

Overview of New Subchapter V of Chapter 11 Bankruptcy And Issues Addressed By Courts Thus Far

Eligibility Debt Limit Increased to \$7.5 Million For One Year Under Subchapter V

On February 19, 2020, the Small Business Reorganization Act of 2019 (“SBRA”) went into effect. Under the SBRA, the United States Bankruptcy Code was amended to include new Subchapter V to chapter 11, which added sections 1181-1195 to the Code. Congress enacted the SBRA to allow small businesses to reorganize their debts in a greatly streamlined and cost effective manner. Under the new Subchapter V of chapter 11, a small business may qualify to reorganize in bankruptcy if their total non-contingent, liquidated, secured and unsecured debt is not more than \$7.5 million, as revised by the Coronavirus Aid, Relief and Economic Security Act (CARES Act), for one year from March 27, 2020.¹

As of December 3, 2020, 1,250 Subchapter V cases have been filed since the SBRA went into effect.² In addition to providing an overview of Subchapter V, this memorandum will provide analysis of the issues that bankruptcy courts have ruled on in Subchapter V cases thus far and explain the role of the Subchapter V trustee.

Impact of CARES Act On Subchapter V’s Debt Limit

By increasing the debt limit to \$7.5 million, nearly three times the original debt limit, temporarily for a one year period under the CARES Act, a far greater amount of debtors likely can qualify for the new Subchapter V, and thereby enjoy the substantial savings in expenses and time, as explained in this article.

¹ 11 U.S.C. §1182.

² American Bankruptcy Institute, Bankruptcy Statistics, Subchapter V cases by state; available at: <https://www.abi.org/sbra>.

Why File For Subchapter V?

Debtors often file to reorganize in chapter 11 in order to restructure their debts, reject unexpired leases and executory contracts, sell unexpired leases and executory contracts via assumption and assignment and in order to negotiate a settlement of pending lawsuits. These benefits are also available to debtors filing for reorganization under the new Subchapter V.

Time & Expense Savings Under New Subchapter V

A unique feature of Subchapter V is that a debtor or individual has 90 days to file a plan of reorganization after the bankruptcy petition is filed with the court and the court enters an order of relief.³ Normally in chapter 11, the plan can take over a year to be confirmed, and also, as explained in this article, the plan requires at least one class of impaired creditors to approve the plan. In contrast, Subchapter V allows a debtor to confirm a plan without approval from any class of creditors. Since creditors cannot reject the plan, the court will likely confirm the plan shortly after the plan is filed, in contrast to regular chapter 11 proceedings, which allow for creditors to reject the plan. Thus, the new Subchapter V will greatly decrease the time and expense of chapter 11 for small businesses.

Cramdown On All Creditors: A Unique Feature of Subchapter V

As mentioned, another unique feature of Subchapter V is that the debtor has the ability to cramdown on all creditors to confirm its plan of reorganization. Normally in chapter 11, at least one impaired class of creditors must approve the plan in order for a court to confirm the plan. However, Subchapter V allows the debtor to confirm a plan without any creditors approving the plan (i.e. cramdown on all dissenting creditors) as long as the plan does not discriminate unfairly

³ 11 U.S.C. § 1189(b).

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against any impaired unsecured creditors and treats each class of unsecured creditor fairly and equitably.⁴ Thus, the debtor can confirm a plan over the objection of any secured or unsecured creditor under Subchapter V.

A debtor's ability to cramdown on all creditors provides the debtor with substantial leverage in negotiating the plan of reorganization. The debtor must provide feasibility projections over the life of the plan including carve-outs for the bankruptcy professionals such as the restructuring financial advisor, bankruptcy lawyer and other professionals. Feasibility projections are an analysis of the viability of the debtor as a going concern. Also, the debtor needs to cure defaults and demonstrate adequate assurances through the use of feasibility projections.⁵

No Creditor Committee Required

Yet another advantage to filing under the new Subchapter V is that unlike regular chapter 11 reorganizations, there is no requirement for the U.S. Trustee to appoint a committee for unsecured creditors.⁶ In regular chapter 11 reorganizations, the reorganizing debtor must pay for the expenses relating to the committee for unsecured creditors such as the fees for professionals representing the committee (e.g. fees for attorneys and financial advisors). Thus, by eliminating the requirement for the appointment of a committee for unsecured creditors, Subchapter V yet again offers further cost savings to small businesses.

