Shkreli Cos. Bankruptcy Illustrates Novel Subchapter V Trend

By **Sam Ashuraey** (May 25, 2023)

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On May 10, Vyera Pharmaceuticals LLC filed for bankruptcy under Subchapter V in the U.S. Bankruptcy Court for the District of Delaware.

Although its noncontingent and liquidated liabilities are below the current $7.5 million cap for Subchapter V, it has tens of millions more dollars of contingent liabilities owed to unsecured creditors.

The plan is premised on a strategy that, if successful, will lead to full recoveries for unsecured creditors and enough remaining proceeds to pay equity holders as well. If this strategy is unsuccessful, unsecured creditors will receive reduced and delayed recoveries.

This is the latest case to demonstrate the potential of Subchapter V for debtors with large contingent or unliquidated liabilities seeking a more efficient form of bankruptcy for the benefit of equity holders.

Subchapter V: Relevant Background

The Small Business Reorganization Act created Subchapter V of Chapter 11 of the Bankruptcy Code, which became effective on Feb. 9, 2020.

Subchapter V "streamline[s] the bankruptcy process by which small business debtors reorganize and rehabilitee their financial affairs," allowing them "to file bankruptcy in a timely, cost-effective manner."[1]

Among other differences with traditional Chapter 11 filings, Subchapter V removes the cramdown requirements that the plan comply with the absolute priority rule and that there be at least one impaired accepting class.[2] This means equity holders can retain their interests even if unsecured creditors vote to reject the plan and there is no other impaired accepting class, provided the plan is fair and equitable.

For a Subchapter V plan to be fair and equitable to unsecured creditors, it must provide for payment of all disposable income for a period of three to five years — or property that is at least equal to the value of such disposable income — there must be at least a reasonable likelihood that the payments will be made under the plan, and the plan must provide for remedies to creditors if the payments are not made.[3]

In addition to these and other changes, Subchapter V:

- Requires the filing of a plan within 90 days of the petition date;[4]
- Does not require the appointment of a creditors committee;[5]
- Does not require the filing of a disclosure statement[6] — instead the plan must include a brief history of the business of the debtor, a liquidation analysis and projections regarding the ability of the debtor to make payments under the plan;[7]

- Provides for the appointment of a Subchapter V Trustee to, among other things, "facilitate the development of a consensual plan of reorganization";[8] and
- Provides that the plan may include payment of administrative costs after the effective date as part of the plan payments of disposable income[9].

In order to be eligible for Subchapter V, a debtor must have "noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition ... in an amount not more than $7,500,000."[10] The determination of whether the amount is contingent or liquidated is made on the petition date.[11]

Accordingly, a contingent and unliquidated claim that becomes noncontingent and liquidated during the pendency of the Subchapter V case would not count toward the $7.5 million cap for eligibility purposes.[12]

There is no limit on the amount of contingent and unliquidated debt. In addition, an entity does not qualify under Subchapter V if it is a member of any group of affiliated debtors that has aggregate debts above the $7.5 million cap.[13]

Vyera Bankruptcy: Background and Proposed Plan

On May 10, Vyera along with five affiliates filed under Subchapter V in the Bankruptcy Court for the District of Delaware.[14]

The debtors were founded by Martin Shkreli to develop and commercialize drugs for rare orphan diseases, the most profitable of which was Daraprim.[15] The debtors report no secured debt, less than $7.5 million in noncontingent liquidated debt, and approximately $10.5 million of cash on hand as of the petition date.[16]

In light of the debtors' significant cash on hand, relatively little debt and no looming debt maturities, the filing and plan were ostensibly meant to address two large contingent liabilities stemming from a suit initiated by the Federal Trade Commission in 2020 for violation of antitrust laws — Shkreli acquired the licensing rights to Daraprim and then increased its price by over 4,000% while restricting the development of generic alternatives.[17]

First, in December 2021, the debtors reached a settlement of the FTC litigation. The settlement requires the debtors to pay $30 million upon the monetization of any of the assets of two of the debtors, including the parent entity, within five to 10 years of the settlement. [18]

The parent company owns 100% of the equity of each of the other debtors, meaning any sale of the debtors' assets outside of bankruptcy up to $30 million would have been made toward the settlement payments.

Second, a competitor of the debtors that manufactures a generic form of Daraprim has threatened to file a complaint asserting a "significant claim, albeit contingent, unliquidated and disputed, which could dwarf the other liabilities and cash balances of the Debtors."[19]

The proposed plan is largely premised on funding debtor Orpha Labs AG to continue the development of a clinical stage drug, ORL-101, which would ultimately fund the recoveries under the plan.

Although ORL-101 is for the treatment of an ultra-rare disease, the debtors state that, if the U.S. Food and Drug Administration approves a new drug application for ORL-101, the FDA may issue a priority review voucher to the debtors.[20]

A priority review voucher reduces the review time for any new drug from the usual 10 months to six months, and can be sold to third parties to expedite the review of an unrelated drug.

