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Subchapter V Is Good for Creditors

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"Good" is a relative term. It is never good for a creditor when its debtor cannot pay. A good solution is a nonbankruptcy workout, but it might not be realistic depending on the circumstances.

Absent a workout, a debtor and its creditors have two basic options: liquidation or reorganization. When the debtor has a reasonable prospect of reorganizing, subchapter V, when available, is often the best alternative for both the debtor and creditors.

Liquidation occurs either through a creditor's enforcement of its remedies under nonbankruptcy law or in a chapter 7 liquidation. A creditor — especially a fully secured creditor — could prefer liquidation to a debtor's attempt to reorganize, but preservation of the debtor's going-concern value through reorganization might result in larger recoveries for creditors. Reorganization potentially enhances the value of a secured creditor's collateral based on its going-concern value,[2] but it might be especially beneficial for unsecured creditors, who often receive little or nothing upon liquidation.

Reorganization for most business debtors occurs in a chapter 11 case because they are not eligible for chapter 12 or 13. A debtor engaged in "commercial or business activities" whose noncontingent and liquidated debts do not exceed the debt limit has a choice between filing a traditional chapter 11 or a subchapter V case, with some exceptions. For example, public companies and single-asset real estate debtors are not eligible for subchapter V.

Subchapter V Is Good for Creditors

Why is subchapter V good for creditors? Simply put, it (1) enhances the prospects for a debtor to reorganize successfully (and therefore pay more to creditors than liquidation), but does not reduce the amounts that a debtor must pay under a plan in a traditional case or change the requirements for treatment of secured claims; (2) has provisions that protect creditors' interests; and (3) reduces costs.

Congress enacted subchapter V "to streamline the process by which small business debtors reorganize and rehabilitate their financial affairs."[3] A sponsor of the legislation stated that it allows small business debtors "to file [for] bankruptcy in a timely, cost-effective manner, and hopefully allows them to remain in business," which "not only benefits the owners, but employees, suppliers, customers, and others who rely on that business."[4]

Some features of subchapter V are "debtor-friendly" in the sense that they enhance the prospects for reorganization of a smaller business. Only the debtor may file a plan.[5] The "absolute priority rule" for cramdown confirmation in a traditional chapter 11 case[6] does not apply,[7] and cramdown confirmation is possible — even if no creditor accepts the plan.[8] Subchapter V permits the court to determine the scheduling for the confirmation process without the mandatory deadline for confirmation that governs in the case of a non-subchapter V small business debtor.[9] Unless the court orders otherwise for cause, the requirements in a traditional chapter 11 case for a disclosure statement in connection with the plan[10] and the appointment of a committee of unsecured creditors[11] do not apply.[12]

These provisions have had several intended consequences. First, subchapter V has made reorganization a feasible alternative for smaller businesses that cannot afford the costs and expenses, or navigate the complexities, of a traditional chapter 11 case. Second, elimination of the absolute-priority rule and the requirement of an accepting impaired class of creditors encourages smaller business principals to provide "sweat equity" by making it possible for owners of the debtor to retain their equity interests upon plan confirmation — a difficult, and often impossible, task under traditional chapter 11. Taken together, these two changes mean that smaller businesses have the ability to reorganize rather than go out of business through liquidation.

These changes may give rise to concerns that subchapter V reduces the rights of secured and

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1 He is the author of *A Guide to the Small Business Reorganization Act of 2019* and *Subchapter V Update* (March 2024), *available at* ganb.uscourts.gov/complex-chapter-11-procedures, as well as ABI's *SBRA: A Guide to Subchapter V of the U.S. Bankruptcy Code*, which is a free download at store.abi.org (unless otherwise specified, all links in this article were last visited on July 12, 2024).

2 11 U.S.C. § 506(a) (value of collateral "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property").

3 H.R. Rep. No. 116-171, at 1 (2019), *available at* govinfo.gov/content/pkg/CRPT-116hrpt171/pdf/CRPT-116hrpt171.pdf.

4 H.R. Rep. No. 116-171, at 4 (statement of Rep. Ben Cline, R-Va.). The court in *In re Progressive Solutions Inc.*, 615 B.R. 894, 896-98 (Bankr. C.D. Cal. 2020), reviewed the legislative progress of the Small Business Reorganization Act of 2019 and included public statements from several cosponsors of the law, including Sens. Charles Grassley (R-Iowa), Sheldon Whitehouse (D-R.I.), Amy Klobuchar (D-Minn.), Joni Ernst (R-Iowa) and Richard Blumenthal (D-Conn.). *See also* Michael C. Blackmon, "Revising the Debt Limit for 'Small Business Debtors': The Legislative Half-Measure of the Small Business Reorganization Act," 14 *Brook. J. Corp. Fin. & Com. L.* 339, 344-45 (2020).