⁴ 11 U.S.C. § 1191(c)(1); § 1191(b).

⁵ 11 U.S.C. § 1129(a).

⁶ 11 U.S.C. § 1195.

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Disclosure Statement Not Required & No Absolute Priority Rule

Unlike regular chapter 11 proceedings, the debtor does not need to file a disclosure statement.⁷ Thus, further reducing costs for a debtor under Subchapter V. Also, the absolute priority rule does not apply in Subchapter V, unlike regular chapter 11 proceedings.⁸ The absolute priority rule requires that all creditor claims be paid in full in order for the debtor to retain ownership in its assets. Courts have ruled that the debtor may retain ownership in its assets if the debtor provides “new value,” such as additional capital provided by the debtor to fund a plan. Also, the “new value” rule does not apply under the new Subchapter V as well, which allowed creditors to object to a plan on the grounds that the “new value” is inadequate.

Administrative Claims

Subchapter V does not require administrative claims, such as claims accrued post-petition, to be paid in full as a requirement for plan confirmation.⁹ Under Subchapter V, administrative claims can be paid over time.¹⁰

Automatic Stay Stops Creditor Collections & Other Liabilities

As soon as the debtor files for bankruptcy the automatic stay will go into effect, and thereby prevent creditors from collecting on debts, foreclosing on real property and obtaining certain judgments on lawsuits, such as tort liability claims, against the debtor. The automatic stay allows the debtor the opportunity to negotiate with creditors and other claim holders such as litigants with lawsuits adverse to the debtor during the bankruptcy period.

⁷ 11 U.S.C. § 1187.

⁸ 11 U.S.C. § 1191(c).

⁹ 11 U.S.C. § 1191(e).

¹⁰ Id.

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Plan Requirements & Confirmation

The plan of reorganization must include a brief history of the operations of the business, liquidation analysis and projections with respect to the debtor's ability to make payments under the plan.¹¹ For a nonconsensual plan, meaning at least one class of impaired creditors do not accept the plan, a debtor will make plan payments for at least three years and up to five years under Subchapter V.¹² For a nonconsensual plan, if the plan satisfies the requirements under Subchapter V and the applicable sections of chapter 11, and the bankruptcy court confirms the plan, then the debtor will operate in bankruptcy for at least three years and up to five years in order to make the plan payments and then will be discharged of its debts. For a consensual plan, if the bankruptcy court confirms the plan, the debtor is entitled to a discharge upon plan confirmation.¹³

The bankruptcy court will confirm the plan as long as the plan does not discriminate unfairly and is "fair and equitable" to each impaired unsecured creditor.¹⁴ Fair and equitable means the debtor needs to commit all of its "projected disposable income" or property of equivalent value in order to make payments under the plan for at least three years and at most five years.¹⁵ Under the plan, the debtor must agree to provide the trustee with as much of the debtor's future income as necessary to fund the plan.¹⁶

The debtor's "disposable income" is income it receives and is not reasonably necessary for the debtor's maintenance and expenses for continuation, preservation or operation of the

¹¹ 11 U.S.C. § 1190(1).

¹² 11 U.S.C. § 1191(c).

¹³ 11 U.S.C. § 1191; § 1181(c).

¹⁴ 11 U.S.C. § 1191(b).

¹⁵ 11 U.S.C. § 1191(c).

¹⁶ 11 U.S.C. § 1186.

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business.¹⁷ The debtor must show a reasonable likelihood it will be able to make all of the payments under the plan, and the plan must provide for appropriate remedies; such remedies may include liquidation of nonexempt assets to protect creditors if the debtor fails to make the payments under the plan. In other words, the debtor must show a bankruptcy court that the debtor is feasible as a going concern.¹⁸

Modifying a Mortgage of a Principal Residence

Also, under Subchapter V, another unique restructuring tool available to a debtor is that the plan can modify the rights of a mortgage claim holder on the business owner's principal residence if the mortgage loan was used primarily as security "in connection" with the business.¹⁹ For instance, if the terms of a business loan included a lien on the business owner's principal residence mortgage then that lien can be modified under the plan, and the business owner may be able to retain his or her ownership rights in the principal residence under Subchapter V.

