NACM'S 129TH CREDIT CONGRESS & EXPO Cleveland MAY 18-21, 2025

Insights From Experience: *A Practical Guide to and Strategies for Protecting Trade Creditors in Subchapter V Cases*

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Date: May 20, 2025

Session: # 37034

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SUBCHAPTER V: AN INTRODUCTION

SUBCHAPTER V: A "SMALL" CHANGE TO THE CODE

- A (relatively) new subchapter of Chapter 11 intended to make the Chapter 11 process more accessible to "small business" debtors
  - Largely streamlines the traditional Chapter 11 process to reduce costs and increase the pace of the process
- Enacted as part of Small Business Reorganization Act of 2019 (SBRA), and went into effect in February 2020
  - Initially debtor-eligibility threshold of approximately $2.7 million in liquidated, non-contingent, secured and unsecured debt as of bankruptcy petition date (excluding debt to insiders/affiliates)
    - Subject to cost of living increases every 3 years
    - Current limit is $3,424,000 for cases filed on or after April 1, 2025 (previously $3,024,000)
  - At least 50% from commercial or business activities of the debtor
- CARES Act increased Sub V debt limit to $7,500,000 (Effective 3/27/2020)
  - Increased debt limit sunset on June 21, 2024
  - Will it be increased again?
    - Possibility of further extending $7.5 million debt limit

BIG THINGS COME IN "SMALL" PACKAGES: THE SUBCHAPTER V BOOM

- Subchapter V has been *incredibly* popular among eligible debtors
- Filings significantly increased each year since enactment of SBRA
- 2,381 Subchapter V filings in 2024; a 32% increase over the 1,808 filings in 2023
  - Large portion of the increase occurred before the reset of the debt eligibility limit on June 21, 2024. E.g.:
    - Filings increased 41% for the first 9 months of 2024 compared to the same period in 2023
    - While the increased limit was in effect, only approximately 26.2% of Subchapter V debtors would have been eligible for Subchapter V under the lower limit that would have otherwise been effect
- 2025 trends:
  - 7% increase in Subchapter V elections in January 2025 vs January 2024
  - 12% decline in Subchapter V elections in February 2025 vs February 2024
- So, why so popular? And what does it mean for creditors?

Source: Epiq

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BUT FIRST, WHY?
THE REASON SUBCHAPTER V WAS ENACTED

TRADITIONAL CHAPTER 11: BIG PROBLEMS FOR SMALL BUSINESS DEBTORS

- Traditional Chapter 11 is often impractical for small and middle market companies
  - Too time-consuming and expensive
  - Process needed drastic streamlining
  - Absolute priority rule puts owner at substantial risk of losing business
- Distressed small businesses forced to rely on non-bankruptcy alternatives
  - Assignment for the benefit of creditors
  - Receiverships
  - UCC Article 9 secured party sale
  - Closing the doors and walking away

TRADITIONAL CHAPTER 11: BIG PROBLEMS FOR SMALL BUSINESS DEBTORS (CONT'D.)

- US trustee fees
- Creditors' committees (stay tuned for next slide . . .)
- Possibility of competing chapter 11 plans
- Onerous confirmation requirements:
  - Potentially time-consuming process
    - E.g., separate disclosure statement requirement
  - Need for an impaired consenting class
  - Administrative claims must be paid on plan effective date
    - e.g., professional fees, post-petition trade claims, and § 503(b)(9) claims
  - Absolute priority rule
    - Equityholders cannot retain interests if creditors are not paid in full (unless certain exceptions are met)

CHAPTER 11: IMPORTANCE OF CREDITORS' COMMITTEES

- Bankruptcy Code provides for appointment of an Official Committee of Unsecured Creditors in Chapter 11 cases
  - Appointed by the US Trustee
  - Typically comprised of about 5-7 of the Debtor's largest unsecured creditors by claim amount

- The Committee (and each of its members) is given a seat at the table to help determine the trajectory of the Chapter 11 case
- The Committee acts as a fiduciary for all unsecured creditors – and as a watchdog, consultant, and negotiator with respect to key issues in the case
  - Committee has standing to be heard on nearly all issues
- Goals
  - Restructure business
  - Preserve a (healthier) customer
  - Maximize distributions to unsecured creditors
  - Minimize or eliminate preference risk
- Committee retains professionals – with its fees and expenses paid by the debtor!