The debtors expect the continued development of ORL-101 would cost approximately $7.8 million and may lead to a PRV being issued in approximately two to three years. The debtors estimate that the PRV can then be sold for between $95 and $120 million based on recent comparable transactions.[21]

Mechanically, on the effective date, reorganized Orpha Labs will be funded with the debtors' cash on hand for the development of ORL-101 with the goal of receiving a priority review voucher, and a liquidating trust would be established and funded with, among other things, the right to receive the proceeds of a priority review voucher monetization.

The liquidating trust would then issue liquidating trust certificates to holders of claims entitling them to receive the proceeds of a priority review voucher monetization. If reorganized Orpha Labs receives a priority review voucher, the proceeds of its sale would be used to pay holders of claims in full and the remainder would be distributed to equity holders.[22]

The debtors note that they are seeking to proceed with confirmation consensually, but that they believe the plan satisfies the requirements for nonconsensual confirmation under Subchapter V.[23]

Significance

Vyera is the latest filing to take advantage of the potential benefits to equity holders of filing under Subchapter V because, compared to traditional Chapter 11, it streamlines the process, reduces costs and encourages the development of a consensual plan.

The Vyera debtors seek to use the breathing spell provided by the Bankruptcy Code to fund and pursue an investment that may lead to recoveries for equity holders further in the future. This likely would not have been a viable option under traditional Chapter 11.

Even if the court approved the priority review voucher strategy, and it was successful, the costs associated with a traditional Chapter 11, including the appointment of a committee, filing of a disclosure statement and a potentially longer case timeline — along with the increased litigation they often lead to — mean administrative costs may have absorbed any recoveries that would have otherwise been available to equity holders.

Moreover, if the debtors chose to proceed nonconsensually in traditional Chapter 11, the cramdown requirements would have been difficult to overcome, even if the debtors were able to create an impaired accepting class and distributed warrants or other instruments to equity holders that only had value after unsecured creditors were paid in full.

Unsecured creditors would still have credible arguments that the plan violates the absolute priority rule because it pursues a risky strategy in order to distribute potential value to equity holders at the expense of recoveries to unsecured creditors, who bear all the risk.

If the priority review voucher is not issued unsecured creditors would receive significantly less because they will not receive the millions invested in ORL-10 — and arguably the Chapter 11 expenses that would not have otherwise been expended.[24]

Unsecured creditors would also presumably receive these reduced recoveries further in the future than they would have if, for example, recoveries were funded through out-of-court sales or Section 363 sales.

Under a Subchapter V cramdown, however, the debtors need only show that there is a reasonable likelihood that the debtor's disposable income — or property not less than the value thereof — will be made under the plan and provide for remedies if they are not.

While unsecured creditors could challenge the reasonable likelihood of payments from a priority review voucher sale being made, one previous decision — In re: Ellingsworth Residential Community Association Inc. in the U.S. Bankruptcy Court for the Middle District of Florida in Oct. 16, 2020 — suggests that the court will grant considerable deference to the debtor's assessment of that likelihood.[25]

Continuing Trend

Two prior bankruptcy court opinions demonstrate the use of Subchapter V by debtors with large contingent liabilities, and, more importantly, that challenges to eligibility based on the size of contingent claims are unlikely to succeed.

In the case of Parking Management Inc. in the U.S. Bankruptcy Court for the District of Maryland in August 2020, a parking operator that managed over 100 facilities obtained orders authorizing rejection of 12 of its leases.

Seven of the leases were rejected as of the petition date, and the resulting rejection damages claims brought the debtor's total liabilities well above the Subchapter V debt limit.

Several creditors and the U.S. trustee argued that the rejection damages from the seven leases should be included in the eligibility debt cap. The court disagreed, finding that, notwithstanding the leases being rejected as of the petition date, a claim is not contingent only if all events that gave rise to the claim occurred prior to the petition date.[26]

The court held that lease rejection is necessarily something that can only occur after the petition date because it requires court approval, and therefore the claims did not exist on the petition date.[27]

The court, looking to guidance from Chapter 12 and 13 cases, reasoned that it should only consider the amount of debt on the petition date, as considering postpetition events would mean a debtor could float in and out of eligibility.[28]

Moreover, the court noted that this approach gives certainty to debtors and allows them to achieve the Subchapter V goal of reorganizing "quickly, inexpensively, and efficiently," and that "[o]pening up eligibility determination to postpetition events, even if deemed to apply retroactively, is contrary to the purpose and spirit of Subchapter V, and could nullify the very benefits it is intended to convey."[29]

In In re: Free Speech Systems in the U.S. Bankruptcy Court for the Southern District of Texas, the debtor filed under Subchapter V in July 2022 after default judgments in two

courts were entered against it, but before the damages trials had concluded.[30]

In October, a jury awarded damages of $1.5 billion against the debtor and its owner, Alex Jones. In December, Jones filed for Chapter 11.