In *In re Ventura*, the bankruptcy court determined that subparagraphs (A) and (B) of § 1190(3) direct it to conduct a "qualitative analysis to determine whether the principal purpose of the debt was not to provide the debtor with a place to live, and whether the mortgage proceeds were primarily for the benefit of the debtor's business activities."²⁰ The court proposed five factors to consider whether the mortgage is subject to modification under § 1190(3): "1) Were the mortgage proceeds used primarily to further the debtor's business interests; 2) Is the property an integral part of the debtor's business; 3) The degree to which the specific property is necessary to run the business; 4) Do customers need to enter the property to utilize the business;

¹⁷ 11 U.S.C. § 1191(d).

¹⁸ 11 U.S.C. § 1191(c)(3)(B).

¹⁹ 11 U.S.C. § 1190(3).

²⁰ *In re Ventura*, No. 8-18-77193-REG, 33 (Bankr. E.D.N.Y. April 10, 2020).

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and 5) Does the business utilize employees and other businesses in the area to run its operations.”²¹

The court found that the debtor purchased the real property to manage it as a bed and breakfast and the primary purpose of the property was to offer rooms for nightly fees, the debtor’s business provided additional services to guests for additional fees, and that mortgage proceeds were used to purchase the building that houses the debtor’s business.²² The court found that the evidence was sufficient to hold a full evidentiary hearing to determine whether the debtor may use § 1190(3) to modify the mortgage.²³

Subchapter V court rulings

In addition to the issue of a Subchapter V debtor’s ability to modify a mortgage of a principal residence as interpreted in the Ventura case, thus far, bankruptcy courts have issued rulings on several Subchapter V issues, including: i) whether a debtor may retroactively elect to file bankruptcy under Subchapter V while such debtor has a bankruptcy case pending and which standard courts should apply in making its decision; ii) whether a debtor is eligible to file for bankruptcy under Subchapter V; iii) whether the automatic stay should be extended beyond the 30 day period after a dismissal of the previous case; and iv) whether a Subchapter V trustee should be allowed to retain counsel before needing legal representation.

Retroactively electing to proceed under Subchapter V

Several bankruptcy courts have ruled that a debtor may retroactively elect to proceed under subchapter V after the case had been pending for some time ranging from one week to 15

²¹ Id. at 33, 34.

²² Id. at 34.

²³ Id.

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months.²⁴ In such cases, bankruptcy courts have found no basis in the SBRA or other statute to prohibit the SBRA's application to cases, which were pending when the SBRA took effect, and that bankruptcy rule 1009 (a) permits a debtor to amend its petition “at any time before the case is closed.”²⁵

At least one bankruptcy court has ruled that a debtor may not retroactively proceed under subchapter V because certain deadlines had already passed; namely the deadline that requires the debtor to file a plan of reorganization within 90 days after the order for relief and the deadline that requires the debtor to hold a status conference in a Subchapter V case within 60 days after the order for relief.²⁶

Qualifying as a “small business debtor”

A bankruptcy court has ruled that a debtor who was not presently operating its business still qualified as a “small business debtor” under Subchapter V if 56% of the debtor’s debt was residual business debt.²⁷

Subchapter V retention of counsel

A bankruptcy court has denied a Subchapter V trustee’s application to retain counsel because the need for legal representation had not arisen.²⁸

²⁴ In re Progressive Solutions, Inc., No. 8:18-bk-14277-SC, 5 (Bankr. C.D. Cal. February 21, 2020) (hereafter, “Progressive Solutions”); In re Glass Contractors, Inc., No. 20-40185 (Bankr. E.D. Tex. February 25, 2020); In re Moore Props. of Person Cty., LLC, No. 20-80081, 7 (Bankr. M.D.N.C. February 28, 2020); In re Body Transit, Inc., 613 B.R. 400 (Bankr. E.D. Pa. March 24, 2020) (hereafter, “Body Transit”); In re Bello, 613 B.R. 894 (Bankr. E.D. Mich. March 27, 2020); In re Ventura, No. 8-18-77193-REG (Bankr. E.D.N.Y. April 10, 2020); In re Bonert, No. 2:19-bk-20836-ER, 5 (Bankr. C.D. Cal. June 3, 2020); In re Trepetin, No. 20-11718-MMH, (Bankr. D. Md. July 7, 2020); In re Blanchard, No. 19-12440, 2020 WL 4032411 (Bankr. E.D. La. July 16, 2020).

