

A New Bankruptcy Lifeline for Startup, Early Stage and Emerging Growth Companies?

Top 10 Questions About Subchapter V Reorganization

Reorganization under Chapter 11 of the Bankruptcy Code offers powers and benefits that are simply not available in out-of-court restructurings. Chapter 11 restructurings, however, are often far too expensive to be a viable option for early stage companies and their investors. And the Chapter 11 process does not enable existing equity to retain ownership without creditor consent unless creditors will be paid in full (or new money is invested).

Recently-enacted Subchapter V provides for the first time an affordable mechanism for companies to reorganize with the benefits of the Chapter 11 process while preserving the interests of common and preferred stockholders.



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Question 1

What is Subchapter V?

- The Small Business Reorganization Act of 2019 (SBRA) took effect on February 19, 2020. The SBRA added a new Subchapter V to Chapter 11 of the Bankruptcy Code (Subchapter V).
- Subchapter V provides certain “small businesses” an opportunity to resolve outstanding liabilities in a streamlined, cost-effective Chapter 11 proceeding.

Question 2

What types of “small businesses” are eligible to reorganize under Subchapter V?

- Eligibility:
 - The company or its affiliate engages in commercial or business activities (other than having its primary business activity be owning single asset real estate).
 - The company does not have more than **\$2,725,625¹** in noncontingent, liquidated, debts (secured and unsecured), *excluding debts owed to affiliates or insiders*.
 - **Noncontingent debt** is a debt that is owed at the time of the bankruptcy and is not dependent on the occurrence of a future event for the liability to arise.
 - **Liquidated debt** is a debt that has a fixed, calculated and determined amount.
 - At least 50% of the company’s non-contingent, liquidated secured and unsecured debt must have arisen from commercial or business activities, excluding debts owed to affiliates or insiders.
 - The company must not be either:
 - A corporation subject to the reporting requirements under sections 13 or 15(d) of the Securities Exchange Act of 1934 or;
 - **An affiliate** of an issuer, as defined in section 3 of the Securities Exchange Act of 1934.
 - The company must state in its Chapter 11 petition whether it is a small business debtor and whether it elects application of Subchapter V.

Question 3

What differentiates a Subchapter V reorganization from a traditional Chapter 11?

- The SBRA revised the Bankruptcy Code to provide, among other things, the following in Subchapter V cases:
 - Elimination of the **absolute priority rule**, which otherwise requires creditor consent or payment in full as a condition to equity retaining its interest (absent new money investment).
 - The debtor **must file a proposed Chapter 11 plan within 90 days**, unless the bankruptcy court extends that deadline. Prepackaged Chapter 11 plans are permitted.
 - The debtor retains the **exclusive right to file a Chapter 11 plan throughout the case**.
 - Chapter 11 plan may be approved **without acceptance** of an impaired class of creditors.
 - Absent an alternative settlement with sufficient creditors, the debtor must commit to paying creditors **all projected disposable income** for a period of three years (or up to five years) following the effective date of the Chapter 11 plan.
 - **Disposable income** is income received by the debtor that is not reasonably necessary to be expended for payment of expenditures necessary for the continuation, preservation, or operation of the debtor’s business.
 - Unless the bankruptcy court orders otherwise, the debtor **does not need to file a disclosure statement**, which is a key document in normal Chapter 11 cases (akin to a prospectus) that summarizes the company’s financial situation and the proposed plan of reorganization to allow stakeholders to make an informed vote.
 - The US Trustee **must** appoint a Subchapter V Trustee to assist in development and administration of a plan of reorganization.
 - **No official creditors’ committee is appointed in** Subchapter V cases unless the bankruptcy court orders otherwise for cause. In most regular Chapter 11 cases a committee is formed by the US Trustee to act as a fiduciary for unsecured creditors and may hire professionals **at the company’s expense**.

¹Temporarily increased to \$7.5 million through March 27, 2021. See Question No. 6.

Question 4

Does a Subchapter V election provide access to the hallmark benefits of a traditional Chapter 11?

- **Yes.** While in Chapter 11, the Subchapter V debtor can continue to operate its business and maintain its governance and management structure throughout the case.
- All attempts to collect on pre-bankruptcy debts and ongoing litigations will be subject to the “automatic stay,” which protects all debtors from creditor demands and enforcement actions, allowing management to focus on a restructuring plan to preserve value and jobs without having to fend off creditor pressures that can disrupt the business as a going concern.
- The Subchapter V debtor may use the Chapter 11 process to obtain new financing, reject contracts and leases that are burdensome or no longer of value to the company, and to sell assets free and clear of liens, claims, and interests.

Question 5

What are the advantages of a Subchapter V reorganization?

- **Reduced expenses:** Reorganizing under Subchapter V should be significantly less expensive for the debtor because certain administrative expenses that a Chapter 11 debtor would normally incur have been eliminated:
 - **No US Trustee fees**²
 - **No Official Creditors’ Committee** (unless ordered by bankruptcy court)
 - **Quicker, more streamlined process**
- **Retention of ownership interest:** Satisfaction of the absolute priority rule is not a requirement for confirmation of a Subchapter V plan.
 - Therefore, Subchapter V provides a greater opportunity for existing equity owners to retain their ownership interests without investing new money, paying creditors in full, or obtaining creditor consent.
- **Disinterested professionals:** A debtor in a Subchapter V case may retain professionals that hold less than \$10,000 in prepetition claims against the debtor.
 - This provides greater flexibility for the debtor to retain existing professionals rather than having to get a new team up to speed due to the theoretical conflict of existing professionals’ creditor status.
- **Exclusive right to file a plan:** Only the debtor may propose a Chapter 11 plan in a Subchapter V case, while other parties in interest may file a plan after the exclusive period expires or terminates in a regular Chapter 11 case.³
- **No impaired accepting class:** There is no requirement that an impaired class of creditors accept the Subchapter V plan.
- **No Official Creditors’ Committee:** No official creditors’ committee is appointed in Subchapter V cases unless the bankruptcy court orders otherwise for cause.
- **Administrative expenses paid over time:** In a Subchapter V plan, the debtor is not required to pay postpetition administrative expenses in full, in cash, on the effective date of the plan.
 - Instead, postpetition administrative expenses, including for postpetition goods, services and professional fees, may be paid over time through the plan.

