# A Look At Subchapter V As Debt Limit Expiration Looms

By **Matthew Brash and Melinda Bennett** (May 7, 2024)

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Subchapter V of Chapter 11 of the U.S. Bankruptcy Code has become a widely used strategic tool for distressed small businesses that is recognized nationally by bankruptcy judges, U.S. trustees, turnaround professionals and bankruptcy attorneys.

Yet, its future role and effectiveness is in limbo as its debt eligibility ceiling of $7,500,000 is scheduled to sunset on June 21 unless it is extended by the U.S. Congress under recently introduced legislation.

Co-sponsored by Sens. Lindsey Graham, R-S.C., Sheldon Whitehouse, D-R.I., Chuck Grassley, R-Iowa, Christopher Coons, D-Del., and John Cornyn, R-Texas, the Bankruptcy Threshold Adjustment Extension Act has been introduced to Congress to provide a two-year extension to the current debt limit under the Bankruptcy Threshold Adjustment and Technical Corrections Act.

**The History and Purpose of Subchapter V Bankruptcy**

Following the effective date of the Small Business Reorganization Act of 2019 on Feb. 19, 2020, which established a new Subchapter V to Chapter 11 for small business debtors, Congress increased the debt eligibility limit from $2,725,625 to $7,500,000 under the CARES Act in March 2020.

This enabled a greater number of businesses who were affected by the economic effects of the COVID-19 pandemic to restructure and stay in business.

This higher debt ceiling was extended in June 2022 under the BTATCA.

The timing of the establishment of Subchapter V bankruptcy just before the beginning of the COVID-19 pandemic was both a blessing and curse for this new avenue for small businesses to restructure in bankruptcy. The original debt threshold was small and therefore only available to smaller companies, often mom-and-pop businesses.

While the higher debt limit put in place with the CARES Act in March 2020 enabled a larger number of small businesses with higher revenue to take advantage of it, professionals found it difficult during the pandemic to get a true sense of how Subchapter V bankruptcies would play out, particularly for businesses heavily affected by pandemic shutdowns, such as restaurants and small hotels.

The goal of Subchapter V is to create a more affordable pathway through bankruptcy for small business debtors with no unsecured creditors committee, no U.S. trustee fees and fast deadlines to keep cases moving so that small businesses can exit bankruptcy more quickly. It does have some exclusions including single asset real estate debtors.

Furthermore, at least 50% of debt must have arisen from commercial or business activities. Subchapter V involves limited creditor leverage as there is no absolute priority rule in place or impaired accepting class needed to cram down a plan, and creditors cannot file a

competing plan.

With the COVID-19 pandemic in the rearview mirror, industry professionals are now getting a more complete picture of the value and utility of Subchapter V bankruptcy for small businesses. It is being used now more than ever, with Subchapter V elections within Chapter 11 increasing by 45% to 1,939 in 2023, according to recent data published by the American Bankruptcy Institute.

Furthermore, a report issued by ABI's Subchapter V Task Force indicates that almost 30% of Chapter 11 cases filed since the SBRA's enactment were Subchapter V cases. The report also revealed that more than 25% of these debtors would not have been eligible under the original, lower debt ceiling.

And while there are some challenges within the Subchapter V process, most professionals agree that the benefits of Subchapter V under the current debt limit far outweigh any potential drawbacks.

If the debt ceiling remains the same or increases, professionals expect continued increases in 2024 Subchapter V filings based on the financial headwinds facing small businesses caused by the winding down of pandemic stimulus, increased cost of funds, higher interest rates, rising default rates and near historic levels of household debt.

**What the Future May Bring for Subchapter V**

As the expiration of the temporary higher Subchapter V debt limit approaches, the consensus among industry professionals is that the legislation proposing a two-year extension to key BTATCA provisions will be passed.

In 2022, the debt limit did expire and then took 60 days to be renewed with the passage of the BTATCA. Given that 2024 is an election year and Congress is focused on many other matters that some would argue are more pressing, we may or may not see the passage of legislation extending the debt limit until after it sunsets.

If the proposed legislation does not pass, the debt limit will revert to a lower debt ceiling, although in that case it would still be higher than the original $2,725,625 threshold due to adjustments for inflation over the past four years since the SBRA was first enacted.

If that happens, most expect that Subchapter V bankruptcy would no longer be widely used and filings would drop dramatically.

There is a group of professionals who would like to see an extension to the BTATCA, but with a debt ceiling of $10 million to $15 million.

