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6 Reasons Why Congress Should Allow Businesses With Up to $10 Million in Liabilities Reorganize Under Subchapter V

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Judy Wolf Weiker is a Principal and co-founder of Manewitz Weiker Associates, LLC, ("MWA"), a woman-owned boutique consulting firm specializing in the management of challenging corporate situations. MWA has been serving clients since 2008. Ms. Weiker has 25+ years-experience in the financial services industry, holding positions with large financial institutions as a workout and turnaround officer, financial analyst, and portfolio manager of distressed investments. Ms. Weiker is a subchapter V Trustee for the Southern District of Indiana (SDIN). She is a Certified Insolvency Restructuring Advisor ("CIRA"), Senior Fellow, National Association of Legal Fee Analysis ("NALFA"), and trained bankruptcy and restructuring mediator listed on the mediation registries for the United States Bankruptcy Court (S.D.N.Y. and S.D.Ind.). Ms. Weiker is a member of the Indiana State Bar since 1991.

The Small Business Reorganization Act ("SBRA") celebrates its second birthday in February 2022. "Subchapter V" – the SBRA's pragmatic addition to chapter 11 – arrived just in time for the economic shock of the global COVID-19 pandemic. It has been a bright spot of activity in an otherwise sleepy bankruptcy system over the past 20 months. As of this writing, more than 2,600 businesses have elected to restructure under the new law: representing about 75% of small business chapter 11 cases filed since the start of 2020. The success rate of subchapter V cases is several times higher than standard chapter 11. About 2/3 of the confirmed plans are consensual with significant creditor support. And these cases are quick, with most businesses confirming plans within 6 months of filing (compared to 11 months in standard chapter 11). The unique provisions of Subchapter V allow debtors to build consensus, avoid protracted litigation, and quickly emerge from bankruptcy with a manageable debt load.

A great number of SBRA success stories involve businesses that would not have been able to seek relief under Subchapter V were it not for Section 1113(a)(5) of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which temporarily added section 1182(1) to the Bankruptcy Code. Section 1182(1) defines a Subchapter V "debtor" as a person who, among other things, has aggregate non-insider debts of not more than $7,500,000 (the "Debt Cap").

Once the CARES Act increased the Debt Cap, hundreds of businesses were able to restructure during the COVID-19 pandemic and become the catalyst for economic recovery in the United States. When a business survives, employees retain jobs, vendors maintain trade partners, lenders restore performing loans, landlords have occupied properties, municipalities realize tax revenues, and communities thrive.

Section 1182(1) was set to expire on March 27, 2021. If that had happened, the definition of a Subchapter V-eligible debtor would have reverted to the "small business debtor" definition in section 101(51D) of the Bankruptcy Code. That section cuts off Subchapter V relief to businesses with debts over $2,725,625. This frustratingly small sum would force any company above that amount into standard chapter 11. Closely held, private businesses would thus, embark on the same road out of debt as that traveled by American Airlines, General Motors, and Pacific Gas & Electric Co. – but without access to the capital markets that allowed those behemoths to restructure.

It is not a coincidence that March 2021 saw the highest number of Subchapter V case filings to date.[1] It is almost certain that a significant number of the 194 businesses that filed that month did so prematurely because they were uncertain whether bankruptcy relief would be available the following week. The day before section 1182(1) was set to expire, the COVID-19 Bankruptcy Relief Extension Act of 2021 extended the $7,500,000 Debt Cap another year to March 27, 2022.

As the current Debt Cap faces yet another sunset in the Spring of 2022, Congress should pass legislation making section 1182(1) a permanent part of the Bankruptcy Code with a Debt Cap to $10,000,000. Passing this legislation is in the best interests of businesses, ownership, and their creditors for a multitude of reasons. There is no good reason not to do it.

Why do businesses with less than $10 million in debt struggle in standard chapter 11? Cost is a factor (the debtor foots the bill for a slew of bankruptcy professionals including lawyers, accountants, brokers, and counsel to official committees), but the problem is more dynamic than that. Small businesses tend to be privately held, kicked-started from the owner's life savings and reliant almost exclusively upon revenues for ongoing liquidity needs. They might have one or two bank lenders, who perhaps provided a term loan to fund a one-time capital project and maybe a modest revolving credit facility. But these loans are not syndicated: there are no bondholders with the power to fund a coordinated restructuring.

1. There is an Underserved Group of Businesses That Cannot Afford to Reorganize in Standard Chapter 11.

Small businesses usually close rather than reorganize. A recent article published on Bloomberg, Yelp Inc., provides data showing more than 80,000 small businesses permanently shuttered from March 1 to July 25, 2020. About 60,000 were local businesses, or firms with fewer than five locations.[2]

A 2018 study published in the American Bankruptcy Institute *Journal* of 76,845 chapter 11 cases filed during fiscal years 2008-2017 (pre SBRA), concluded that only about 25% of the debtors with assets or liabilities less than $10 million were able to confirm a plan in standard chapter 11.[3] For debtors with assets exceeding $10 million the chance of achieving confirmation grew to approximately 40%.

