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

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Originally drafted for EisnerAmper
12.3.22

On August 23, 2019, the Small Business Reorganization Act (the "SBRA") was signed into law and created a streamlined and more efficient and cost-effective method by which small businesses in the United States can take advantage of the corporate reorganization provisions of the United States Bankruptcy Code (the "Bankruptcy Code").[1] As noted below, private equity funds may find the new provisions added to the Bankruptcy Code as a result of the SBRA to be attractive options in managing distressed portfolio companies, either through reorganization or court-supervised sale. Specifically, the SBRA allows small businesses to utilize the bankruptcy process without expending the substantial financial resources and time typically associated with "traditional" Chapter 11. Put simply, "Chapter 11 is expensive and complex business…."[2] The SBRA provides small businesses the opportunity to avoid unnecessary expenses associated with traditional Chapter 11, while allowing for a quicker path to reorganization.

Under Chapter 11 of the Bankruptcy Code, certain corporate debtors may reorganize their assets, liabilities, and, at times, their entire business structure, by entering into a contract, called a Chapter 11 Plan of Reorganization (a "Plan"), with their creditors. Under a Plan, a debtor may modify the rights of its creditors, including, but not limited to, adjusting amounts due, maturity dates, interest rates, and even relieving the debtor of its nonmonetary obligations under certain contracts, with the counterparty being granted an unsecured claim in the debtor's bankruptcy case.[3] Additionally, in a Plan the debtor places all of its creditors into separate "classes" based on the type and priority of claim the creditor asserts against the debtor (i.e., secured class, priority unsecured class, general unsecured class, equity holder class, etc.).[4]

Once the debtor proposes a Plan that meets the requirements of the Bankruptcy Code, each class of creditors votes on whether to accept or reject the Plan. Generally, if at least 1/2 of creditors in each class vote to accept the Plan (provided those creditors represent at least 2/3 of the amount of total claims against the debtor in that class), then the Plan will be "confirmed" and becomes a binding contract between the debtor and all creditors that received proper notice of the bankruptcy case.[5] Put another way, if a debtor meets the strict requirements for Plan confirmation set forth in Chapter 11 of the Bankruptcy Code, the Plan is a binding contract even against creditors that did not vote to accept the Plan.[6]

The SBRA created a new subchapter of Chapter 11 ("Subchapter V") specifically for the reorganization of "small businesses" as that term is defined in the Bankruptcy Code.[7] Subchapter V, entitled "Small Business Debtor Reorganization," eliminates several of the substantial hurdles a Chapter 11 debtor faces in the Plan confirmation process. In order to qualify for Subchapter V, a putative debtor must: (i) be a person; (ii) be engaged in commercial or business activities; and (iii) have aggregate noncontingent liquidated secured and unsecured debts of not more than $7,500,000,[8] excluding debts owed to affiliates or insiders. Additionally, at least 50% of the debtor's aggregate noncontingent liquidated debt must arise from commercial or business activities.[9]

Some (but not all) of the specific significant advantages of Subchapter V over traditional Chapter 11 are as follows:

- No Appointment of Unsecured Creditors' Committee: Traditional Chapter 11 allows for the appointment of an official committee of unsecured creditors, which generally consists of up to seven of the debtor's top unsecured creditors that serve the interests of the entire body of unsecured creditors as a whole.[10] An unsecured creditors' committee wields a great deal of power and may be able to delay or even prevent Plan confirmation. Additionally, such a committee may hire professionals whose fees are paid by the debtor's estate, which reduces funds available for distribution to creditors and equity holders.[11] However, in Subchapter V, unless a court orders otherwise, no committee is appointed, which eliminates substantial costs to the estate and provides for a more unobstructed path to Plan confirmation.[12]

- No Absolute Priority Rule: In its simplest terms, the Absolute Priority Rule of traditional Chapter 11 requires that until all unsecured creditors in one class of claims be paid in full under a Plan, creditors in a lower priority class may not be paid at all (i.e., if general unsecured creditors aren't paid in full under a Plan, equity security holders can't receive any distribution under the Plan).[13] Subchapter V departs from the Absolute Priority Rule and allows a court to confirm a Plan even if a lower priority class of creditors receives a distribution despite a higher priority class not being paid in full.[14] This is a significant departure from traditional Chapter 11 and allows equity holders to retain their interests in a debtor over the objection of nonconsenting creditors without having to pay all higher priority claims in full.
- No Competing Plans: In traditional Chapter 11, if a debtor does not propose a Plan within 120 days of its bankruptcy filing (subject to extension by the court), any of its creditors may propose a competing Plan.[15] Such a competing Plan will naturally be adverse to the debtor's interests, as the debtor effectively loses control of the Chapter 11 process. In Subchapter V only the debtor may file a Plan.[16] This is a substantial advantage over traditional Chapter 11 in that it ensures that the debtor remains in control of Plan proposal and confirmation.
- No Disclosure Statement: In addition to a Plan, a debtor in traditional Chapter 11 is required to draft and file a disclosure statement that provides adequate information upon which a creditor can rely in making an informed judgment on whether to vote to accept or reject a Plan.[17] This additional requirement adds substantial expense to the confirmation process. However, in Subchapter V a debtor is not required to draft and file a disclosure statement, with only a Plan being sufficient.[18]
- Creditor Consent Not Required: A debtor may confirm a Plan in Chapter 11 even if one or more classes of creditors vote to reject the Plan as long as, among other things, at least one impaired class of creditors accepts the Plan.[19] Subchapter V eliminates the requirement that the debtor gain acceptance from an impaired class. Rather, a Subchapter V debtor may confirm a Plan without the consent of any creditors provided the Plan does not unfairly discriminate and is "fair and equitable" as that term is defined in the Bankruptcy Code.[20] Eliminating the necessity of an accepting impaired class eliminates substantial expense and time associated with negotiating with creditors and drafting multiple amendments to a Plan to gain acceptance.

As set forth above, Subchapter V is an efficient and relatively inexpensive method by which a company can reorganize its debts and liabilities when compared to traditional Chapter 11. Private equity funds in the business of taking controlling stakes in companies, or acquiring them outright, many times find that these portfolio companies are experiencing financial distress, debt ridden, and/or poorly performing. Funds exploring options to shed the debt of their portfolio companies, or even offload the same in a judicially monitored sale, should look first to Subchapter V, provided the company meets the debt threshold set forth above. Indeed, Subchapter V eliminates significant time-consuming hurdles to Plan confirmation. Specifically, Subchapter V restricts creditor ability to derail the confirmation process, which generally leads to extensive delays in attempts to appease all parties in interest. Furthermore, many of the costly procedures of traditional Chapter 11 are eliminated, resulting in reduced fees and allowing for distribution to equity holders that may not otherwise be available. In sum, Subchapter V offers small business debtors a streamlined process and tools tailored specifically for a fast low-cost alternative to more cost-prohibitive traditional Chapter 11.