SUBCHAPTER V: A Powerful Tool for Early-Stage, Venture Capital Backed Companies in a Crisis

Executive Summary

- Subchapter V of Chapter 11 of the Bankruptcy Code went into effect on February 1, 2020.
19, 2020, and allows companies with less than $2,725,625 in liquidated, noncontingent liabilities (not including liabilities owed to insiders) to reorganize under Chapter 11 without stripping existing equityholders, including holders of common and preferred stock, of their ownership interest.

- Subchapter V also allows for the confirmation of a nonconsensual Chapter 11 plan of reorganization (i.e., not consented to by any classes of creditors, subject to certain exceptions for secured creditors) as long as the plan is “fair and equitable,” generally meaning that the plan requires the reorganized company to apply all of its projected disposable income during a 3- to 5-year period towards payments to the company’s pre-bankruptcy creditors under the plan. In this context, disposable income generally means the income that is not reasonably necessary to continue, preserve or operate the business of the reorganized company.

- Subchapter V is not a tool that only has value in bankruptcy court. Its availability can also serve as a powerful tool in out-of-court restructuring discussions, equalizing risk across the capital structure and encouraging necessary constituencies to compromise.
- By providing a viable, in-court restructuring option and encouraging more equitable out-of-court restructurings, Subchapter V also creates unique opportunities for early-stage investors willing to consider distressed investing opportunities.

**Overview**

When liquidity and solvency crises cannot be solved solely with additional capital investments or cost-cutting, one or more parties surrendering or modifying their negotiated rights and protections is almost always required to solve the crisis. Where all required constituencies are aligned, reaching a compromise to move forward can at times be easy. In other cases, especially when one or more parties seek to aggressively enforce their rights against the company, compromise can be more difficult to come by.

In those more difficult cases, often the key factor determining the success and overall fairness of the process is whether there is an adequate incentive available to encourage even-handed compromise and a consensual solution. The most obvious incentive, and the one historically most often relied upon by early-stage companies, is the existential crisis that threatens the liquidation of the company. Unfortunately, experience shows that relying on the risk of liquidation alone all too often results in a disappointing outcome from the equityholders’ perspective. This is arguably because liquidation does not present relatively equal levels of risk for all parties involved; in fact, in many cases the risk of liquidation weighs heavily in favor of the non-equity parties, who are likely to receive all value in a liquidation. As of February 19, 2020, however, companies with less than $2,725,625 in liquidated, noncontingent liabilities (not including liabilities owed to insiders) have a much better mechanism at their disposal to encourage compromise.

As of February 19th, companies under the $2,725,625 liability threshold may choose to reorganize under new Subchapter V of Chapter 11, which, among many other important changes, permits equityholders to retain their ownership interest in the reorganized company as long as the plan of reorganization is “fair and equitable” to...
each class of the company’s creditors. As a result, and unlike pure reliance on the potential failure of the business, the possibility of a Subchapter V restructuring provides a much more equally dangerous mechanism to encourage compromise and achieve an equitable out-of-court restructuring of the business. Understanding what can be accomplished through Subchapter V is important when facing liquidity and solvency crises, aiding in the determination of a company’s “minimally acceptable compromise” in out-of-court negotiations and helping to drive discussions towards a solution that is equal to or better than that minimally acceptable position.

To that end, in this note we first explain how knowledge of Subchapter V can be applied in a workout or restructuring scenario, explain important aspects of how Subchapter V works and how it can be used to achieve a non-consensual restructuring if necessary, and also discuss opportunities and the need for early stage investors in an early-stage restructuring context.

**Tackling the Crisis**

The typical approach to a liquidity or solvency crisis can be thought of as one that works towards a goal while pivoting among a number of increasingly less preferential solutions, ranging from a fully out-of-court agreement to a traditional Chapter 11 process that isn’t pre-arranged or pre-supported. Success is often dependent on a company’s ability to nimbly shift from one solution to the next as necessary.

The ideal solution is one that identifies which of the company’s obligations must be reduced or modified to achieve a sustainable position and reaches a fully consensual arrangement with required parties to put those reductions or modifications in place. To this end, the proposed reductions or modifications in an out-of-court scenario are generally less drastic than those a company could (and likely would) propose in a Subchapter V scenario. By leveraging the company’s ability to more aggressively reduce or modify obligations through Subchapter V, the company can encourage required parties to compromise to a satisfactory extent out-of-court. These sorts of consensual restructurings can be negotiated and styled in many different fashions depending on the nature of the primary obligations being reduced or modified, from a simple amendment to outstanding financing obligations, to an amendment or termination of a burdensome agreement to a global settlement agreement with numerous parties. The key is that the solution is consensual and not compulsory, allowing for an expedited and confidential process.

In some instances where the consent of several parties is required, a company may find itself with the consent of many parties but not the consent of all parties necessary to achieve the desired out-of-court solution. In such instances, a pivot to the first less preferential solution may be necessary, specifically a prepackaged or prearranged Chapter 11 bankruptcy. In a prepackaged bankruptcy, the company commences bankruptcy having already formally solicited and received sufficient approval from its creditors to permit court approval of a specific, largely consensual Chapter 11 plan of reorganization. In a prearranged Chapter 11 bankruptcy, the company commences bankruptcy before it formally solicits its creditors for approval, but it does so with the documented support (often by means of a plan or restructuring support agreement) of key creditors to a specific Chapter 11 plan. In
either case, the company commences bankruptcy with substantial creditor support for a specific, already documented resolution, using the power of Chapter 11 less for leverage in a negotiation but instead primarily to drag-along a dissenting minority or to otherwise impose the proposed solution on constituencies across the company’s capital structure. Commencing bankruptcy in this manner and for this purpose accelerates the process of confirming a Chapter 11 plan and exiting bankruptcy, possibly in as little as 45 to 60 days.

