THE CREDIT TIMES

CCC of New York

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March 2023 *A Publication of The Commercial Collection Corp. of NY, Inc.*

In this installment of The Credit Times, we feature an article by Jennifer D. Raviele, Special Counsel, Kelley Drye & Warren LLP. The article originally published in the Credit Research Foundation's, 1Q 2022 Credit & Financial Management Review. This article was an excellent update on Subchapter V of the Chapter 11 bankruptcy code originally designed to help streamline and reduce costs for small businesses looking to reap the benefits that larger companies access through reorganization. In this article, Jennifer does an excellent job of highlighting the changes in the law, as well as the practical implications and potential strategies that creditors may want to consider as the changes have had some time to age. Special thanks to the Credit Research Foundation (CRF) for allowing us to republish this article. For more information on CRF and how membership can add value for credit and collection practitioners, please visit the link on the CRF banner at the end of this article.

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Subchapter V Changed The Chapter 11 Bankruptcy Landscape – How Should Creditors Protect Their Interests?

Since the new law went into effect on February 19, 2020, over 3,000 Subchapter V cases have been filed. More than one-third filed in California, Florida, and Texas. While more companies are electing to file under Subchapter V, it remains to be seen whether the changes actually lead to more successful reorganizations.

Although the benefits to small Main Street businesses are evident, Subchapter V is also ripe for manipulation. While it eases the complex requirements of the Chapter 11 statutory framework and reduces the associated costs, helping small businesses reorganize rather than liquidate, creditors should be concerned about companies that are not Main Street businesses manipulating Subchapter V to capitalize on those benefits. Critics argue that safeguards should be added to the new statute to ensure that large companies and private equity funds cannot use Subchapter V to circumvent the creditor protections embodied in Chapter 11. Creditors contesting a company's eligibility for Subchapter V must take immediate action with assistance from experienced bankruptcy counsel.

Creditors should be particularly wary of the reduced oversight provided in the Subchapter V context. Unlike traditional Chapter 11 cases, an official committee of unsecured creditors is not appointed at the beginning of a Subchapter V case. While a committee can be appointed for cause, the burden and expense are on individual creditors to assert that a committee is necessary to adequately protect unsecured creditor interests. While Subchapter V trustees are appointed in every Subchapter V case, they do not have the typical powers of trustees appointed under other chapters of the Bankruptcy Code. Instead, Subchapter V trustees typically act like mediators, helping facilitate the development of a consensual plan of reorganization, which is a far cry from the investigative powers of a committee or Chapter 11 trustee.

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Another critical difference is that, unlike Chapter 11 debtors, Subchapter V debtors do not have to promptly pay post-petition claims. In a Chapter 11 case, creditors typically know that all debts incurred after the filing must be paid by the debtor either in the ordinary course of business or on the effective date of the plan. This includes claims for goods shipped to the debtor post-petition and rent due to landlords while the debtor occupies their premises. Subchapter V, in contrast, permits debtors to pay post-petition claims over the course of three years after the plan effective date, thereby extending the time within which vendors and landlords will have to front money to the debtor and increasing the risk that those claims will not be repaid in full.

Chapter 11 cases move at different speeds depending on the type of case; some are very fast and others take months or even years. Subchapter V cases all move very quickly. Within six weeks of filing, the debtor must file a status report with the court detailing its efforts to reach a consensual plan of reorganization. At the two-month mark, the court will hold a status conference to discuss those efforts and will often press the debtor to ensure that it will comply with the timeline. Three months after filing, the debtor must submit its plan of reorganization. While the plan filing deadline is habitually extended in Chapter 11 cases, courts have made it clear that extensions of this deadline in Subchapter V cases will be the rare exception.

There is no time to waste. Creditors should prepare in advance to know their rights, monitor filings, and retain experienced counsel to formulate strategies that immediately protect their interests when these cases file.

I. What is Subchapter V?

Small business owners are often wary of Chapter 11 for a number of reasons including: (i) its cost and complexity; (ii) the failure to see it as a tool they can use to reorganize their businesses; and (iii) the feared stigma, guilt, and shame associated with being someone who does not pay their debts. As a result, small business owners frequently wait too long to address problems until there is little value left and they are forced into liquidation or worse. Chapter 11 is intended to permit companies to restructure and receive a fresh start, while maximizing recoveries for creditors; however, the practical impact of its complex requirements is that the process can be ill-suited for Main Street businesses that do not need to fail but have no choice other than to liquidate.