5 11 U.S.C. § 1189(a).

6 11 U.S.C. § 1129(b)(2)(B).

7 11 U.S.C. §§ 1181(a), 1191(b)(c).

8 Section 1191(b) removes the requirement of § 1129(a)(10) in a traditional chapter 11 case that if any class of claims is impaired, at least one impaired class has accepted the plan.

9 Section 1129(e) requires plan confirmation in a small business case within 45 days of the filing of the plan unless the court extends it under § 1121(e)(3). Section 1129(e) does not apply in a subchapter V case. 11 U.S.C. § 1181(a).

10 11 U.S.C. § 1125.

11 11 U.S.C. § 1103.

12 11 U.S.C. § 1181(b).

unsecured creditors and diminishes their prospects for recovery on their debts. However, careful examination of the entire subchapter V package and anecdotal experience reveal that subchapter V in concept and operation actually preserves all material substantive rights of creditors and enhances their prospects for a greater recovery. Analysis of whether subchapter V is good for creditors requires consideration of two questions: Is reorganization better for creditors than liquidation, and if so, is subchapter V better for creditors than traditional chapter 11?

Reorganization vs. Liquidation

A fundamental premise of the Bankruptcy Code is that by preserving the debtor's going-concern value, reorganization makes more money available for creditors.[13] From the standpoint of unsecured creditors, anecdotal experience in the context of a smaller business is that the premise is usually correct. The common result of liquidation of a smaller business is that its assets produce little or nothing in excess of the debts that the assets secure.[14] It follows that unsecured creditors have little to lose and possibly much to gain through reorganization.

Whether reorganization is advantageous for a secured creditor is a more nuanced question. In a nonoperating liquidation, a fully secured creditor will realize full payment from its collateral, but only if the liquidation value exceeds the debt. It may view reorganization as a nuisance that delays its payment and introduces the risk that its collateral might depreciate in the event of a default after reorganization.

On the other hand, reorganization frequently enhances the value of collateral through the realization of going-concern value, either through preservation of the business or a sale as a going concern. Therefore, an undersecured creditor might recover more through reorganization. Nevertheless, an undersecured creditor might prefer the certainty and finality of prompt liquidation to the uncertainties of a larger payment through reorganization.

Because unsecured creditors are almost always better off through reorganization than liquidation, subchapter V is good for unsecured creditors because it makes reorganization possible in many cases that would otherwise result in the sale of assets in nonoperating liquidations. It is likewise good for secured creditors when reorganization is in their interest. Subchapter V is not just good for those secured creditors who do not want to be bothered by reorganization.

Subchapter V vs. Chapter 11

The next question is whether reorganization under subchapter V is better for creditors than a traditional chapter 11 case. As an initial matter, it is important to recognize that subchapter V does not alter any of the chapter 11 provisions that govern the treatment of claims during the administration of the case or in a plan. For example, the debtor cannot use cash collateral without a court order.[15]

Secured creditors have the same rights to adequate protection[16] and to seek relief from the stay.[17] With regard to the plan, an undersecured creditor may elect to have its claim treated as fully secured,[18] the same cramdown requirements in § 1129(b)(1)(A) in a traditional chapter 11 case apply to the cramdown treatment of a secured claim,[19] and, under the plan, creditors must receive at least what they would have received in a hypothetical chapter 7 liquidation.[20] The court might convert a subchapter V case to chapter 7 or dismiss it for the same reasons as in a traditional case.[21]

Administrative aspects of subchapter V provide significant advantages for creditors. Appointment of a subchapter V trustee is mandatory.[22] The trustee has the duty to "facilitate the development of a consensual plan of reorganization"; a consensual plan obviously requires dialogue with the debtor and creditors about an acceptable plan for payment of claims. The court, on the request of a creditor, the trustee or the U.S. Trustee, for cause, might order the trustee to conduct an investigation of the debtor.[23] The court may remove the debtor from possession for cause[24] so that the trustee takes over administration of the case, equivalent in substance and effect to the appointment of a trustee in a traditional case.