In October 2021, the ABI published a fascinating study, "Subchapter V Cases by the Numbers,"[4] which shows how the SBRA works for small business. Of the 465 cases reported in the study, more than 50% had confirmed a plan within 6 months of filing bankruptcy (with more than 100 debtors in the data set awaiting confirmation at the time the study was published). The plan was consented to by all creditor classes approximately 59% of the time. Perhaps most significant, however, is the fact that 34% of the debtors in the study would not have been eligible for relief had the Debt Cap remained at $2,725,625.

These ABI studies confirm the existence of an "underserved" group of businesses in America, which, but-for Subchapter V, have no meaningful option to reorganize under federal bankruptcy law. The data show that businesses with assets and/or liabilities under $10 million struggle in standard chapter 11, while those that are eligible thrive in Subchapter V. Outside of bankruptcy these businesses are at the mercy of their creditors: restructuring means a hodgepodge of borrowing, ad hoc payment plans negotiated one creditor at a time, more borrowing, forbearances, and austerity pledges. Not only do these solutions take months of dogged effort to accomplish, but the inability to leverage consensus among multiple interested parties results in too little too late, increasing the likelihood that the business will end up in receivership, chapter 7, or some other wind-down process.

Why do businesses with less than $10 million in debt struggle in standard chapter 11? Cost is a factor (the debtor foots the bill for a slew of bankruptcy professionals including lawyers, accountants, brokers, and counsel to official committees), but the problem is more dynamic than that. Small businesses tend to be privately held, kicked-started from the owner's life savings and reliant almost exclusively upon revenues for ongoing liquidity needs. They might have one or two bank lenders, who perhaps provided a term loan to fund a one-time capital project and maybe a modest revolving credit facility. But these loans are not syndicated: there are no bondholders with the power to fund a coordinated restructuring. Then there are the trade creditors, landlords, and perhaps a former owner whose attitudes vary from ambivalence to incandescent rage depending on their history with the debtor. Individually, these creditors may have just enough leverage to crater a case, but not enough to catalyze a reorganization. Subchapter V solves this by giving the debtor greater control over the outcome.

If Congress allows section 1182(1) to expire, many businesses that drive local, state, and regional economies will be left without meaningful restructuring options in chapter 11. Regardless of what we mean when we refer to a "small" business, a Debt Cap of under $3 million is a terrible undershoot. Many businesses will have no choice but to liquidate or be acquired. Many individuals running small businesses will be unable to risk starting a new enterprise.

The data show that permanently increasing the Debt Cap to $10 million will strength the economy by allowing the majority of small businesses to quickly restructure their debts.

2. Allowing More Businesses to Reorganize Under Subchapter V Will Not Detrimentally Impact Creditor Recoveries.

Studies have shown that unsecured creditors fare better when the debtor continues to generate income.[5] Many unsecured creditors are trade vendors or landlords who would prefer to retain a paying customer and tenant than have it go out of business. Employees are creditors, too. According to the Small Business Administration, small businesses employ 47.1% of US employees. When businesses reorganize rather than liquidate or relocate, people keep their jobs.

Under Subchapter V, businesses must commit 3 to 5 years of net income to pay creditors. Their plan of reorganization must include "appropriate remedies" in the event of a payment default. This court-supervised process, coupled with the oversight of the Subchapter V trustee will lead to realistic payment plans, binding on all creditors, with a better chance at success than the alternative: shut down and liquidation.[6]

In theory, secured creditors enjoy tremendous leverage thanks to the collateral that they hold. In reality, an all asset lien on a small business with few marketable hard assets can only get you so much. Foreclosure brings the burdens of ownership or low-return liquidations. Receiverships must be paid for, often by the creditor. Personal guarantees help, but do not funda-

mentally change the problem of an insolvent business (from which the guarantor derives their income) for which there is no buyer or possibility of refinancing. The COVID-19 pandemic brought the secured creditor's predicament into full relief: with many debtor's revenues dropping so drastically and collateral valuations in flux, many lenders opted to extend their loans rather than take more drastic and permanent actions. Where the final crisis of 2008 brought the Great Recession, the economic fallout from COVID-19 appears to have begat "The Great Forbearance."

Sometimes the business has truly failed, and there is nothing to be done but wind-down. But in most cases, the secured creditor's best chance of recovery lies in allowing the business to live, generate revenue, and pay its debts. Subchapter V reflects this reality by eliminating the absolute priority rule. It allows equity to remain in place and have something to work for 3-5 years in the future, while paying the businesses creditors what it can.

