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Subchapter V: A New Reorganization Model for Small Businesses The Bankruptcy Issue

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SUBCHAPTER V:
A New Reorganization Model for Small Businesses

By Gary E. Sullivan

Chapter 11 bankruptcy has been a graveyard for far too many small businesses. Too often, small businesses enter a Chapter 11 bankruptcy case only to have the bankruptcy case subsequently dismissed or converted to liquidation in Chapter 7.

For several years prior to 2019, a brew of practitioners, academics, and judges weighed in on the probable causes of the high rate of failure of small business reorganizations in Chapter 11. Among other explanations, traditional Chapter 11 cases were deemed to be too expensive, too complicated, and too drawn out for a typical small business to fund and survive. Following years of commentary and studies designed to recommend changes that could make Chapter 11 more effective for small businesses, Congress acknowledged in 2019 that "small business chapter 11 cases continue to encounter difficulty in successfully reorganizing."[1]

Help arrived. Seeking to streamline the process[2] by which small businesses reorganize, Congress passed the Small Business Reorganization Act of 2019 [the "SBRA"]. The SBRA introduced a new small business subchapter of Chapter 11 that was codified as Subchapter V.[3] This subchapter provides a new model for struggling small businesses seeking to reorganize.

Definition of "Small Business" for Purposes Of Subchapter V

Since the passage of SRBA, the definition of *small business* – those qualifying to file a small business case under Subchapter V – has expanded significantly. Using debt as the measure of the size of a business, the SRBA originally limited eligibility for Subchapter V to businesses with non-contingent, liquidated debts of no more than $2,725,625.[4] Along came the pandemic and with it enactment of the CARES Act. One provision of the CARES Act expanded the non-contingent, liquidated debt dollar limit to qualify as a "small business" for purposes of Subchapter V to $7,500,000.[5] The higher dollar amount definition of small business was recently renewed and will remain in effect until 2024.[6]

Key Features of Subchapter V

In several important respects, Subchapter V differs from the traditional Chapter 11 model. This article highlights and briefly discusses some (but certainly not all) of the features of this new small business reorganization model.

One central difference is the role of the bankruptcy trustee. In traditional Chapter 11 cases, existing management (the Debtor-In-Possession, or DIP) is empowered to administer the bankruptcy case, and the appointment of a bankruptcy trustee is disfavored and rarely occurs.

By contrast, Subchapter V requires the appointment of a trustee in every case, with the role of that trustee including a novel duty to "facilitate" development of a consensual reorganization plan.

A second difference is the abrogation of the absolute priority rule in Subchapter V cases, allowing existing small business owners to more confidently make additional

investments in the future of the reorganized business. Additionally, Subchapter V vests the exclusive power to propose a reorganization plan in the debtor, thereby streamlining the confirmation process and avoiding prolonged fights over competing plans proposed by creditors or other stakeholders.

Finally, Subchapter V enables the modification of a mortgage on the debtor's principal place of residence in certain circumstances.

Subchapter V Trustee : Overseer and… Mediator?

Subchapter V requires the appointment of a trustee in every case.[7] The length of a Subchapter V reorganization plan is similar to the length of plans in chapter 13 individual reorganization cases – three to five years.

As for the trustee, the term served by the Subchapter V trustee is determined by the type of plan confirmed. If a consensual plan, agreed to by debtor and creditors alike, is confirmed by the court, the trustee's duties end following substantial consummation of the plan.[8] If a contested plan is confirmed, the trustee's roles continue until the plan is complete.[9] Many of the duties of a Subchapter V trustee are "traditional" bankruptcy trustee duties, including objecting to claims, administering payments, filing reports, and being heard on various matters such as valuation disputes, confirmation and any sale of property of the estate.[10]

In one important respect, however, a Subchapter V trustee takes on a duty foreign to trustees in Chapters 7 or 11 or 13: the duty to "facilitate the development of a consensual plan of reorganization."[11]

The contours of what all a Subchapter V trustee might do to "facilitate" the development of a consensual plan are somewhat nascent and evolving given that Subchapter V was only codified a few years ago. The Bankruptcy Code provides little to no guidance.

Furthermore, during those few short years, the pandemic, along with the substantial monetary and fiscal stimulus provided by the federal government, caused a sharp drop in bankruptcy filings including business filings. As a result, the numbers of Subchapter V cases filed since 2019 has been relatively small; hence, caselaw discussing Subchapter V trustees' roles is predictably sparse.