Subchapter V contemplates that the case move promptly and involves the court in the process, and the data demonstrate that it has been effective in accomplishing this objective.[25] The court must conduct a status conference within 60 days of the case filing,[26] and the deadline for the debtor to file a plan is 90 days after filing, unless the court extends it based on "circumstances for which the debtor should not justly be held accountable."[27]

Although subchapter V does not ordinarily require the filing of a disclosure statement in connection with a plan, the court may require one in appropriate cases. In any event, the plan must contain the critical information that creditors need in a disclosure statement: a brief history of the debtor's business operations, a liquidation analysis, and projections with respect to the debtor's ability to make payments under the proposed plan.[28] Moreover, the more robust reporting requirements applicable to a debtor in a small business case (which do not apply in a traditional case) govern a subchapter V case.[29]

13 "Chapter 11 embodies a policy that it is generally preferable to enable a debtor to continue to operate and to reorganize or sell its business as a going concern rather than simply to liquidate a troubled business. Continued operation may enable the debtor to preserve any positive difference between the going concern value of the business and liquidation value. Moreover, continued operation can save the jobs of employees and the tax base of communities, and generally reduce the upheaval that can result from termination of a business." Richard Levin & Henry Sommers, 7 *Collier on Bankruptcy* ¶ 1100.01 (16th ed. 2024).

14 *See* "A Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize," Nat'l Bankr. Conference (Jan. 3, 2010), at 5, *available at* nbconf.org/our-work. The proposal cites a number of studies, including Douglas Baird, Arturo Bris & Ning Zhu, "The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study," working paper at 3, 18-19 (2007) (contrasting larger cases involving significant assets and sophisticated debt structures with small businesses that have simple asset and debt structures).

15 11 U.S.C. § 363(c)(2).

16 11 U.S.C. § 363(e).

17 11 U.S.C. § 362(d).

18 11 U.S.C. § 1111(b).

19 11 U.S.C. § 1191(b), (c)(1).

20 11 U.S.C. § 1129(a)(7), the so-called "best interest of creditors" test in a traditional chapter 11 case, applies in a subchapter V case. 11 U.S.C. § 1191(a), (b).

21 11 U.S.C. § 1112.

22 11 U.S.C. § 1183(a).

23 11 U.S.C. § 1183(a)(2).

24 11 U.S.C. § 1185(a).

25 *See* "Chapter 11 Subchapter V Statistical Summary Through May 31, 2024," U.S. Trustee Program, *available at* justice.gov/ust/page/file/1499276/download; Final Report of the ABI Subchapter V Task Force, Appendix B at 91-92 (2024), *available at* subvtaskforce.abi.org; Hon. Michelle M. Harner, Emily Lamasa & Kimberly Goodwin-Maigetter, "Subchapter V Cases by the Numbers," XL *ABI Journal* 10, 12, 59-60, October 2021, *available at* abi.org/abi-journal.

26 11 U.S.C. § 1188.

27 11 U.S.C. § 1189.

28 11 U.S.C. § 1190(1).

29 11 U.S.C. § 1187(a), (b).

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Subchapter V thus provides useful protections for creditor interests that usually do not exist in the traditional chapter 11 case of a smaller business. In many (or most) smaller cases, unsecured creditors do not participate at all, and no one is interested in serving on a committee. Monitoring and supervision of a traditional case is left to the U.S. Trustee or a secured creditor. The involvement of the trustee in a subchapter V case increases the likelihood that administration of the case and operation of the debtor's business will occur properly and in accordance with the Bankruptcy Code and Federal Rules of Bankruptcy Procedure, or that the case will be promptly dismissed or converted (or that the debtor will be removed from possession[30]) if the debtor cannot reorganize or problems exist.

Subchapter V Reduces Case Costs

These provisions that protect creditor interests have the additional important consequence of reducing the costs and expenses of the case. Streamlined procedures and the requirement for prompt filing of a plan shorten the case and therefore reduce the fees of the debtor's professionals. Subchapter V trustees ordinarily do not employ professionals. The usual absence of a committee of unsecured creditors removes the expense of paying their professionals and reduces the fees of professionals employed by the debtor and creditors, because they do not have to spend time dealing with a committee's professionals. Although the debtor is responsible for paying the fees of its professionals and those that a committee employs, professional fees that the debtor must pay is money that is unavailable for creditors.