The key difference between Subchapter V and standard chapter 11 is the elimination of the confirmation requirement that the debtor obtain an "impaired accepting class" of creditors. In small business cases, where the debtor needs to "cram down" a secured claim to the present value of its collateral and issue new paper to the creditor, the latter's unsecured deficiency claim becomes a blocking vote dooming the entire reorganization. Whether the creditor votes "no" out of ambivalence or anger, the outcome seldom results in more money more quickly for the creditor. Subchapter V still incentivizes debtors to obtain yes votes across all creditor classes,[7] but taking the blocking position away from secured creditors allows them focus on obtaining the best available economic outcome.

Subchapter V ensures that the debtor's payment plan will be both fair and realistic. Secured creditors can evaluate the debtor's income projections and argue for a higher payment. If they believe the business is just temporarily under-valued, and if their secured claim is not of inconsequential value, they can make the election under section 1111(b) of the Bankruptcy Code and preserve their secured claim at par.

3. The Eligibility Requirements of Section 1182 Are Sufficient to Prevent Abuse.

Even if Congress were to increase the Debt Cap to $10 million, not every kind of entity would be eligible for Subchapter V relief. Section 1182 excludes several kinds of entities from Subchapter V.

The so-called "single asset real estate" debtor is barred from reorganizing under Subchapter V.[8] This prevents debtors who essentially have one creditor from using the SBRA to force new paper on the mortgagee, perhaps at a low point in the real estate market. These "two party" disputes are relegated to standard chapter 11.

Debtors who are part of a business enterprise that has collective debts over $10 million are also ineligible: thereby preventing an organization from strategically discharging its liabilities and those of one or more subsidiaries in Subchapter V where the total combined debts exceed the Debt Cap.[9]

Finally, publicly traded companies and their affiliates are excluded, thereby preventing debtors with access to capital markets from using Subchapter V to restructure their debts.[10]

These exclusions reflect policy choices that ensure only "true" small businesses are eligible for Subchapter V. Raising the Debt Cap to $10 million would not necessarily disturb the status quo among corporate enterprises with access to capital markets and their creditors.

4. Subchapter V Trustees Ensure Transparency and Trust.

Every Subchapter V case has a trustee, who is an expert in the SBRA and can assist the debtor in reaching a consensual plan with its creditors. The Subchapter V trustee serves the role of a monitor, sounding board, and occasional mediator to foster trust among all stake holders. The trustee can advise the debtor how to best achieve its goals, while also reviewing the debtor's affairs, monitoring its business performance during the case, and testing the assumptions about its projected disposable income upon which the plan of reorganization is most commonly funded. The trustee must appear and be heard at critical hearings during the case and often works closely with the United States Trustee, participating in the initial debtor interview and section 341 meeting of creditors to identify issues that the debtor may need to address in order to confirm a plan. The trustee is also there to respond to creditor inquires and can mediate disputes, potentially obviating the need for plan objections or contested confirmation hearings.

The Subchapter V trustee typically works without professional advisors and can respond flexibly to the size and needs of the case. Although trustees are compensated for their work as an administrative professional, their fees are usually a fraction of those incurred by the debtor's counsel. With the trustee, Subchapter V provides a counterbalance to the debtor's considerable leverage to confirm a plan without unanimous consent while keeping the costs of running the case manageable.

Subchapter V trustees can also step in to administer the bankruptcy estate if the debtor is removed for misconduct. This avoids the immediate liquidation of the business. The Court may also call for the formation of a creditors' committee with its own counsel to advocate for the needs of unsecured creditors if the circumstances so warrant. With these options, a Subchapter V case can attains the oversight and attributes of a standard chapter 11 as needed.

5. A $10 Million Debt Cap Would Have No Meaningful Impact on the Number of Cases that Currently File under Standard Chapter 11 or Consumer Chapters.

Raising the Debt Cap to $10 million would make bankruptcy relief a meaningful option for businesses that are presently underserved by the existing laws. The companies that would therefore benefit from a permanent increase to $10 million are either not currently filing for bankruptcy, or if they are, they are failing in standard chapter 11 or liquidating in chapter 7 having missed their window to reorganize.

While individuals are eligible for subchapter V, section 1182's definition of a Subchapter V debtor requires that at least 50% of the person's debts arise from commercial or business activities. Most individuals who file bankruptcy to restructure "consumer" debts, file chapter 13. For these debtors, their largest debt is the mortgage on their home, or perhaps medical debt

Finally, making section 1182(1) permanent with a Debt Cap of $10 million would provide certainty to all stakeholders. As demonstrated by the high bankruptcy filing numbers in March 2021 when the CARES Act's $7.5 million Debt Cap was set to expire, uncertainty about changes in the law often drives debtors to rush into bankruptcy before exhausting consensual out-of-court options.

or student loans. These debts would not qualify as obligations arising from commercial or business activities since they were not incurred in connection with profit seeking activities. Accordingly, most individuals are ineligible for Subchapter V regardless of the Debt Cap.