CHAPTER 11: IMPORTANCE OF CREDITORS' COMMITTEES (CONT'D.)

- Negotiate/Litigate Issues Regarding Chapter 11 Financing and Use of Cash Collateral
- Investigate Debtor's Acts and Financial Affairs
- Monitor and Evaluate Viability of Debtor's Business
- Request Appointment of a Chapter 11 Trustee or Examiner if There is Debtor Misconduct
- Active Involvement in 363 Sale of Business/Assets
  - Seeks to encourage competitive bidding
- Formulate/Negotiate Chapter 11 Plan
- Waive or Bury Preference Claims Against the Trade
- Investigate and Pursue causes of action that provide recovery to GUCs
  - Lien challenge and other claims vs. lender
  - Preference and other avoidance claims against insiders
  - Claims against directors and officer
- Post-Confirmation Trust

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SUBCHAPTER V: *PROBLEM SOLVED?*

SUBCHAPTER V: CONGRESS ADDRESSED THE "BIG" PROBLEMS FOR SMALL BUSINESS DEBTORS

- No US Trustee fees
- Debtor has sole right to file a plan (but generally must do so within 90 days)
- **No Creditors' Committee appointed (unless Court orders otherwise for cause)**
  - **Appointment of Subchapter V trustee**
    - Does Subchapter V Trustee fill the shoes of the Creditors' Committee? (stay turned for next slide . . .)
- Significantly relaxed confirmation requirements:
  - Expedited process
    - Plan must be filed within 90 days
    - No separate disclosure statement requirement
  - No need for an impaired consenting class (i.e., plan may be confirmed via "cramdown" even if rejected by all impaired classes of creditors)
  - **Administrative claims may be deferred and paid over the term of the Plan (i.e., 3-5 years)**
  - **Abrogation of the Absolute Priority Rule!**
    - Equity holders can retain their interests even if unsecured creditors are not paid in full so long as debtor contributes all of its ***projected disposable income*** over 3-5 year period post-confirmation

SUBCHAPTER V TRUSTEE

- Limited Power – More of an oversight role than a true trustee. Subchapter V trustee does not take possession of debtor's assets or take control of the business
- Appears and may be heard at hearings/status conferences, and "shall appear" at any hearing that concerns:
  - The value of property subject to a lien
  - Sale of property of the estate
  - Confirmation of a plan under Subchapter V
  - Modification of the plan after confirmation
- Facilitates the development of a consensual plan of reorganization
- Ensures debtor complies with plan/payment requirements for non-consensual plan
- **May be granted investigative duties for cause**
  - **Requires court approval**
  - **Cannot commence litigation**
- Takes over duties of chapter 7 or 11 trustee if debtor ceases to be a debtor in possession
- In general, no trustee appointment in traditional chapter 11 cases unless extreme circumstances

SUBCHAPTER V: A "BIG" SUCCESS

- A plan is confirmed in 50% of all Subchapter V cases
  - Pre-SBRA, only about 25% of debtors with less than $10 million in liabilities were able to confirm a plan in traditional chapter 11
- 69% of confirmed Subchapter V plans were accepted by all creditor classes
- Most Subchapter V plans are confirmed within 6.4 months of the petition date