The creditor protections follow the case and the debtor through to the confirmation process. Subchapter V modifies confirmation requirements in order to enhance the prospects of reorganization and to preserve the value of the debtor's business for the benefit of all stakeholders.

For almost all small businesses, the managers are its owners, and the business's profitable operation requires their active involvement. The debtor's going-concern value depends on the "sweat equity" of the entrepreneurs who own and manage it. This value is "portable" because if the business liquidates, the entrepreneurs have the business connections and expertise to transfer the debtor's going-concern value to a new business.[31]

Preservation of the value of a smaller business through its reorganization usually requires that its owners continue to own and manage it. Confirmation requirements in a traditional chapter 11 case make this complicated, expensive, difficult and often impossible. Several features of subchapter V address this problem by changing the plan process and confirmation requirements to permit owners to retain their equity in the reorganized debtor.

One change is that only the debtor may file a plan. Another alters the absolute-priority rule for cramdown confirmation to permit owners to retain their equity interests. A third permits cramdown confirmation even if no creditor accepts the plan. These provisions do not reduce what a plan must pay creditors to meet the confirmation requirements in a traditional case.

The inability of a creditor to file a reorganization plan for a smaller business in a subchapter V case is not much different as a practical matter from a traditional case. The debtor has the exclusive right to file a plan in a traditional case for 120 days, subject to reduction or extension for cause;[32] subchapter V requires the filing of a plan within 90 days.[33]

In any event, creditors rarely want to file a plan. Reorganization of a debtor under management imposed by creditors is not likely to be feasible.[34] Creditors obtain little or no value through ownership of a smaller business and typically are not interested in doing so.

In a traditional chapter 11 case, the absolute-priority rule provides that owners of equity interests in an entity (or an individual) may not retain their equity interests (or property) if an unsecured class does not accept the plan unless it provides for payment in full. The rationale is that in the absence of acceptance, creditors are entitled to the equity interests in the debtor (or the debtor's property). The so-called "new value" corollary permits an exception to the rule if the plan meets its requirements.

The Absolute-Priority Rule

The absolute-priority rule makes it difficult for a smaller business to confirm a plan. The debtor is in bankruptcy because it cannot pay its debts in full. General unsecured creditors often do not participate in the case at all beyond filing a proof of claim, so a common result is that the unsecured class has no votes at all.

Even if all unsecured creditors accept the plan, an undersecured creditor can control the vote of the unsecured class and invoke the absolute-priority rule if its unsecured deficiency claim is large enough. For example, assume that 20 general unsecured creditors have debts totaling $100,000 and the undersecured creditor holds a debt of $300,000 secured by assets worth $200,000. If all general unsecured creditors accept the plan but the undersecured lender votes its $100,000 unsecured deficiency claim to reject the plan, the unsecured class has not accepted it because creditors holding two-thirds of the amount of the unsecured claims have not accepted it.

The new-value exception permits a debtor to avoid the application of the absolute-priority rule, but its application poses substantial problems, uncertainties and potential litigation expenses. A primary obstacle is the owners' ability to

30 11 U.S.C. § 1185(a).

31 *See* Douglas G. Baird & Edward R. Morrison, "Serial Entrepreneurs and Small Business Bankruptcies," 105 *Colum. L. Rev.* 2310, 2311-12 (2005) (recognizing portability of value by entrepreneur principals in small businesses).

32 11 U.S.C. § 1121(b), (d).

33 11 U.S.C. § 1189(b).

34 *See In re Cleary Packaging LLC*, 2023 WL 8703920 (Bankr. D. Md. 2023) (creditor's plan for its ownership of business was not feasible in view of testimony of key employees that they would not work for company under creditor's management).

produce enough cash to meet the requirement that the new value be "substantial."[35]

In the case of a smaller business, the fact that the traditional absolute-priority rule can permit creditors to acquire the equity of the business is not useful to creditors. Creditors do not want to own equity interests in a smaller business with no liquidity and usually no enterprise value without the principal who built it. The profitability of a smaller business is largely dependent on the management and services of the owners, who are likely to disappear with their equity interests. Thus, successful invocation of the absolute-priority rule prevents confirmation and results in liquidation (which might be a secured creditor's desired result), but it otherwise has no economic value for creditors and other stakeholders. Rather, the advantage of the absolute-priority rule for creditors is its value as a strategic tool to negotiate for larger payments to obtain their acceptance of the plan or to prevent confirmation so that liquidation results.

