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Expert Analysis

What To Know About the Bankruptcy Code's New Subchapter V


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Our country's protection for debtors has come a long way over time. Some of the earliest settlers came to America, not on the Mayflower, but as indentured servants. Did you know that one of the early Revolutionary War heroes, Henry ("Light Horse Harry") Lee, who went on to become governor of the Commonwealth of Virginia (and yes, also the father of General Robert E. Lee), spent his last days in debtor's prison? The same dubious distinction of time spent in debtor's prison also befell two signers of the Declaration of Independence.

While Congress began passing legislation regarding bankruptcy relief early in the 19th century, it took a decision by the U.S. Supreme Court in 1833 to abolish debtor's prison, and it was not until The Nelson Act of 1898 before the country had its first modern bankruptcy legislation. Our current Bankruptcy Code traces back to the Bankruptcy Reform Act of 1978.

Flash forward almost 50 years to the COVID pandemic, our bankruptcy laws have developed into a well-established mechanism for protection of both individual and business entity protection, but that relief was frequently beyond the reach of debtors who found the process of filing for relief too complicated and, ironically, too expensive. Notwithstanding COVID's almost instantly devastating impact on the economy, the number of bankruptcy filings in this country in 2020 declined more than 30% from the prior two years.

While there may have been other reasons for the decline in filings (for example, state emergency debt moratorium legislation; consumer and business stimulus programs; and even Pandemic-related court closures), Congress, as early as 2019, saw the need to increase the ability of small businesses to utilize the reorganization benefits of Chapter 11 in a more efficient and less expensive procedure. It passed the Small Business Reorganization Act of 2019 (the SBRA), which became effective on Feb. 19, 2020, right at the start of the pandemic in this country. (Another attempt at broad, consumer-based legislative relief introduced that year by Sen. Elizabeth Warren, the Consumer Bankruptcy Reform Act of 2020, died in Congress.)

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The SBRA created a new pathway for small businesses to remain in control of running their businesses, which is the usual reason for choosing to seek relief under

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Chapter 11, while eliminating many of the reasons that typical Chapter 11 proceedings exhausted the patience, and wallets, of both debtors and creditors.

But first you ask, of course, what is a "small business" under Subchapter V? Well Congress had the "obvious" answer—it was any business that had debt that did not exceed $2,725,625. If your business had a dollar more in debt you were just not small enough. (Though researched, how Congress decided on that very precise number as a cap for defining "small" still eludes the author.)

As noted above, since bankruptcy filings actually decreased substantially in 2020, Subchapter V was obviously not an immediate success if the goal was to help small businesses obtain a fresh start through bankruptcy. The low and arbitrary cap on the debt limit was an obvious problem, which was fixed by raising the debt limit to a higher, round number, $7,500,000, when President Joe Biden signed into law, as part of the 2020 CARES Act. (Coronavirus Aid, Relief and Economic Security Act of 2020, Pub. L. No. 116-136, 134 Stat. 281 (effective May 17, 2020).) As a consequence, the vast majority of Chapter 11 filings in the last two years were made under Subchapter V.

So what are the features of Subchapter V that differentiate it from a regular Chapter 11 and make it more appealing to small businesses? (It is worth noting that an individual may also qualify to be debtor under Subchapter V in certain situations. §1182(1)(A) of the Bankruptcy Code defines who may be "debtor" under Subchapter V and states in pertinent part that a debtor "means a *person* engaged commercial or business activities …" (emphasis added). Under §101(41) of the Bankruptcy Code, a "person" includes an individual, partnership and a corporation). And are there any other qualifications that must be met for its use and availability?

First of all, Subchapter V can only be used where the majority of the debt arose from the commercial and business activities of the debtor. It is not a filing option, for example, for a business which consists solely of the ownership and operation of single asset real estate. See 11 U.S.C. §1182(1)(A). Note also that in determining eligibility for Subchapter V, §1182(1)(A) of the Bankruptcy Code expressly excludes certain debts from the $7,500,000 debt ceiling: (1) all debt owed to affiliates and insiders, (2) contingent debts and (3) unliquidated debts.

Some of the benefits of using the Subchapter V filing option are immediate. For example, the requirements to assemble and file (1) the schedules of assets and liabilities and (2) monthly operating reports are eliminated. Instead, the debtor must write up a brief history of its business operations, a liquidation analysis and projections of its ability to make payments under a proposed plan. The debtor also needs to file a plan within 90 days of the petition date. (The court can extend the 90-day period for cause under §1189(b) of the Bankruptcy Code.