Because the development of a consensual plan requires that the debtor and creditors reach an agreement, some commentators view the Subchapter V trustee's facilitation role as that of a mediator.[12] In this regard, arriving at a consensual plan of reorganization is simply "settling the case" with the trustee serving as mediator. Many of the practices and techniques employed by mediators in general will almost certainly serve Subchapter V trustees well as they attempt to bring debtors and creditors together with the goal of arriving at consensual plans of reorganization in Subchapter V cases.

Goodbye, Absolute Priority Rule; Hello, Disposable Income

Another important reform imbedded in Subchapter V is the abrogation of the Absolute Priority Rule [APR]. APR is a general legal doctrine that requires that a class of claimants in the capital structure be paid in full before an inferior class may receive value. Chapter 11 requires that reorganization plans adhere to APR.[13] In the context of a garden variety Chapter 11 case, APR requires, for instance, that objecting unsecured creditors receive full payment of their claims before equity holders can retain or receive any value.[14] A plan of reorganization that violates the APR cannot be confirmed. As a result, the owners of a business in bankruptcy often have a disincentive to make additional equity investments in support of the reorganization and may even lose their equity to unsecured creditors.[15]

Subchapter V cases are free from the limitations of the APR. Owners of small businesses in bankruptcy can now seek confirmation of plans of reorganization that propose fresh investments from equity holders regardless of whether or not receiving value from the new investments would otherwise violate the APR.

Instead of applying the APR, Subchapter V requires that a small business dedicate all its "disposable income" toward paying creditors for a period of at least three years to as long as five years.[16] This feature of Subchapter V is similar to the chapter 13 individual reorganization model. Central to this model is the quid pro quo requiring that unsecured or under-secured creditors accept less than full payment in exchange for the debtor's promise to dedicate all disposable income for a period of years to the payment of creditors' claims.[17]

The Exclusive Right to Propose a Plan of Reorganization

In addition to being free from the strictures of the APR, debtors in Subchapter V also enjoy the exclusive right to propose a plan of reorganization.[18] The ability to propose a plan is a source of control in a bankruptcy case. In a traditional chapter 11 case, that control is vested in the DIP for a limited period of time, called the *exclusivity period*.[19] Once the exclusivity period lapses, creditors are free to file their own competing plans.[20] The ability to file a competing plan provides a creditor leverage in several ways, not least of which is the ability to seek support from other creditors to have the competing plan confirmed.

By vesting the exclusive right to file a plan in the debtor, Subchapter V strengthens the debtor's hand in negotiations with its creditors. Paired with the trustee, aka the consensual plan facilitator, Subchapter V debtors are placed in a strong position in terms of seeking consensus among creditors regarding the terms of a reorganization plan. Anecdotes by bankruptcy practitioners support the notion that plans are being confirmed more quickly and more efficiently in Subchapter V versus traditional chapter 11 cases.[21]

Debtor's Shiny New Power: Cramming Down a Residential Mortgage

A debtor's ability to reduce the amount of a secured claim can be a powerful tool in bankruptcy because secured claims generally must be paid in full only up the amount of value of the property.[22] By way of example, if a creditor is owed $50,000 secured by a security interest in collateral worth $10,000, bankruptcy allows the amount of that creditor's secured claim to be "crammed down" to $10,000.

When a creditor's claim is secured by a mortgage on debtor's principal place of residence, however, the

debtor is prevented from cramming down that claim in Chapter 11 or Chapter 13 cases.[23] Accordingly, bankruptcy has historically offered little to no respite from a mortgage taken out by a small business owner on his or her home.

Thanks to Subchapter V, small business owners can now cram down mortgages on their homes. Or at least some of them. There are two basic requirements for cramming down a mortgage on the small business debtor's home: (i) the mortgage loan proceeds were not used to acquire the home, and (ii) the loan proceeds were used primarily in connection with the small business of the debtor.[24] As to the latter requirement, a reasonable construction of "primarily" is that over half the proceeds were used in the small business.