With respect to any concern that a $10 million Debt Cap would take debtors away from standard chapter 11, it must be noted that such debtors are the runts of chapter 11, who struggle to survive and seldom achieve successful outcomes. As confirmed in the ABI studies cited above, these cases do little more than incur professional fees and delay payment to creditors. While creditors' committees are the rule as opposed to the exception in these cases, such committees are seldom formed for lack of interest. Accordingly, a small business in standard chapter 11 usually ends up operating without the oversight of an unsecured creditors' committee or the key statutory provisions that will allow them to leverage the secured creditor into a restructuring. They are, effectively, Subchapter V debtors, without the tools to achieve the success that Subchapter V has generated for all stakeholders.

6. Certainty to all Stakeholders

Finally, making section 1182(1) permanent with a Debt Cap of $10 million would provide certainty to all stakeholders. As demonstrated by the high bankruptcy filing numbers in March 2021 when the CARES Act's $7.5 million Debt Cap was set to expire, uncertainty about changes in the law often drives debtors to rush into bankruptcy before exhausting consensual out-of-court options. The U.S. saw a similar spike in filings in 2005 before the Bankruptcy Abuse and Creditor Protection Act brought sweeping changes to the consumer reorganization provisions in the Bankruptcy Code.

Certainty of outcome spurs consensus in most workouts. When lenders, landlords, trade creditors, and judgment holders know what tools a debtor has available in chapter 11, they are more likely to act rationally and provide the debtor with the concessions it needs to generate value for everybody.

As stakeholders negotiate "in the shadow of Subchapter V" many businesses will be saved from filing bankruptcy altogether. Out-of-court deals may even provide more value to creditors from the saved costs of going through bankruptcy. Accordingly, raising the Debt Cap to $10 million will be a catalyst to reorganizations of small and midsize companies, and will likely save many businesses without requiring each of them to file bankruptcy in the first place.

Conclusion

Most of the Subchapter V filings to date were driven by pre-pandemic problems: commercial disputes, bad loans, and other catastrophes that began years earlier. The economic fallout from COVID-19 has been muted, at least temporarily by fiscal spending and a "wait and see" approach. Debtors and creditors are currently in the Great Forbearance. Nevertheless, a mountain of debt – consumer, corporate, municipal, and sovereign – must be restructured in the years ahead. The COVID-19 cases are only just beginning to trickle into the bankruptcy courts. While the economy has shown signs of recovery in 2021, volatility is likely to remain for several years. Subchapter V has yet to see the true tail of the COVID-19 pandemic and the Great Forbearance.

Allowing the Debt Cap for Subchapter V to revert to under $3 million would cut many businesses off from meaningful bankruptcy relief at the precise time when they might need it most. These "big" small businesses collectively employ a lot of Americans and consume a lot of goods and services. They are critical nodes in the local economies than make up one national economy.

Subchapter V is a proven success and extending relief to more businesses by permanently increasing the Debt Cap to $10 million, will benefit debtors, creditors, and the economy by saving businesses and jobs. It is the pragmatic solution that our country needs. 🏛

ENDNOTES:

1 *See* American Bankruptcy Institute, Subchapter V Case Dashboard, available at: http://www.abi.org/sbra (last visited Nov. 13, 2021).

2 *See* Bloomberg.com "Small Businesses Are Dying by the Thousands – And No One Is Tracking the Carnage" by Madeline Ngo, August 11, 2021.

3 Ed Flynn, "Chapter 11 Is for Individuals and Small Business?," XXXVII *ABI Journal* 12, 102-03, December 2018.

4 Hon. Michelle M. Harner, Emily Lamasa, and Kimberly Goodwin-Maigetter, "Subchapter V Cases by the Numbers," XL *ABI Journal* 12, 59, October 2021.

5 *See* Arturo Bris et al., *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 61 J. Fin. 1253, 1269 (2006).

6 *See e.g., ABI Journal - Small Business Reorganization Act: Implementation and Trends (justice.gov)* (noting that confirmation of Subchapter V cases were six times higher than the percentage of confirmed plans for small business cases that did not proceed under subchapter V during the first 7 months of the effective date of Subchapter V).

7 A debtor who obtains acceptances from each impaired creditor class may obtain a discharge of its debts at confirmation. *See* 11 U.S.C. § 1141(d)(1)(A).

8 *See* 11 U.S.C. § 1182(1)(A) (excluding a person "whose primary activity is the business of owning single asset real estate.").

9 *See id.* § 1182(1)(B)(i).

10 *See id.* § 1182(1)(B)(ii) and (iii).