It is noteworthy that the Bankruptcy Code does not expressly state what is the consequence if the debtor fails to file a plan in 90 days. Thus this area will need to be developed by the courts.) Not only is less disclosure required to start the Subchapter V case, but Subchapter V also eliminates the requirement of a disclosure statement in connection with the filing and solicitation of approval of the plan, unless the court orders otherwise for cause. 11 U.S.C. §1181(b).

A very important distinguishing feature from a regular Chapter 11 is the fact that, subject to certain limitations, the absolute priority rule, wherein a dissenting class of unsecured creditors can block any plan to pay a junior class of debt unless the unsecured are paid in full, is eliminated in Subchapter V.

In fact, under Subchapter V, unsecured creditors' committees have been eliminated. See 11 U.S.C. §§1102(a)(3) and 1181(b). Such sections provide that there will not be a creditors' committee in a Subchapter V case unless the court orders otherwise for cause. In and of itself, that is a major streamlining of the entire bankruptcy proceeding.

Of critical importance are several features that make it easier for a debtor to confirm a cramdown plan under Subchapter V than under the traditional Chapter 11. (A cramdown plan is a plan in which not all classes of creditors have voted to accept the plan. Often under a cramdown plan the debtor will retain its assets without paying its creditors in full.) First, only the debtor can file a plan. 11 U.S.C. §1189(a). Thus, the debtor has an unlimited exclusive period, whereas the traditional Chapter 11 debtor has only 120 days of exclusivity (subject to the debtor's right to ask the court for an extension up to 18 months from the petition date). 11 U.S.C. §1121. This gives significant control of the case to the debtor, since it is the only party that can submit a plan for confirmation under Subchapter V.

Second, while generally the Chapter 11 plan confirmation requirements under §1129(a) must be met in order to confirm a Subchapter V plan, there are a number of key exceptions. The requirement under §1129(a)(10) that at least one impaired class of creditors accept the plan is eliminated. 11 U.S.C. §1191(b).

Also eliminated is the absolute priority rule for a cramdown of unsecured claims under §1129(b). Subchapter V allows a debtor to cramdown a plan if it, among other things, provides that the value of the property to be distributed under the plan in a three-year period (or such longer period as the court determines, not to exceed five years) is not less than the projected disposable income of the debtor. (See 11 U.S.C. §1191(c)(2). Section 1191(d) of the Bankruptcy Code sets forth the calculation of "disposable income.")

In addition, unlike in Chapter 11, plan confirmation under Subchapter V does not require payment of all administrative claims on confirmation. Section 1191(e) allows administrative claims to be paid over time if the Subchapter V plan is confirmed as a cramdown plan under §1191(b).

Moreover, post-confirmation, the Subchapter V debtor is also the only party that can seek to modify a plan. Thus, if the business prospers beyond projections in the following years (as many businesses did in 2021), neither the trustee nor any unsecured creditors can seek to modify the plan to increase payments under the plan.

Yes, there is a trustee in a Subchapter V proceedings, but the trustee's rule is more limited and advisory than Chapter 7 or Chapter 11 trustees, and the debtor is not required to pay the trustee's fees. 28 U.S.C. §1930(a)(6)(A).

Also, in Subchapter V a debtor (unlike a chapter 11 debtor) is not required to pay quarterly fees to the U.S. Trustee. See 11 U.S.C. §1930(a)(6). This can be a savings of thousands of dollars over the life of an extended proceeding.

There is another important feature of Subchapter V which business lawyers should be aware of. Whereas typically the Bankruptcy Code requires that all accrued legal fees to be paid by the debtor to the attorney prior to filing a petition in order to avoid conflicts, this requirement has been modified under Subchapter V in order to provide a lower hurdle for the small business debtor and its counsel. (Under §1195 of the Bankruptcy Code an attorney holding a prepetition claim that is less than $10,000 is not disqualified from representing the debtor in the Subchapter V case. Accordingly, counsel needs to be aware of this claim limit when counseling a client prior to filing under Subchapter V).

When the 2020 CARES Act increased the debt cap for small businesses to $7.5 million, the increase was only intended to be temporary, and Congress set the increase to expire on May 27, 2021. As the COVID pandemic lingered, however, Biden extended the expiration date another ten months to March 27, 2022. As this article is being written, that date had already expired without further extension by Congress. However, on March 14, 2022, Sen. Chuck Grassley (R-Iowa) introduced a bill—the Bankruptcy Threshold Adjustment and Technical Corrections Act, S.3823, 117th Congress (2021-2022)—to make the higher limit permanent, and Blumberg News reported widespread bipartisan support for the bill.

To be clear, Subchapter V was designed to aid small businesses, typically owned by a sole proprietor or family, such as a restaurant or local retail store that could be viable long term if it had assistance in handling its current debt. Even with the increased debt cap, it is not a replacement for reorganization of most larger businesses under the traditional Chapter 11 proceeding.