² In Chapter 11 cases (except Subchapter V cases) a fee must be paid to the US Trustee program each quarter between the date of the bankruptcy filing and the date the case is closed, dismissed or converted to a liquidation. The fee is calculated based off company disbursements and ranges from \$250 to \$250,000 per quarter.

³ In a regular Chapter 11 case the debtor has the exclusive right to file a plan for 120 days, which can only be extended by the court to 18 months from the filing date.

Question 6

What impact has COVID-19 relief legislation had on Subchapter V?

- **The CARES Act** revised the Bankruptcy Code by increasing the maximum debt threshold for a debtor to qualify as a Subchapter V debtor from **\$2,725,625 to \$7,500,000** until March 27, 2021 (which may be extended or modified through future legislation).
- **The Consolidated Appropriations Act** temporarily modifies the Bankruptcy Code to provide greater protections for debtors:
 - Subchapter V debtors are permitted an additional 60 days to pay rent (this is in addition to the existing 60-day “for cause” delay available to all Chapter 11 debtors), where a small business debtor has and is continuing to experience a material COVID-19-related financial hardship.
 - All Chapter 11 debtors now have an extended 210 days to assume or reject a lease (and, as before, may request an additional 90-day extension).
- **The Consolidated Appropriations Act** also contains provisions to allow Subchapter V debtors (but not any other Chapter 11 debtors) to obtain PPP loans, but such provisions will only go into effect in the sole discretion of the SBA administrator.

Question 7

What are the unique hurdles of a Subchapter V reorganization?

- **Eligibility limits:** Low original debt threshold; the CARES Act increase is only temporary and may not be extended beyond March 27, 2021 (although there is a pending proposal to extend the increase by a year).
- **Appointment of a Subchapter V trustee:** A trustee is automatically appointed in a Subchapter V case to assist in development of a confirmable plan, administer plan payments and advise the court.
- **Shortened time to file a plan:** The Subchapter V debtor only has a 90-day period to file a Chapter 11 plan, though the bankruptcy court may extend that period under certain circumstances.
- **Funding the plan with projected disposable income:** The Subchapter V debtor is required to devote projected disposable income or its value to pay creditors over the course of at least three years.
 - The court may require a longer period for payments or distributions, not to exceed five years.
 - Courts have not developed a uniform approach in either evaluating projected disposable income or determining whether plan payments should be based on a three-year period or five-year period.

Question 8

What does a Subchapter V Trustee do?

- The US Trustee appoints a Subchapter V Trustee **in every** Subchapter V case.
- The Subchapter V Trustee is expected to:
 - Assist the Subchapter V debtor in the development of consensual Chapter 11 plan.
 - Ensure that the debtor makes timely payments required under the confirmed Chapter 11 plan.
 - Appear and be heard at any court hearing that concerns:
 - The value of property subject to a lien;
 - Confirmation or modification of a Chapter 11 plan; and
 - The sale of the company's assets outside of the ordinary course.
 - Appear and be heard at court status conferences.
 - If the court orders for cause and on request of a party in interest, the Subchapter V Trustee must:
 - Investigate the debtor's acts, conduct, assets, liabilities and financial condition, the operation of the debtor's business and the desirability of continuing the business, and any other relevant matters.
 - File a report setting out the results of the investigation.

Question 9

Does Subchapter V offer greater protections for management?

- **Possibly.** Subchapter V eliminates the official creditors' committee mandate, which **may** spare the debtor and its management from an often automatic, costly and hostile committee investigation.
 - **However,** the debtor and its management are not insulated from investigation completely. Subchapter V Trustee may investigate the debtor under certain circumstances (see Question No. 8), or parties in interest may seek permission from the court to pursue their own investigation or seek the appointment of a committee.

Question 10

What should be my considerations in deciding whether or not to elect the Subchapter V option?

- **Eligibility:** Companies considering electing the Subchapter V option must closely evaluate whether they are eligible to be a Subchapter V debtor. All parties in interest, including the US Trustee, may object to the Subchapter V designation. Any resulting litigation will be costly and ultimately distract the company, its management and professionals from the restructuring process.
- **Transparency:** Reorganizing under Chapter 11 requires intense levels of transparency and public disclosure in comparison to an out-of-court restructuring.
- **Predictability:** Subchapter V is a relatively new statutory scheme so there is limited binding guidance regarding its provisions. There is also limited experience as to how bankruptcy judges, who often rule from the bench, will respond to restructuring strategies that employ the new statutory scheme.

Contact Us

We stand ready and able to help you think through these questions and position you for the best possible outcome.

Financial Restructuring



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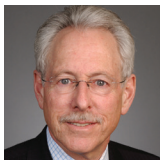
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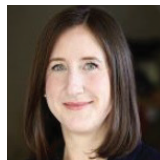
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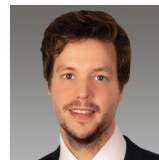
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