Bankruptcy practitioners and academics have long observed that small businesses were not being served by Chapter 11. In 2005, Congress added certain small business protections to the Bankruptcy Code, notably focused on shortening the bankruptcy timeframe. Still only one-quarter of small business bankruptcy cases could achieve reorganization. After years of study and analysis, the American Bankruptcy Institute ("ABI") and the National Bankruptcy Conference ("NBC") recommended further changes to the Bankruptcy Code, which precipitated the enactment of the Small Business Reorganization Act (the "SBRA") in 2019. The SBRA became effective shortly before the onset of the COVID-19 pandemic.

The SBRA permitted small businesses to restructure under a modified form of Chapter 11, specifically the new Subchapter V. The main goals of Subchapter V were to address the hurdles to successful reorganization that small businesses faced by relaxing the complex requirements of Chapter 11, reducing some of the costs, and shortening the length of the process.

Before Subchapter V, Chapter 11 was the only bankruptcy option for a company that wanted to retain control of its operations and continue its business. During a Chapter 11 bankruptcy case, the debtor may pursue several avenues, including a sale of some or all of its assets, a plan of reorganization, or liquidation. Notably, with few exceptions, the company is in the driver's seat. In contrast, a Chapter 7 filing results in the immediate appointment of a Chapter 7 trustee and the creation of a bankruptcy estate, which is then liquidated by the trustee.

"The SBRA endeavors to strike a balance between Chapter 7 and Chapter 11." A Subchapter V trustee is appointed at the beginning of each case, but the debtor continues to operate its business. However, that right can be taken away for, among other things, "fraud, dishonesty, incompetence, or gross mismanagement." No committee is appointed automatically, but one can be for cause. Only the debtor can file a plan, but it must do so within 90 days of the bankruptcy filing, or else the case may be dismissed or converted to Chapter 7. No disclosure statement is required. Even if no creditors support the plan, the court may confirm it if the applicable standards are met. And, most importantly for small businesses, the owners can maintain their equity interests in certain circumstances, even if creditors are not paid in full.

II. What is a Small Business?

The gating issue for Subchapter V is that a company's debts must be low enough to qualify as a small business. When a bankruptcy petition is filed, the debtor must have "aggregate noncontingent liquidated secured and unsecured debts" below a fixed amount. When the SBRA was first enacted in 2019, the debt limit was $2,725,625. When the Coronavirus Aid, Relief, and Economic Security Act was passed in early 2020 to provide economic relief during the pandemic, the debt cap was temporarily raised to $7.5 million through March 27, 2021. In response to the ongoing economic impact of the pandemic, the COVID–19 Bankruptcy Relief Extension Act extended the $7.5 million debt limit until March 27, 2022.

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At the time of this article, there is no legislation proposed to extend the debt limit beyond the March 27, 2022 expiration. However, media outlets have reported that Congress is in discussions to extend the debt limit. The next extension may be longer than the last, or even permanent.

Before the SBRA was enacted, both the ABI and NBC recommended a higher debt limit. The ABI proposed a permanent increase to $10 million. The Executive Director of ABI, Amy Quackenboss, recently noted "with mounting economic uncertainties amid the ongoing pandemic, congressional consideration of extending or permanently making the expanded eligibility limit of small businesses electing to file for subchapter V under chapter 11 will provide a proven path for small businesses to successfully restructure, reduce liquidations and save jobs." However, it remains to be seen whether Congress will extend the debt limit increase before its expiration or retroactively after its expiration or fail to extend it at all. A similar bipartisan effort to extend other bankruptcy protections instituted under the Consolidated Appropriations Act failed and, as a result, those protections expired on December 27, 2021.

III. How Should Creditors Protect Their Interests in Subchapter V Cases?

[1] Question Eligibility for Election as Subchapter V Debtor

To qualify as a small business, a debtor must prove that it is "small" and the main way the courts determine that is by assessing the company's debt level.

In making reorganization less expensive and time consuming for small businesses, Subchapter V strips away some important creditor protections embodied in Chapter 11. When balancing the interests of debtors and creditors, these modifications may be justified to preserve Main Street businesses. However, the burden is on creditors to guard against strategic debtors that are not Main Street businesses trying to take advantage of the relaxed oversight and flexibility provided under Subchapter V.