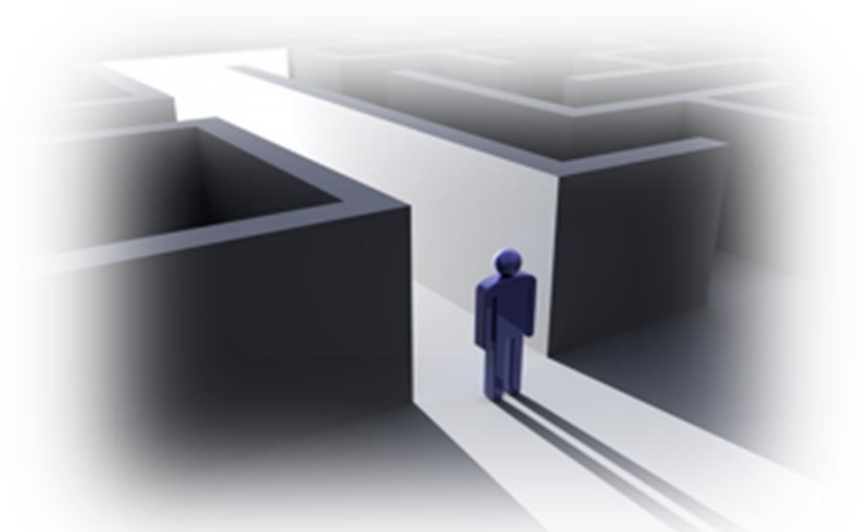
Source: ABI Subchapter V Task Force Final Report

WHO'S GOT YOUR BACK, TRADE?

- In the absence of a creditors' committee, the Subchapter V trustee has not filled the void to protect unsecured creditors' interests in Subchapter V cases:
  - Limited funding
  - Limited powers:
    - Not automatically bestowed with investigative powers (e.g., lien review, D&O actions, etc.)
      - Only granted "for cause"
    - *In re Ghatanfard* (S.D.N.Y. 2024) – held the bankruptcy court cannot grant a Subchapter V trustee the power to prosecute estate causes of action.
  - Largely lacks any stake in the case (i.e., has no claim against, or ordinary course business with, debtor)

WHO'S GOT YOUR BACK, TRADE?

- **<u>Bottom line</u>** – unsecured creditors must have their own back in Subchapter V; so be assertive!
  - Individual steps unsecured creditors can take to protect their interests in Subchapter V
  - Potential to form ad hoc creditor groups (more on that later . . .)
  - Nothing stops trade creditors from moving for the appointment of a creditors' committee (which would then take the case out of Subchapter V)



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PRACTICAL TIPS TO PROTECT TRADE CREDITORS' RIGHTS IN SUBCHAPTER V

CREDITOR STRATEGIES

- <u>First things first</u> – consider whether eligibility may be contested.
  - Has the debtor been engaged in the requisite commercial or business activities sufficient to qualify as a “small business debtor”?
  - Is the debtor liquidating (are liquidating debtors eligible?)
  - Are landlords’ and other creditors’ rejection damage claims included in eligibility calculation?
    - Courts are split

CREDITOR STRATEGIES

- Traditional Chapter 11 tools and remedies available to trade creditors:
  - Critical vendor treatment
  - 503(b)(9) priority
  - Recoupment, setoff, etc.

CREDITOR STRATEGIES

- Consider soliciting creditor votes against plan to create non-consensual plan
  - Problem with a silent, non-voting class – are they deemed to accept?
- Challenge plan payments
  - Debtor must contribute all projected disposable income to the plan
  - Creditors should be prepared to examine the Debtor’s projections, which can be manipulated
    - Consult with Subchapter V trustee in vetting projections
  - Creditors should consider working with Subchapter V Trustee on plan issues
  - Creditors could seek to expand plan period to 5 years

CREDITOR STRATEGIES

- Object to any extended payment of administrative claims under the plan
  - Carefully considered further extensions of credit
- Confirmation:
  - Scrutinize assets available for distribution and means for implementing the plan
  - Court split as to whether debtor may be compelled to include a “true up” to recover on upside if the debtor exceeds projections:
    - YES – *In re Staples* (Bankr. M.D. Fla., January 2023)
    - NO – *In re Packet Construction, LLC* (Bankr. W.D. Texas, April 2024)