Where a company is unable to secure meaningful creditor support and has run out of time to continue pursuing out-of-court solutions, a further pivot to the least preferential solution may be necessary: an unsupported and more adversarial Chapter 11 process. However, using the protections afforded by Chapter 11, and especially Subchapter V, a company can use the Bankruptcy Code to continue operations while aggressively working towards plan confirmation and an exit from the bankruptcy process.

**The Power of Subchapter V**

**The Debtor-in-Possession**

Importantly, initiating a bankruptcy proceeding under Subchapter V of Chapter 11 of the Bankruptcy Code does not mean that the company necessarily loses control of its business. In fact, in any Chapter 11 case, the company is automatically deemed a “debtor-in-possession,” and management remains in control of all of the company’s assets and business operations. Although the company’s pre-bankruptcy management may be removed from control for cause, this is an uncommon event and unlikely in the absence of fraud, dishonesty or gross mismanagement and where a company diligently works towards consummating a restructuring.

**The Automatic Stay**

One of the most important and powerful benefits of the Chapter 11 process is the benefit of the automatic stay, which automatically stops substantially all actions and proceedings against the company and its property. Triggered immediately upon the filing of a bankruptcy petition, including one under Subchapter V of Chapter 11, the automatic stay forbids both formal and informal actions against the company connected to events or claims that preceded the bankruptcy filing, which typically include any attempt to actively terminate a commercial contract. Creditors and other parties can request relief from the automatic stay, but obtaining that relief requires meeting a high burden of proof. As a result, the automatic stay provides companies in Chapter 11 with a valuable breathing spell to evaluate and address problems, communicate with core constituencies and negotiate a plan of reorganization.

**Assuming and Rejecting Contracts**

Another important and powerful benefit of the Chapter 11 process is that it affords the company the right to choose whether to assume or reject each of its “executory” contracts (i.e., contracts where there are material obligations left to be performed
by both parties). Where a company in Chapter 11 elects to reject an executory contract, rejection is treated as a material breach of the agreement that occurred immediately prior to the commencement of the Chapter 11 case. Although this means that the counterparty to a rejected contract retains a claim for breach of contract against the restructuring company, that claim is subject to the restructuring embodied in the Chapter 11 plan, and in Subchapter V can be reduced or modified in a “fair and equitable” manner.

The Ultimate Benefit: The Confirmed Chapter 11 Plan

The final and ultimate benefit of a Chapter 11 restructuring is the ability to confirm (i.e., obtain court approval of) a Chapter 11 plan of reorganization. A confirmed plan of reorganization is effectively a compulsory agreement modifying the obligations of the reorganized company that is binding on all of the company's constituencies. Of critical importance for the purposes of this article, under Subchapter V, confirmation of a plan does not require the consent of a single class of creditors (with certain exceptions for secured creditors), permits the company's existing equityholders to retain their ownership interest and does not require that all “administrative claims” (i.e., claims that accrue during the Chapter 11 case and certain other specific categories of claims) be paid in full as a condition to confirmation. Instead, court approval of a Subchapter V plan requires only that the plan does not discriminate unfairly and is “fair and equitable” to each class of the company's creditors. To be considered “fair and equitable,” the plan must provide that the reorganized company apply all of its projected “disposable income” during a 3- to 5-year period towards payments to the company's creditors under the plan. Disposable income in the Subchapter V context generally means the income that is not reasonably necessary to continue, preserve or operate the business of the reorganized company.

Although this requirement may hamper a reorganized company's ability to aggressively scale during that 3- to 5-year period, any delay is almost certainly a better outcome for a company's founders, equity-holding employees and preferred stock investors than an immediate liquidation or fire sale in almost every instance. Although Subchapter V provides for nonconsensual plans of reorganization, where the plan is confirmed consensually, the company is entitled to a discharge of its pre-bankruptcy obligations upon confirmation (subject to the terms of the plan). Where a nonconsensual plan is confirmed, the company receives its discharge after completing the payments required under the plan (and potentially after completing only those payments required during the first 3 years of the plan).

A Note of Caution

Reorganizing under Chapter 11, and in particular under Subchapter V, has many benefits, but requires intense levels of transparency and is not without cost and risk. Any company considering an out-of-court restructuring or Subchapter V reorganization should consult with experienced counsel and should carefully consider each option available. In addition, Subchapter V has been available to businesses for a limited time, and there is accordingly limited legally binding guidance regarding its provisions.
Opportunities for Investors

Subchapter V provides for the first time a viable mechanism for venture capital backed companies to reorganize with the benefits of the Chapter 11 process while preserving the interests of common and preferred stockholders. As a result, its availability also presents opportunities for early-stage, distressed investments that are uniquely value additive and may justify relatively off-market, investor friendly terms. While the challenges presented by these opportunities will often require nuanced, bespoke solutions, solving those challenges and informing investors of these distressed opportunities will be a critical element of Subchapter V’s long-term success. We have already discussed these opportunities with a number of investors and will continue to assist investors in evaluating these opportunities.

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