**Opportunities to Enhance Subchapter V Bankruptcy**

Subchapter V bankruptcy has shown its value and utility in many ways since its inception and will continue to be a useful and important tool for distressed small businesses and their professionals should the current debt limit be maintained or increased.

As the bankruptcy community has learned more about Subchapter V bankruptcy, we can examine ways that the process could be further enhanced to not only address the needs of small businesses but also of Subchapter V trustees and other professionals engaged in the process.

While solutions for some of these challenges would likely fall outside of legislative action to extend or increase the debt limit, they could be addressed by local jurisdictional rules or future amendments to the Federal Rules of Bankruptcy Procedure.

**Ensuring Subchapter V Trustees Are Paid**

One pressing issue facing Subchapter V trustees is the fees — or lack thereof — that are paid for their services in the case.

Subchapter V provides that the trustee's fee can be paid through the debtor's Subchapter V plan, or in many filed plans, on or around the effective date or as soon as reasonably possible.

There are often situations in many, if not all, jurisdictions in which the Subchapter V trustee is not being paid — either due to a case being dismissed or converted, a plan being rejected, a debtor unable to make plan payments, or other factors.

Nonetheless, Subchapter V trustees are being asked to attend status hearings, trials and evidentiary hearings as well as testify to the viability of a filed plan of reorganization. Some Subchapter V trustees have been carrying outstanding, unpaid balances of up to six figures.

There have been some efforts to ensure the Subchapter V trustee is being fairly compensated.

Some Subchapter V trustees are filing a motion for a retainer at the onset of the case, as seen in In re: Roe in the U.S. Bankruptcy Court for the District of Oregon in January. Certain jurisdictions are encouraging debtors to carve out a monthly payment for the trustee in their cash collateral budgets.

In other cases, debtors counsel can set aside, as part of their retainer, fees and expenses to cover the Subchapter V trustee. In addition, Subchapter V trustees are looking to their respective U.S. trustee to advocate for rule changes, as judges are not tolerant of them not getting paid.

**Addressing Plan Confirmation When Creditors Don't Vote**

The bankruptcy court shall confirm a consensual Subchapter V plan under Section 1129(a) if all requirements of Section 1129(a) except (a)(15) are met and all impaired classes must accept the plan.

However, when there are no votes in an impaired class — as often occurs with the IRS, state taxing agencies and other federal government agencies as creditors — can a plan still be confirmed a consensual plan, or must it be confirmed as a nonconsensual plan under Section 1129(b)?

In recent cases, we have seen alternatives that may provide answers, but further direction is needed on how best to approach this situation. In the event a nonconsensual plan is confirmed, the Subchapter V trustee acts as the plan administrator or disbursing agent.

Although the intentions are good and some debtors need adult supervision, in the event a plan is not objected to, but confirmed as nonconsensual — because a class of creditors didn't vote — the debtor or a designee, other than the Subchapter V trustee, can administer

the plan or act as a disbursing agent.

**Managing Debtor Defaults on Subchapter V Plan Payments**

At times, debtors in Subchapter V cases are unable to fulfill the obligations of a confirmed plan due to external or internal causes.

Some Subchapter V plans are approved knowing there is a risk that the debtor will default on payment, however, the alternative of a liquidation yields almost no recovery.

The Subchapter V trustee role is to monitor and follow up with the debtor, debtor's counsel and creditors as it relates to plan payments, and in the event of default or lateness of payment, understand and confirm timing for payments to be made and if no payment is made, take appropriate next steps.

These steps might involve a cure period within which the debtor has the ability to cure any late payments. The Subchapter V trustee can also contact the U.S. Trustee's Office and inform the trial attorney for the case.

They can also consider other strategies such as including default provisions in the plan, modifying the plan, seeking a relief from stay or the dismissal or conversion of the plan.

While these measures provide alternatives for the Subchapter V trustee, they also look to their local U.S. trustee and policymakers for guidance, and determine best practices as it relates to jurisdictional rules and procedures.

While the Subchapter V process is not perfect, it has proven itself to be by and large an impactful and valuable addition to the Bankruptcy Code for small businesses and their professionals.

If proposed legislation to extend the current debt ceiling is passed, bankruptcy professionals can also seek new ways to work with their local jurisdictions to advocate for rule or code changes and guidance that bring even more efficiencies and clarity to the process, maximizing the value that Subchapter V brings to distressed small businesses.

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