²⁵ Progressive Solutions at 10, 11; Body Transit at 11.

²⁶ In re Double H Transp. LLC, No. 19-31830-HCM, (Bankr. W.D. Tex. March 5, 2020).

²⁷ In re Wright, No. 20-01035-HB, 3 (Bankr. D.S.C. April 27, 2020).

²⁸ In re Penland Heating and Air Conditioning, Inc., No. 20-01795-5-DMW (Bankr. E.D.N.C. June 11, 2020).

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Extension of automatic stay after dismissal of case

A court has held that the automatic stay could not be extended for a Subchapter V debtor that: (i) experienced no change in financial circumstances following dismissal of a traditional chapter 11 case; and (ii) failed to demonstrate that it could propose a confirmable Subchapter V plan.²⁹

Role of Subchapter V trustee

In addition to having a fiduciary duty to the bankruptcy estate, the Subchapter V trustee has specific duties that are stated in § 1183, which refer to and incorporate certain duties of a chapter 7 trustee as provided for in § 704(a) and also chapter 11 trustee duties stated in § 1106(a).

The Subchapter V trustee's duties include: i) being accountable for all property received;³⁰ ii) examining proofs of claims and objecting to allowance of any claim that is improper if a purpose would be served;³¹ iii) opposing the discharge of the debtor if advisable;³² iv) providing information concerning the bankruptcy estate and estate's administration as requested by a party in interest unless the court orders otherwise;³³ and v) creating a final report and filing a final account of the administration of estate with the bankruptcy court and United States Trustee.³⁴

Also, the Subchapter V trustee has a duty to investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the

²⁹ In re Crilly, No. 20-11637-SAH (Bank. W.D. Okla. June 30, 2020).

³⁰ 11 U.S.C. § 704(a)(2).

³¹ 11 U.S.C. § 704(a)(5).

³² 11 U.S.C. § 704(a)(6).

³³ 11 U.S.C. § 704(a)(7).

³⁴ 11 U.S.C. § 704(a)(9).

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desirability of the continuance of the debtor's business, and any other matter relevant to the case or to the construction of a plan of reorganization unless the court orders otherwise;³⁵ and to file a statement of investigation after the investigation is completed.³⁶

Furthermore, the Subchapter V trustee must file reports as necessary and the court orders after confirmation of a plan under § 1106(a)(7), appear and be heard at the status conference as required by § 1188 and any hearing concerning the value of property subject to a lien, confirmation of a plan filed under Subchapter V, modification of the plan after confirmation or the sale of property of the estate and ensure that the debtor commences making timely payments required by a confirmed plan.³⁷

If the debtor ceases to be a debtor in possession, under § 1183(b)(5), the Subchapter V trustee's duties expand to i) operating the debtor's business and the duties as provided in § 704(a), as previously explained; ii) filing the list, schedules and statements pursuant to § 521(1) if the debtor has not already done so;³⁸ iii) providing information required by a government unit for any year the debtor has not filed a tax return.³⁹

Also, the Subchapter V trustee must provide the applicable notice to the holder of the claim and appropriate state child support enforcement agency, as set forth in § 704(c) if there is a claim for domestic support obligation and facilitate the development of a consensual plan of reorganization.⁴⁰

³⁵ 11 U.S.C. § 1106(a)(3).

³⁶ 11 U.S.C. § 1106(a)(4)(A).

³⁷ 11 U.S.C. § 1183(b)(3), (4).

³⁸ 11 U.S.C. § 1106(a)(2).

³⁹ 11 U.S.C. § 1106(a)(6).

⁴⁰ 11 U.S.C. § 1183(b)(6), (7).

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Limited Time to File

At this time the debt limit of \$7.5 million under the new Subchapter V is limited to one year from March 27, 2021 unless Congress decides to extend the period of time. Accordingly, it is imperative that debtors in financial distress with assets over \$2.7 million strongly consider their options for restructuring their businesses under the new Subchapter V of chapter 11 in a timely manner before the one year period expires on March 27, 2022 and the debt limit returns to \$2.7 million.