All Stakeholders Share in the Opportunity for Reorganizational Success

The requirement in traditional chapter 11 cases for acceptance by one class of creditors is advantageous for creditors for similar reasons when the debtor either has no other classes of unsecured creditors or cannot obtain acceptance from an impaired class that it can separately classify. Subchapter V eliminates these difficulties for smaller businesses, resulting in all stakeholders having a realistic opportunity for a successful reorganization that many debtors would not even attempt in the absence of subchapter V.

Subchapter V replaces the theoretical economic value for creditors in the debtor's equity interests that the absolute-priority rule recognizes with the projected-disposable-income requirement.[36] The projected-disposable-income test requires that the debtor commit projected disposable income to make payments under the plan for a period of three to five years, as the court determines.

In addition, subchapter V protects creditors with a heightened feasibility requirement for cramdown confirmation.[37] The court must determine that either the debtor will be able to make all payments under the plan[38] or that a reasonable likelihood exists that the debtor will be able to make the plan payments.[39] If the court concludes that only a reasonable likelihood exists, the plan must provide appropriate remedies to protect creditors if default occurs.[40] Moreover, the subchapter V trustee remains in place after cramdown confirmation.[41]

From the unsecured creditors' standpoint, subchapter V is likely to enhance the prospect of larger distributions. The traditional absolute-priority rule provides no effective remedy for unsecured creditors in smaller business cases, who are likely to receive nothing if it is successfully invoked, whereas the projected-disposable-income requirement provides the prospect that they will receive some return on their debts. Unsecured creditors who have continued to provide goods or services to the debtor also benefit from having a continuing customer. Subchapter V is good for unsecured creditors.

For a fully secured creditor, the changes are immaterial. It has no unsecured claim and, therefore, no ability to insist on the debtor's compliance with the absolute-priority rule. The requirements for cramdown treatment of a fully secured claim in a subchapter V case are identical to those in § 1129(b)(2)(A) that apply in a traditional case.[42]

Subchapter V's provisions likewise do not affect the rights of an undersecured creditor with regard to the secured portion of its debt. An undersecured creditor has the same rights to contest the debtor's valuation of its collateral and whether the plan's treatment of its claim complies with § 1192(b)(2)(A) that it has in a traditional case.

Depending on the size of its unsecured deficiency claim in comparison to the amount of the debtor's unsecured debt, the undersecured creditor in a subchapter V case might still control the vote of the unsecured class. Although rejection by the unsecured class does not trigger the absolute-priority rule or empower the undersecured creditor to block confirmation as it might in a traditional case, a subchapter V plan must still provide fair and equitable treatment of unsecured claims, including compliance with the projected-disposable-income test.

Conclusion

By making reorganization more likely for a smaller business, subchapter V might frustrate secured creditors who prefer to pursue their liquidation remedies without the bother of bankruptcy. Except for the loss of an undersecured creditor's blocking position, subchapter V — at a minimum — does not alter a secured creditor's rights and in no way reduces its recovery. At the same time, its emphasis on prompt, streamlined and less costly procedures, and the involvement of the subchapter V trustee and the court in the administration of the case, provide significant benefits for creditors that do not exist in a traditional case.

Subchapter V has some "debtor-friendly" features that enhance the prospects for reorganization and preservation of a debtor's going-concern value for the benefit of both the debtor and other stakeholders, including unsecured creditors, taxing authorities, employees, customers and suppliers. However, it likes secured creditors, too. Many of its provisions favor secured creditors, but at a minimum, it does no harm to their economic interests.

Subchapter V is a rare example of legislation that is good for everybody. abi

35 For a discussion of these issues in the context of exceptions to a corporate discharge after cramdown confirmation in a subchapter V case, *see* Paul W. Bonapfel & Robert Schaaf, "Do § 523(a) Exceptions to Discharge Apply to the Discharge of a Corporation in a Subchapter V Case After 'Cramdown' Confirmation Under § 1191(b)?," 32 *Norton J. of Bankr. Law and Practice* §§ II(C)(2), V(B)(7)(A), (B) (No. 4 Art. 1, December 2023).
36 11 U.S.C. § 1191(c)(2).
37 *Id.*
38 11 U.S.C. § 1191(c)(3)(A).
39 11 U.S.C. § 1191(c)(3)(B)(i).
40 11 U.S.C. § 1191(c)(3)(B)(ii).
41 11 U.S.C. § 1191(c)(3).
42 11 U.S.C. § 1191(c)(1).

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