Although the ability to cram down a home mortgage is doubtless a valuable right in a small business bankruptcy case, there is an obvious practical limitation: the value of the home must leave the secured claim under water. Because home values in most areas of our state have continued to climb over the past few years, the Subchapter V home mortgage cramdown provision may well be the proverbial solution in search of a problem. Or, just perhaps, the ongoing unwinding of the monetary stimulus that fueled the housing boom may breathe new life into this cramdown power. Only time will tell.

Final Thoughts

Struggling small businesses now have new tools available for reorganizing thanks to Subchapter V. This new model should lead to higher rates of confirmed plans of small business reorganizations and, hopefully, the preservation of more value for the benefit of debtors and creditors alike. ▲

Endnotes

1. H.R. Rep. No. 116-171, at 4 (2019).
2. *Id.* at 1.
3. Subchapter V is codified at 11 U.S.C. 1181 – 1195. All remaining citations in this article will be to sections of Title 11 of the U.S. Code unless otherwise indicated.
4. Small Business Reorganization Act of 2019, Pub. L. No. 116-54, §1182, 133 Stat. 1079, 1079 (2019).
5. CARES Act, Pub. L. No. 116-136, § 1182, 134 Stat. 281, 310-11 (2020).
6. Bankruptcy Threshold Adjustment and Technical Corrections Act, Pub. L. No. 117-151, §1182, 136 Stat. 1298, 1298 (2022).
7. 11 U.S.C. § 1183(a). By contrast, in traditional Chapter 11 cases, the DIP administers the case and a trustee can only be appointed under rare circumstances such as when current management engages in fraud, dishonesty, incompetence or gross mismanagement. § 1104(a)(1).
8. 11 U.S.C. § 1183(c).
9. *Id.*
10. *Id* at § 1183(b).
11. *Id* at § 1183(b)(7). To the extent there is a cousin to this facilitator role, it would be a Chapter 13 trustee whose duties include "assist[ing] the debtor in performance under the plan." § 1302(b)(4).
12. Given the statutory language and legislative goals of Subchapter V, the "facilitate" language "suggests that the Subchapter V trustee is cast in the role of mediator and overseer." Patricia Redmond, *Come Together: The Unique Role of Subchapter V Trustees and the Cautionary Tale of* 218 Jackson, 40 Am. Bankr. Inst. J., 12 (2021).
13. § 1129(b)(2)(B)(ii).
14. *Id.*
15. Although beyond the scope of this article, there is an important exception to the APR called the *new value corollary*. Under certain limited circumstances, existing equity holders can receive value from fresh equity contributions even if receipt of that value would otherwise violate the APR. Bank of Am. Nat'l Trust and Savings Assoc. v. 203 North LaSalle Street P'ship, 526 U.S. 434 (1999).
16. 11 U.S.C. § 1191(b).
17. The Subchapter V debtor maintains an important power in this regard: the exclusive right to seek post-confirmation modification of a non-consensual plan. *See* William L. Norton III & James B. Bailey, *The Pros and Cons of the Small Business Reorganization Act of 2019*, 36 Emory Bankr. Dev. J. 383, 385-386 (2020).
18. § 1189(a).
19. The court can expand the length of the exclusivity period in traditional chapter 11 cases "for cause." § 1189. *See also* Chapter 11 – Bankruptcy Basics, United States Courts, *https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics#:~:text=%C2%A7%201189.,cause%22%20up%20to%2018%20months* (last visited Aug. 27, 2022).
20. Creditor-led negotiations for terms of alternative plans often begin well before the exclusivity period lapses. In many cases, negotiations among creditors begin before the debtor even files bankruptcy.
21. "My experience is that these new Subchapter V cases are being confirmed faster and for less professional fees. My opinion is that the success rate appears to be much higher than normal success rates for traditional Chapter 11 cases." Donald R. Calaiaro, *The New Subchapter V Chapter 11 Bankruptcy*, 24 J. Allegheny Cty. Bar Ass'n Note 6, 7 (2022). For a more comprehensive look at how small businesses are faring in Subchapter V, *see* Paula S. Berran *et. al., Has Subchapter V Solved the Problems of Small Business Bankruptcies? Views and Reflections of Subchapter V Trustees on the First Two Years of the New Law*, 31 Bankr. L. & Prac. NL Art. 3, 1 (June 2022).
22. § 506(a)(1).
23. §§ 1123(b)(5),1322(b)(2).
24. § 1190(3).

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