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Benefits of Subchapter V Under the Bankruptcy Code to Private Equity Funds in Managing Distressed Assets (Update)

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Following EisnerAmper's 2022 article on the "Benefits of Subchapter V Under the Bankruptcy Code to Private Equity Funds in Managing Distressed Assets," which detailed how the provisions of Subchapter V of the Bankruptcy Code provide for an efficient and relatively inexpensive method by which a company can reorganize its debts and liabilities, there have been several developments.

Subchapter V is a subset of the larger Chapter 11 reorganization scheme found in the Bankruptcy Code. Though Subchapter V utilizes many of the provisions found in traditional Chapter 11, many of the latter's requirements are lessened for a "small business debtor," which is, with some limitation, (i) a person; (ii) engaged in commercial or business activities; (iii) having aggregate noncontingent liquidated secured and unsecured debts of not more than $7,500,000, excluding debts owed to affiliates or insiders; and (iv) having at least 50% of the debt arise from commercial or business activities.

Debt Threshold Sunset

As noted above, to be a small business debtor and qualify for Subchapter V relief, a putative debtor must have aggregate, noncontingent, liquidated secured and unsecured debts of not more than $7,500,000. Subchapter V was introduced pursuant to the August 2019 Small Business Reorganization Act ("SBRA"), which originally established a debt ceiling of $2,725,625 for Subchapter V eligibility. However, several factors, most notably the COVID-19 pandemic, caused Congress to temporarily raise that threshold to its current level of $7,500,000 pursuant to the 2020 Coronavirus Aid, Relief, and Economic Security Act. Though the expanded debt ceiling was legislatively extended on several occasions, the Subchapter V debt limit is set to decrease on June 21, 2024, to $3,024,725.

In December 2023, the American Bankruptcy Institute ("ABI") Subchapter V Task Force released its Preliminary Report of ABI's Subchapter V Task Force on Maintaining the $7,500,000 Debt Cap for Subchapter V Eligibility (the "Sub V Report"), which argued that the current debt threshold should be permanently extended because (i) the current debt cap provides consistency as well as access to debt restructuring that many small businesses would be unable to obtain under traditional Chapter 11; (ii) most Subchapter V debtors have filed bankruptcy under the current threshold, as it was established soon after Subchapter V went into effect; (iii) lowering the threshold would make Subchapter V inaccessible to many small businesses, because more than 25% of current Subchapter V debtors would be ineligible under the lower threshold; (iv) no clear rationale exists for lowering the debt threshold; and (v) an overwhelming majority of bankruptcy professionals, judges, and academics support making the current $7,500,000 threshold permanent.

Though Congress has yet to act regarding permanently extending the current debt threshold, unless it takes the recommendations set forth in the Sub V Report, a lower debt limit would result in a significant change in the landscape of small business bankruptcy under Subchapter V and would likely also result in an ineffective method of reorganization under the Bankruptcy Code.

Non-Dischargeability of Certain Debts

The goal of a Subchapter V debtor is to file and have confirmed a plan of reorganization. Such a plan details, among other things, the treatment of the debtor's creditors, including the disposition of assets and payments of amounts owed to such creditors. Generally, under Subchapter V, a debtor proposes to make payments to its creditors over a period of three to five years. Upon completion of the payments detailed in a plan of reorganization the debtor, with some exception, is granted a discharge of all debts that arose prior to confirmation of the plan and certain debts arising post-confirmation.

While Subchapter V is "small business" bankruptcy, its provisions are available to individual debtors if they meet the requirements for eligibility as set forth above. Generally, individual debtors under all chapters of the Bankruptcy Code may have their debts discharged except for certain debts set forth in Bankruptcy Code Section 523(a). Specifically, Section 523 excepts from discharge any debt that, among other things, arises from fraud, fraudulent pretenses, or false representations. Notably, Section 523(a) notes that "[a] discharge under [the Bankruptcy Code] does not discharge an individual debtor from any debt" set forth in its expansive recitation of nondischargeable debts.

The interplay between the provisions of Subchapter V governing a debtor's discharge and Section 523(a) have created differing opinions as to what debts a corporate debtor may discharge under Subchapter V. On one hand, Section 523(a) states that its exceptions to discharge apply only to individual debtors; on the other hand, Section 1192, governing discharge in Subchapter V, merely states that a debtor is granted a discharge of all debts "except any debt . . . of the kind specified in section 523(a)," without the qualifying "individual" language. This disparity in language has resulted in a split of authority between federal courts as to whether a corporate debtor may discharge debts under Subchapter V that an individual debtor generally may not discharge.

Most recently, in April 2024, the Fifth Circuit Court of Appeals, in the case of Avion Funding, L.L.C. v. GFS Indus., L.L.C. (In re GFS Indus., L.L.C.), held that "although the question is complicated by a certain textual awkwardness in the Bankruptcy Code, we . . . rule that, in Subchapter V proceedings, both corporate and individual debtors are subject to the list of § 523(a) discharge exceptions." In so holding, the Fifth Circuit applied the precise language of both Sections 523(a) and 1192(a) and found that (i) Section 1192 governs the discharge of debts of a "debtor" and does not distinguish between individual and corporate debtors and, thus, applies equally and with the same force to both; (ii) Section 1192 excepts from discharge "any debt . . . of the kind specified in section 523(a)"; and (iii) Section 523(a) lists 21 kinds of nondischargeable debts. Thus, the court reasoned, "the most natural reading of § 1192(2) is that it subjects both corporate and individual Subchapter V debtors to the categories of debt discharge exceptions listed in § 523(a)."

