance industries expect—will burgeon in 2022.

This article provides an overview of Subchapter V provisions of which creditors should be aware, including: (i) the meaning of “small business debtor” and the current increased debt threshold for filing under Subchapter V, (ii) key distinctions between a Subchapter V case and a traditional (non-Subchapter V) Chapter 11 case, and (iii) the creditors' rights and protections that remain unaltered by Subchapter V.

Why Was Subchapter V Enacted?

The stated purpose of the SBRA is “to streamline the process by which small business debtors reorganize and rehabilitate their financial affairs.” H.R. Rep. No. 116-171, at 1 (2019). The underlying goal of this streamlined process is to give small businesses a better opportunity to

reorganize, which historically has been difficult for them through Chapter 11 proceedings. Chapter 11 is more suited for larger, often publicly traded companies with substantial and complicated debt structures. Accordingly, the reorganization process in Chapter 11 is often long and expensive, with significant legal fees payable to counsel not only for the debtor company, but also for one or more official committees, as well as quarterly fees payable to the Office of the United States Trustee (UST).

Subchapter V seeks to remedy the high administrative costs and lengthy time burdens that many small businesses encounter in traditional Chapter 11 cases, so that they are more likely to confirm a plan and avoid liquidation. For both debtors and creditors, this means that cases will move faster, and plan payments should begin sooner. Speed and cost savings, however, come at the expense of certain rights of creditors to challenge a debtor's proposed reorganization.

Who Is Eligible to File Under Subchapter V?

As noted above, only a few weeks after the SBRA took effect in February 2020, Congress, as part of the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), which took effect on March 27, 2020, amended the new Subchapter V to expand the eligibility of companies seeking bankruptcy protection thereunder. Most notably, the maximum debt threshold for eligibility was increased almost threefold—from \$2,725,625 to \$7,500,000. It was estimated that under the increased debt cap well over 50% of all Chapter 11 cases would be eligible for Subchapter V treatment.

The increased Subchapter V debt threshold under the CARES Act was scheduled to sunset after one year, but in March 2021 it was extended for another 12 months until March 2022. As businesses continue to feel the adverse economic impact of the pandemic, it is expected that Congress and the President will agree to a further extension. If the increased threshold is not extended, or ultimately made permanent, its looming expiration will no doubt cause many small businesses to elect to file under Subchapter V while they still can.

Only “small business debtors” are eligible for Subchapter V. Bankruptcy Code section 101(51D) defines a small business debtor as person (including an individual or business): “engaged in commercial or business activities ... in an amount not more than \$7,500,000 [previously \$2,725,625] (excluding debts owed to 1 or more affiliates or insiders) not less than 50 percent of which arose from the commercial or business activities of the debtor.” Specifically excluded from this definition is any entity the primary purpose of which is the owning of a single-asset real estate.

Significantly, a qualifying debtor must expressly elect to proceed under Subchapter V; it does not apply automatically. A creditor may object to a debtor’s Subchapter V designation within 30 days from the section 341(a) creditors’ meeting, or within 30 days from the filing of an amended designation if later. *See* Fed. R. Bankr. Proc. 1020(b). As to the conversion of cases pending in bankruptcy court prior to the effective date of Subchapter V, courts have been liberally permitting such re-designation, even where a case had been pending for more than a year. *See In re Ventura*, 2020 WL 1867898 (Bankr. E.D.N.Y. 2020). *See, e.g., In re Body Transit Inc.*, 613 B.R. 400 (Bankr. E.D. Pa. 2020); *In re Moore Properties of Person County LLC*, 2020 WL 995544 (Bankr. M.D.N.C. 2020); *In re Progressive Solutions Inc.*, 2020 WL 975464 (Bankr. C.D. Cal. 2020).

How Does Subchapter V Differ from a Traditional Chapter 11?

(1) The Subchapter V Trustee

In a traditional Chapter 11 case, a trustee is appointed only for cause, such as fraud or gross mismanagement, and the trustee then seizes control of the debtor’s operations. By contrast, in all Subchapter V cases the UST, which serves as the government watchdog in bankruptcy cases, automatically appoints a Subchapter V Trustee. There are 10 Subchapter V Trustees eligible for appointed in the District of New Jersey, including one of the authors of this article.

The Subchapter V Trustee has a narrower set of duties and powers than a Chapter 11 (or Chapter 7 or 13) Trustee, and is primarily tasked with the responsibility to “facilitate the development of a consensual plan of reorganization,” 11 U.S.C. §§1183, 1184, and thereafter to “ensure that the debtor commences making timely payments required by a plan.

(2) Accelerated Case Administration and Plan Confirmation Process

With respect to plan filing and confirmation, and general case administration, Subchapter V cases generally move faster and less expensively than typical Chapter 11 cases. This is accomplished by altering the typical manner in which the case proceeds. Among these changes are that: (a) no committee of unsecured creditors, with the ability to hire professionals paid by the debtor’s estate, will be formed unless cause exists (*see* 11 U.S.C. §1181(b)); (b) no quarterly fees are payable to the UST, a significant savings of potentially tens of thousands of dollars; and (c) no disclosure statement, separate from the reorganization plan and subject to approval before solicitation of creditor acceptance of the plan, is required. Instead, a Subchapter V plan must include certain of the information ordinarily included in the disclosure statement. *See* 11 U.S.C. §1190(1).