Diligent creditors, in consultation with their counsel, must be ready to challenge a Subchapter V election and question whether the debts asserted by the debtors are accurate. Should unliquidated claims be liquidated? Should contingent claims be non-contingent? Courts are likely to look critically on debtors who try to skirt the rules. Some have noted that, while the "extraordinary powers and cost-saving provisions granted to small business debtors [by Subchapter V] are certainly laudable, it is important to keep in mind that the overall purpose and function of the Bankruptcy Code is to strike a balance between creditor protection and debtor relief."

[2] Request Appointment of an Official Committee of Unsecured Creditors

Unlike traditional Chapter 11 cases, Subchapter V cases do not require the appointment of an official committee of unsecured creditors. The absence of a committee may reduce the overall costs for small business debtors compared to Chapter 11 cases where the committee is permitted to hire its own professionals, including attorneys, financial advisors, and investment bankers, at the debtor's expense. Also, the practical impact of not having a committee is that the relief sought by the debtor, including the plan, is unlikely to be contested, saving both time and money for the debtor.

The lack of a committee reduces vital oversight of the bankruptcy case and debtor's management. The system of checks and balances offered by the committee is eviscerated and the role of the Subchapter V trustee, as discussed in detail below, does not replace committee oversight. Congress acknowledged that "[w]hile the Bankruptcy Code envisions that creditors will play a major role in monitoring these cases, this often does not occur, chiefly because creditors in these smaller cases do not have claims large enough to warrant the time and money to participate actively in these cases."

Creditors should be aware that, while it is not the norm, a committee may be appointed in a Subchapter V case upon a showing of cause. The Bankruptcy Code does not define cause, but courts may consider whether the committee is necessary to supervise the debtor, will improve creditor recoveries, and will help the case get resolved quickly.

[3] Understand the Limited Role of the Subchapter V Trustee

At the beginning of each Subchapter V case, a Subchapter V trustee is appointed. This trustee role is unlike the trustee roles provided by Chapters 7 and 11. The Bankruptcy Code specifically states that the Subchapter V trustee does not have the broad powers of a Chapter 11 trustee, which include operating the debtor's business, investigating the debtor, receiving property, reviewing and objecting to claims, and filing a plan.

The Subchapter V trustee's main responsibility seems to be to "facilitate the development of a consensual plan of reorganization." This is similar to a Chapter 13 trustee's duty to "advise and assist the debtor in the creation and completion of a plan."

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In practice, Subchapter V trustees typically end up acting more like mediators or facilitators, conducting very little, if any, of the oversight expected from a committee in a traditional Chapter 11 case.

While an individual creditor is unable to change a Subchapter V trustee's role and purpose, it is important for creditors to understand the limits of that role and open lines of communication with the Subchapter V trustee as early as possible, raising any concerns they may have about the debtor or the case.

[4] Use Shortened Plan Timeframe as Leverage

In traditional Chapter 11 cases, section 363 sales of substantially all of a debtor's assets are common case outcomes; however, Subchapter V cases mostly involve reorganization plans, even though section 363 asset sales have occurred in limited circumstances.

Subchapter V makes the plan process easier for small businesses. Only the debtor may file a plan in Subchapter V. In traditional Chapter 11 cases, the debtor has a limited time within which it has the exclusive right to file a plan, after which other parties in interest can submit competing plans. Subchapter V avoids the increased costs attendant to addressing competing plans and eliminates the traditional Chapter 11 requirement of filing a disclosure statement with the plan.

In exchange for relaxing the plan requirements, Subchapter V debtors must satisfy an expedited plan timeline. Within roughly six weeks of filing the case, the debtor must submit a status report to the court detailing its efforts to reach a consensual plan. At the two-month mark, the court will hold a status conference to discuss that report and, in practice, courts will be critical of a debtor's efforts at this point to ensure it meets the statutory deadlines. After only three months in bankruptcy, the debtor must file its plan. Extensions of this deadline may be granted only "if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable." While courts routinely grant extensions of the debtor's exclusive period to file a plan in traditional Chapter 11 cases, over the last two years, courts have made it clear that extensions will not be granted to Subchapter V debtors in the ordinary course. Once the plan is filed, Subchapter V does not require a debtor to confirm the plan within a fixed amount of time.