CREDITOR ABILITY TO CHALLENGE DISCHARGEABILITY OF CLAIMS

- Applicability of exceptions to discharge under consensual plan?
  - **No** – *Halo Human Resources, LLC v. American Dental of LaGrange, LLC* (Bankr. M.D. Ga. Jan. 31, 2025)
    - Only applies to non-consensual plans
- Creditors may argue that the individual exceptions to discharge under section 523(a) apply to corporate Subchapter V debtors
  - Section 523(a) provides for non-dischargeability of claim owing by individual debtor arising from, *inter alia*:
    - Fraud
    - Willful and malicious injury other section 523(a) grounds
    - Other grounds listed in section 523(a)

CREDITOR ABILITY TO CHALLENGE DISCHARGEABILITY OF CLAIMS

- Applicability of exceptions to discharge to both corporate and individual Subchapter V debtors
  - Yes
    - Circuit court holdings that that section 523(a)(2) fraud exception to discharge applies to *both* corporate and individual Subchapter V debtors that have confirmed non-consensual plans
      - Fourth Circuit decision – *In re Cleary Packaging*
      - Fifth Circuit decision – *In Matter of GFS Industry LLC*
  - No
    - Ninth Circuit Bankruptcy Appellate Panel decision – *In re Off-Spec Solutions, LLC* – exception to discharge applies only to individual Subchapter V debtors
- The split stays strong; courts remain divided!
  - In February 2025, a Florida bankruptcy court sides with Ninth Circuit – *Spring v. Davidson* (Bankr. N.D. Fla. Feb. 14, 2025)
  - In March 2025, a Colorado bankruptcy court sides with the Fourth and Fifth Circuits – *In re ETG Fire, LLC* (Bankr. D. Colo. Mar. 17, 2025)

FILLING THE COMMITTEE'S SHOES

- **The Subchapter V Trustee <u>is not</u> a fiduciary for unsecured creditors**
  – Creditors can seek to have Subchapter V trustee investigate possible claims against the Debtor and third parties, such as insiders
    - Court approval required
  – But, Subchapter V trustee cannot prosecute claims

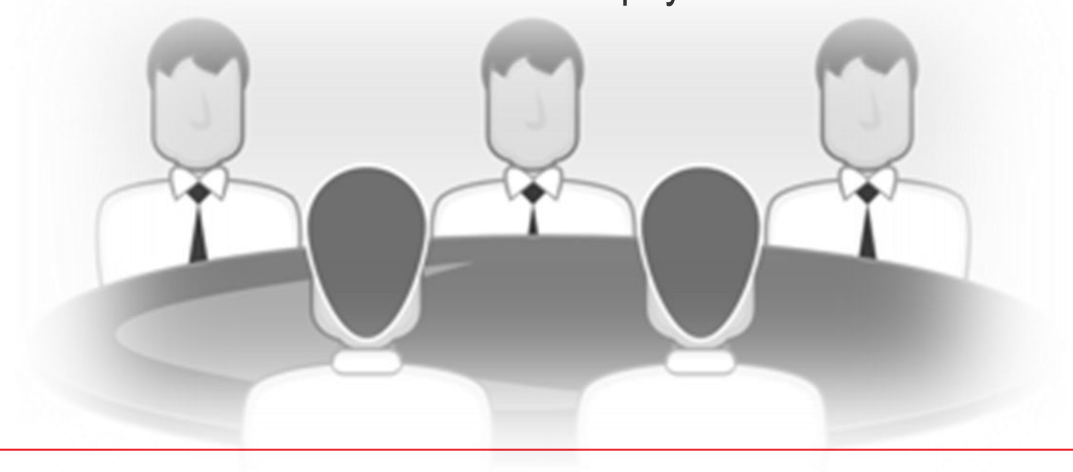
FILLING THE COMMITTEE'S SHOES

- **Consider forming ad hoc committee**
  - Share cost of fees and expenses incurred in the case
  - Strength in numbers – potentially stronger voice in the case
  - Ad hoc committee may investigate claims against secured lenders and third parties
  - Ad hoc committee may also move for appointment of a statutory creditors' committee
  - Potential for substantial contribution claim
  - Need to be cognizant of antitrust concerns

POTENTIAL LEGISLATIVE CHANGES TO SUBCHAPTER V:

AMERICAN BANKRUPTCY INSTITUTE SUBCHAPTER V TASK FORCE

- Reviewed the implementation and administration of Subchapter V
- Presented its final report and recommendations on Subchapter V
  - Debtor eligibility recommendations
    - Subchapter V debt limit should be permanently set at $7.5 million with inflation adjustment
      - While $7.5 million debt limit has been in effect through 12/31/2023
        - About 26.2% of Subchapter V debtors would have been ineligible for Sub V relief if $7.5 million debt limit was not in effect
        - Plan confirmation rate higher
    - Debt limit should not include future rent payments



AMERICAN BANKRUPTCY INSTITUTE SUBCHAPTER V TASK FORCE (CONT'D.)

- More ABI Subchapter V Task Force recommendations:
  - Role of Subchapter V trustee
  - Case administration recommendations
  - Plan and confirmation recommendation
    - Silent non-voting class deemed to accept plan
      - Reduces the likelihood of non-consensual plans
  - Debt dischargeability recommendation
    - Non-dischargeability claims only against individual debtor
  - Post confirmation administration matters

NACM GIVES CREDITORS A VOICE

- NACM has been at the forefront of promoting creditors' rights and giving a voice to the otherwise unheard in connection with Subchapter V
- NACM organized members to provide testimony to the ABI Subchapter V Task Force
- In addition, and particularly in light of the Task Force's final report, NACM published a whitepaper, *Subchapter V: Essential Insights for Credit Professionals*,* to:
  - Explore issues facing trade creditors (and debtors) in Subchapter V, and
  - Examine the practical implications of Subchapter V for B2B trade creditors
- In the whitepaper, NACM quotes certain of its members with respect to their thoughts on Subchapter V:
  - "I have only seen one customer so far successfully complete their Subchapter V plan. Few of these cases have long-term success on the reorganization side, this is largely to be expected though. If you look at the success rate of Chapter 13 cases, it is similar. They confirm a plan and are not able to perform most of the time."
  - "The lack of disclosures and the reduction of available information for creditors in this subchapter is a major pain point."
  - "[Administrative expense] claims can be made over three to five years, so it creates a burden for us to collect and ensure payments are being made."
- NACM members also testified that the $7.5 million debt ceiling expanded Subchapter V to medium-sized businesses

**The whitepaper was co-authored by NACM, Lowenstein Sandler LLP, and PACE Government Relations*

NACM GIVES CREDITORS A VOICE

- NACM's whitepaper advocates for (among other things):
  - Enhanced notice mechanisms (e.g., free access to ECF/PACER for creditors)
  - Improved disclosures
  - Increased creditor involvement (e.g., requiring impaired classes to vote in favor of plan and appointing a creditors' committee in cases involving certain minimum debt thresholds)
  - Restricting the ability to defer administrative expense claims
  - Enhancing the role and powers of the Subchapter V trustee
  - Post-confirmation enforcement mechanisms (including true-up requirements)
- **Remember**: creditor involvement is critical!

**The whitepaper was co-authored by NACM, Lowenstein Sandler LLP, and PACE Government Relations*

QUESTIONS

SUBCHAPTER V: PUBLICATIONS

- *NACM Whitepaper – Subchapter V: Essential Insights for Credit Professionals*
  NACM, Lowenstein Sandler LLP, PACE Government Relations

- July/August 2024
  A Big Win for Creditors of Small Business Debtors, *Business Credit*
  Bruce S. Nathan, Michael Papandrea

- September/October 2024
  SUBCHAPTER V CRAMDOWN PLAN PAYMENTS: True-Up to Actual Disposable Income or Stay True to Projected Disposable Income?, *Business Credit*
  Bruce S. Nathan, Michael Papandrea

- February 2025
  Subchapter V Trustee's Limited Powers: Do Not Fill Void Arising From Absence of Creditors' Committee, *Business Credit*
  Bruce S. Nathan, Michael Papandrea

- May 2025
  More Court Rulings Denying the Applicability of the Exceptions to Discharge to Corporate Subchapter V Debtors – link forthcoming (currently unpublished)

THANK YOU

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