Other important changes include:

- The bankruptcy court holds a status conference within 60 days of the case filing “to further the expeditious and economical resolution” of the case.
- The debtor must file a report not later than 14 days before the status conference, detailing the debtor’s efforts to achieve a consensual plan of reorganization.
- The debtor must file a plan of reorganization not later than 90 days after entering bankruptcy, unless the need for the extension is caused by circumstances “for which the debtor should not justly be held accountable.” 11 U.S.C. §1189(b). By contrast, there is no mandatory deadline for filing a plan in a traditional Chapter 11, and a debtor’s “exclusive” period to do so is routinely extended.

Perhaps the most significant changes, however, relate to confirming a plan of reorganization. In a traditional Chapter 11 case, any party-in-interest may file a plan once the debtor’s “exclusivity period” has expired. In a Subchapter V case, there are no competing plans permitted; the

debtor maintains an exclusive right to confirm a plan throughout. See 11 U.S.C. §1189(a). Furthermore, the debtor need not obtain the acceptance of an impaired consenting class of creditors to confirm a Subchapter V plan. See 11 U.S.C. §1191(b). Unlike traditional Chapter 11 plans, a Subchapter V plan may be approved by the court even if no class of creditors accepts it.

(3) Equity Holders Can Continue Ownership Post-Confirmation

Under the absolute priority rule in non-Subchapter V cases, the debtor's existing owners cannot retain equity in the debtor over the objection of a class of unsecured creditors, unless the class is paid in full or the owners contribute new capital to the company. As a result, traditional Chapter 11 cases often result in the cancellation of equity interests.

By contrast, in a Subchapter V case, equity holders can continue to own and manage their business even where all creditors vote against the plan and object to confirmation; provided, however, that the plan cannot discriminate unfairly and is "fair and equitable" with respect to each class of claims. A Subchapter V debtor satisfies the fair and equitable requirement if the plan pays unsecured creditors all of the debtor's "disposable income" for a period of three to five years. Disposable income excludes income that is reasonably necessary to be expended "for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor." 11 U.S.C. §1191(d)(2).

(4) Deferred Payment of Administrative Expense Claims

In a traditional Chapter 11 case, administrative expense claims (i.e., post-bankruptcy expenses and obligations) must be paid in the ordinary course of business or in full on a plan's effective date. In Subchapter V, a small business debtor may stretch payment of administrative expenses, including professional fees, over the term of the plan; i.e., up to three to five years. See 11 U.S.C. §1191(e).

(5) Discharge

If the court confirms a consensual plan in Subchapter V, typically with the help of the Subchapter V Trustee, the debtor receives a discharge of its liabilities at confirmation. However, if the confirmed plan is a non-consensual/cramdown plan, the debtor does not receive a discharge until all plan payments are completed. *See* 11 U.S.C. §1192.

Creditor Protections that Are Unaltered by Subchapter V

Despite the significant changes outlined above, certain creditor protections in Chapter 11 remain unaltered in Subchapter V cases, including, without limitation, the following:

- The “best interest test” is preserved, such that in order to be confirmed a plan must provide creditors at least as much value as they would receive if the small business debtor was liquidated and not reorganized. *See* 11 U.S.C. §1129(a)(7).
- Secured creditors retain their rights to have their collateral “adequately protected” against diminution in value, or be granted relief from the automatic bankruptcy stay to realize on their collateral. *See* 11 U.S.C. §362(d). Secured creditors also retain their right to be paid the present value of their collateral under any confirmed plan.
- To assume executory contracts, small business debtors still must first cure defaults and provide adequate assurance of future performance. *See* 11 U.S.C. §365(b).
- Claims for goods delivered to the debtor within 20 days before the bankruptcy are still treated as administrative expenses claims under 11 U.S.C. §503(b)(9).

Conclusion

Subchapter V has greatly altered Chapter 11 bankruptcies involving qualifying small businesses, as to both the plan process and the rights of creditors. Creditors must be even more vigilant at the outset of a Subchapter V case, as the matter will proceed more quickly and the opportunities to object to and challenge the debtor’s actions are curtailed.

Among other things, affected creditors should promptly review the bankruptcy petition to confirm whether the debtor qualifies for Subchapter V treatment, and to object if not. If the

debtor does qualify, creditors quickly should file an appearance and contact the Subchapter V trustee to discuss their interests and concerns. Creditors also should be prepared for the debtor's initial status report, the early case status conference, and the filing of a plan within 90 days, all as mandated by the SBRA.

Finally, creditors must pay close attention to the new statutory provisions for plan confirmation, as the procedures and substantive requirements are different in several material respects.

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