Creditors should be aware of the stringent timeframe surrounding the Subchapter V plan process. This is a potential leverage point when negotiating with a Subchapter V debtor. Knowing that the debtor must file its plan within three months should inform a creditor's approach in discussions with the debtor regarding its claim, contract, or lease.

[5] Contest Non-Consensual Plans and Claim Distribution Projections

In traditional Chapter 11 cases, a debtor cannot confirm a plan over the objection of an unsecured creditor if the equity owners will retain their interests. The purpose of Subchapter V, however, is to increase the number of small businesses that successfully reorganize and permit their owners to remain in control. In furtherance of these goals, a Subchapter V debtor may confirm a plan that permits the owners to retain their equity interests, even if unsecured creditors object because they are not being paid in full, as long as the plan is "fair and equitable" and "does not discriminate unfairly." For a Subchapter V debtor to prove that its plan is fair and equitable, the plan must provide that all of the debtor's "projected disposable income" for three years post-emergence will be used to make payments under the plan. Post-petition administrative expenses can also be paid over the life of the plan, as opposed to the requirement in traditional Chapter 11 cases that such claims be paid on the plan effective date.

While these changes are helpful for small business owners who may get a second chance to succeed, they also create an incentive for companies to manipulate their status with respect to Subchapter V eligibility requirements so they can take advantage of Subchapter V and maintain their equity interests.

Even though a Subchapter V debtor can confirm its plan over the objection of an unsecured creditor that is not being paid in full, the debtor will not receive a discharge of its debts until all payments required under the plan are made, which is typically three years post-emergence. If the plan is completely consensual, the debtor receives its discharge on the plan effective date. Most debtors will want the discharge to be effective as early as possible for a number of reasons, including the ability to avoid paying Subchapter V trustee fees. Creditors should use the knowledge that debtors typically want the discharge on the plan effective date as leverage in exchange for support of a debtor's plan (within the permissible boundaries of the Bankruptcy Code).

Creditors should also pay close attention to the debtor's projected disposable income since there is a lack of certainty about the boundaries of this concept and it is also ripe for manipulation. The debtor has a strong interest in proposing the lowest possible disposable income since it drives the amount of future claim distributions. Even if a debtor's future disposable income is greater than projected, creditors will not receive any greater distribution on their claims.

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[6] The Expedited Pace Requires Immediate Attention

One of the problems Subchapter V sought to remedy is that small businesses are less likely to reorganize when their cases linger in Chapter 11 for an extended period of time. Several facets of Subchapter V, discussed above, address this issue: (1) mandatory case status conference within 60 days of the bankruptcy filing; (2) at least 14 days before that status conference, the debtor must submit a report to the court detailing its efforts to reach a consensual plan of reorganization; and (3) the debtor must file the plan within 90 days of the bankruptcy filing.

For several reasons, including decreased professional fees, the expedited pace of Subchapter V cases undoubtedly preserves the going concern value of the debtor's business as opposed to the more protracted and cumbersome Chapter 11 process. However, while the shortened timeframe may preserve the company, it can be disastrous to creditors' interests if they do not get involved early. It is critical that creditors either track bankruptcy filings for impact on their interests or have knowledgeable bankruptcy counsel that will update them as soon as filings occur. While it is important to be involved in traditional Chapter 11 cases early, it is even more important that creditors are involved in Subchapter V cases as soon as possible after they file.

About the author:

Jennifer Raviele, Special Counsel, Kelley Drye & Warren LLP, focuses her practice on bankruptcy – specifically on representing creditors in Chapter 11 and Chapter 7 bankruptcy proceedings and out-of-court restructurings. A New York Metro Super Lawyers "Rising Star," Jennifer identifies the strengths and weaknesses of a client's position, clarifies specific goals and objectives, and executes an action plan to pursue the maximum recovery, whether through effective negotiation, litigation, or a hybrid of the two.

Jennifer has been involved in countless retail and restaurant bankruptcy cases in which she represented the owners and managers of shopping centers and addressed the full spectrum of related issues. Her experience includes handling contested assumptions, assignments, and rejections of leases, litigating claims against a debtor's estate, arguing the contours of stub rent and related disputes over DIP financing, and issues related to a debtor's plan of liquidation or reorganization. To request the list of sources Jennifer used in her article, please email: chaynie@commmercialcollection.com

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