In finding that Section 523(a) applies to corporate debtors in Subchapter V, the Fifth Circuit joined the Fourth Circuit Court of Appeals, which, in June 2022, stated:

"While we recognize that the relationship between § 523(a) and § 1192 might be a bit discordant—or perhaps more accurately, clumsy—we find more harmony from following a close textual analysis and contextual review of § 1192(2) and thus conclude that it provides discharges to small business debtors, whether they are individuals or corporations, except with respect to the 21 kinds of debts listed in § 523(a)."

The decisions of the Fourth and Fifth Circuits contrast with several courts that have found that, despite the "clumsy" relationship between Sections 523(a) and 1192, corporate debtors under Subchapter V are not subject to the former's non-dischargeability provisions. Specifically, the Fourth and Fifth Circuits disagreed with (i) the United States Bankruptcy Court for the Eastern District of Michigan; (ii) the United States Bankruptcy Court for the District of Idaho; (iii) the United States Bankruptcy Court for the District of Maryland; and (iv) the Bankruptcy Appellate Panel for the Ninth Circuit Court of Appeals.

Unmatured Leases as Non-Contingent Debt

As noted above, a requirement for eligibility under Subchapter V is that the putative debtor must have aggregate, noncontingent, liquidated secured and unsecured debts of not more than $7,500,000. Questions have recently arisen as to whether a bankruptcy court should include a debtor's lease obligations in determining if a debtor meets the Subchapter V eligibility requirements, which questions have resulted in disparate legal authority.

In June 2023, the United States Bankruptcy Court for the Eastern District of Virginia found that a debtor's lease obligations should be taken into account when calculating the amount of the debtor's noncontingent liquidated debt liability. With the commencement of its Subchapter V case, the debtor in Macedon filed a motion to reject two unexpired leases of real property. Combined, the "uncapped" lease obligations owing under the leases proposed to be rejected totaled $14,390,820, well above the Subchapter V debt threshold. The respective landlords moved the court for an order dismissing the debtor's case, arguing that, among other things, it was not eligible to be a Subchapter V debtor based on the remaining obligations owing under the leases.

In its ruling, the court relied on a previous decision of the United States Bankruptcy Court for the District of Maryland to note that a debt is contingent where it depend[s] on a future event that may or may not occur. In finding that the debtor's full lease obligation should be included in the determination of whether the debtor was eligible for Subchapter V, the court stated:

"The debt at issue is liability under the leases, and that liability arose pre-petition, on the dates the leases were fully executed. For example, it could not be said that if the debtor vacated the premises on the 31st of one month during the lease term, that it would not still owe the landlord for the next month and the remainder of the lease term. While it may be argued that the timing of payments is the future extrinsic event that may never occur, the court disagrees. The timing of lease payments is simply that: timing. Absent the end of the world, we know the future date will occur."

As such, the court held that the debtor's full lease obligations were noncontingent and rendered the debtor ineligible for Subchapter V. However, rather than dismiss the case outright, the court chose to revoke the debtor's Subchapter V designation.

In contrast, the United States Bankruptcy Court for the Southern District of New York, in dicta, stated that a debtor's future payment obligations under an unexpired lease should rarely, if ever, be included in the Subchapter V debt limit obligations. Primarily, the court noted that an opposite holding would severely restrict Subchapter V eligibility, as many debtors are parties to long-term leases with future obligations well above the debt limit. Furthermore, the court reasoned the benefits of an unexpired lease many times exceed the burdens thereunder, thus making the lease a net asset rather than a liability. Finally, until a debtor decides to either assume or reject an unexpired lease, the amount and nature of its obligations under the lease remain contingent and unliquidated. If the debtor assumes the lease, it will be required to pay the full contractual amount but, alternatively, if the debtor rejects the lease then the damages owed to the landlord will be capped at an amount that may be well below the Subchapter V debt threshold. As such, until the debtor elects to either assume or reject, "any eventual debt is both contingent and unliquidated prior to that election."

Conclusion

Subchapter V remains an efficient and cost-effective method by which small business may reorganize under the Bankruptcy Code. However, if Congress declines to permanently extend the $7,500,000 debt threshold, this method will be severely restricted, requiring small businesses to seek reorganization through the more costly and time-consuming scheme under traditional Chapter 11. Furthermore, before deciding to proceed under Subchapter V, restructuring professionals are advised to have a thorough understanding of the nature of the debtor's liabilities as well as familiarity with the precedent set forth in the jurisdiction in which the debtor will commence its Subchapter V case. Absent such familiarity and understanding, debtors run the risk of having their Subchapter V election revoked or, worse, having their case dismissed outright.

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