The plaintiffs moved to revoke the debtor's Subchapter V eligibility, arguing that the combined debts of the debtor and Jones exceeded the eligibility requirement.

They argued that the Subchapter V requirement that affiliated debtors not exceed the debt cap continues after an initial Subchapter V filing, rather than only being determined as of the petition date.

The court denied the plaintiffs' motion, holding that the statutory language of Section 1182 of the Bankruptcy Code, as well as Bankruptcy Rule 1020, are clear that the liabilities of subsequently filing affiliate did not affect an initial Subchapter V election and the court should rely on a debtor's statement of election unless it is untrue or incorrect.

Moreover, like Parking Management, the court found that limiting eligibility challenges to a debtor's statement on the petition date is consistent with the streamlined nature of Subchapter V, and revoking eligibility means "debtors could float in and out of Subchapter V at any time."

However, a recent opinion clarifies that courts will not simply defer to a debtor's characterization of a claim as noncontingent or unliquidated.

In In re: Hall in May, the U.S. Bankruptcy Court for the Middle District of Florida distinguished merely disputed claims from noncontingent and liquidated claims for purposes of eligibility under Subchapter V.[31]

The debtors initiated an adversary proceeding against their main creditor arguing that the debt was, among other things, fraudulently induced, and should therefore be calculated at $0 or at least be reduced by the amount of the prepayment penalty.

The court held that because the claim amount was readily ascertainable, the claim was liquidated, and should therefore be included in the debt cap amount.

Outlook

Subchapter V is a viable option for debtors with large contingent or unliquidated liabilities — and relatively small noncontingent and liquidated liabilities — that seek to retain value for equity holders.

Courts have so far demonstrated that they are unlikely to sustain an objection to Subchapter V eligibility based on the amount of contingent or unliquidated debt, prioritizing instead the importance of maintaining the certainty and predictability of the process.

As a result, debtors with similar debt profiles will continue to contribute to the increasing number of Subchapter V filings.

Sam Ashuraey is an associate at Paul Hastings LLP.

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[1] H.R. Rep. No. 116-171, at p. 1, 4 (2019), available at https://www.congress.gov/116/crpt/hrpt171/. CRPT-116hrpt171.pdf.

[2] § 1191(b), (c).

[3] § 1191(c).

[4] § 1189(b).

[5] § 1181(b).

[6] Id.

[7] § 1190.

[8] § 1183(b)(7).

[9] § 1191(e).

[10] § 1182 (1)(A).

[11] In re Parking Mgmt., Inc., 620 B.R. 544, 551-552 (Bankr. D. Md. 2020).

[12] 1182(1)(A).

[13] 1182(1)(B).

[14] In re: Vyera Pharmaceuticals, LLC, et al. (Case No. 23-10605).

[15] Declaration of Lawrence R. Perkins in Support of the Debtors' Subchapter V Petitions and First Day Pleadings (Docket No. 10) (the "Perkins Declaration") at ¶ 12.

[16] Id. at ¶¶ 50, 51. See also Voluntary Petition (Docket No. 1) at 13-14 (Non-contingent and liquidated claims listed in the list of top 20 unsecured creditors consist of approximately $2.7 million, in addition to a $2.1 million contingent claim by Duane Morris LLP).

[17] Id. at ¶¶ 13, 14. The Debtors' report that decreased revenues due to the introduction of competing generic alternatives to the Debtors' drugs also contributed to the filing. Id. at ¶ 56.

[18] Id. at ¶ 62.

[19] Id. at ¶ 69.

[20] Plan at VI.G.

[21] See Debtors' Joint Subchapter V Plan of Reorganization and Liquidation (Docket No. 11) (the "Plan") at III.F.

[22] Id.

[23] Id. at III.E.

[24] The Debtors do not discuss the likelihood, but according to the Government Accountability Office, "[f]rom fiscal year 2009, when the first PRV was awarded, through fiscal year 2019, FDA awarded 31 PRVs, mostly for drugs to treat rare pediatric diseases. U.S. Government Accountability Office, Drug Development: FDA's Priority Review Voucher Program, Jan. 31, 2020, available at https://www.gao.gov/products/gao-20-251#:~:text=From%20fiscal%20year%202009%2C%20when,million%2C%20according%20to%20available%20data.

[25] In re Ellingsworth Residential Cmty. Ass'n, Inc., 2020 WL 6122645, at *4 (Bankr. M.D. Fla. Oct. 16, 2020).

[26] Id. at 554

[27] Id.

[28] Id.

[29] Id.

[30] 649 B.R. 729 (Bankr. S.D. Tex. 2023).

[31] In re Hall, 2023 WL 3330347 (Bankr. M.D. Fla. May 5, 2023); see also Parking Management at 551 (holding that it did not need to find a lack of good faith or candor to review the claims as long as there was "reasonable ground to dispute" whether claims were contingent or liquidated).