Subchapter V Eligibility Ruling Raises Uncertainty For Tenants

By **Sam Ashuraey** (August 16, 2023)

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The U.S. Bankruptcy Court for the Eastern District of Virginia held in June that all remaining rent under a lease should be factored into a lessee's Subchapter V eligibility, without regard to the 502(b)(6) cap or whether the lease will be rejected.

Courts following this approach would find any potential debtor whose long-term lease obligations — when added to other noncontingent and liquidated debts — exceed the debt limit to be ineligible for Subchapter V.

Legal Background

Subchapter V of Chapter 11 of the U.S. Bankruptcy Code "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]

In order for a debtor to be eligible under Subchapter V, it must, among other things, have "aggregate noncontingent liquidated secured and unsecured debts as of [the petition date] not more than $7,500,000."[2]

In general, debts are contingent if some future event must occur before the debt is owed.[3] A debt is liquidated if the amount is readily determinable.[4]

A tenant debtor has the right to reject — or terminate — a lease in bankruptcy. Upon rejection of a commercial lease, the lessor's damages claim against the debtor will be capped under Section 502(b)(6) of the Bankruptcy Code.

A simplification of Section 502(b)(6) can be described limiting a homeowner's damages, as of the date of the calculation, as follows: the amount of rent due for the greater of one year or 15% of the remaining term of the lease — not to exceed three years — plus any unpaid rent due as of such date.

Case Summary

The debtor in In re: Macedon Consulting Inc. entered into two long-term commercial leases in 2019.[5]

Following a decline in revenue and a reduction in employees during the pandemic, the debtor attempted to find subtenants or assignees. When this was unsuccessful, it attempted to terminate the leases and settle with its lessors.

After these attempts also failed, the debtor filed under Subchapter V of Chapter 11 in February.

On the petition date, the debtor filed a motion to reject the leases as of the petition date, along with its plan of reorganization. The debtor listed the total amount of its secured and unsecured claims at approximately $2.8 million.

Of this, approximately $2 million was for the lease rejection damages claims and was listed as contingent, unliquidated and disputed. The amount was capped under Section 502(b)(6) of the Bankruptcy Code. The debtor's plan sought to pay all claims in full assuming the rejection damages it listed.

The lessors argued that the debtor was not eligible under Subchapter V because its noncontingent and liquidated liabilities exceeded the debt limit of $7.5 million. They argued that the court should consider all rent that remained for the life of the leases notwithstanding rejection, which was approximately $14.4 million.

The court agreed with the homeowners, and held that the remaining amount due under the term of the lease was not contingent. In doing so, the court distinguished the only other case directly on point, In re: Parking Management in the U.S. Bankruptcy Court for the District of Maryland in 2020.[6]

In that case, the court held that rejection damages were contingent because they depended on post-petition events. Most notably, a court must issue an order approving the rejection.

In contrast, Macedon distinguished rejection claims, which it agreed were contingent, with liabilities under a lease.

The court found that the liabilities under the leases were not contingent because the debtor became liable on the date it executed the lease — "absent such rejection, the Debtor owes $14,390,820 under the lease."[7] The court would not "ignore the Debtor's existing pre-petition liability under the Leases in favor of post-petition events when determining eligibility."[8]

Similarly, without providing additional analysis, the court found that the liability was liquidated at the remaining $14.4 million due under the lease.[9]

Significance and Outlook

This case raises — but does not address — issues regarding how a court should calculate the amount of debt owed under a lease.

Debt "As Of" the Petition Date

A lease may be rejected — as it was in this case — as of the petition date, constituting a breach immediately before the petition date.[10] This, in turn, gives rise to a claim "as of" the petition date.[11]

Based on the principle that a statute should be read as harmonious, the amount of debt the debtor has as of the petition date should be the rejection claim amount, not the remaining rent.

If a court adopts this logic and uses the rejection damages amount, it would also follow that the debt owed as of the petition date is contingent based on the reasoning in Parking Management.

Debt vs. Claim

The statute uses the phrase "noncontingent liquidated debts" as of the petition date.

Arguably, since the Bankruptcy Code defines debt as "liability on a claim," it is broader than claim.[12] It should therefore include all remaining rent under the lease notwithstanding rejection. However, courts have stated that the terms "debt" and "claim" are coextensive.[13]

Based on this view, a court should look to the amount of the rejection damages claim, since that is the amount that would be owed to the debtor in bankruptcy. This is certain because as of the petition date, if a commercial homeowner lease is rejected, it will hold a rejection damages claim capped under 502(b)(6).

Moreover, under this analysis it would again follow that the claim is contingent.

Future Subchapter V Debt Limit Reduction

As a practical matter, the current $7.5 million debt limit for Subchapter V eligibility is set to expire in June 2024.[14] Assuming the debt limit reverts to $2,725,625, the ruling in Macedon may make many more tenants ineligible for Subchapter V.

Policy Favoring Rejection

The ability to shed burdensome leases and contracts is one of the main advantages of Chapter 11.[15]

An inability to file for Chapter 11 with the goal of rejecting contracts or leases will limit the use of Subchapter V for potential debtors. These debtors may otherwise benefit from Subchapter V while regular Chapter 11 may be too expensive or litigious.[16]

Conclusion

The case law on Subchapter V eligibility is still developing, but cases so far have emphasized the importance of certainty when limiting challenges as to eligibility.[17]

Doubt as to whether a court will use the remaining rent under the lease or the rejection damages claim as the basis for the Subchapter V eligibility creates significant risk for potential debtors.

This uncertainty will be amplified if courts also must resolve arguments addressing the questions above.

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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. Subchapter V, among other differences with "traditional" chapter 11, (a) removes the "cramdown" requirements that the plan comply with the absolute priority

rule and that there be at least one impaired accepting class (b) requires the filing of a plan within 90 days of the petition date, (c) only allows the debtor to file a plan, (d) does not require the appointment of a creditors committee, (e) does not require the filing of a disclosure statement (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), (f) provides for the appointment of a subchapter V Trustee to, among other things, "facilitate the development of a consensual plan of reorganization" and (g) provides that the plan may include payment of administrative costs after the effective date as part of the plan payments of disposable income. See 11 U.S.C. §§§1181; 1183; 1189; 1190; 1191.

[2] 11 U.S.C. 1182(1)(A).

[3] See In re Taylor & Assocs., L.P., 193 B.R. 465, 475 (Bankr. E.D. Tenn. 1996).

[4] E.g., In re Pearson, 773 F.2d 751, 755 (6th Cir. 1985).

[5] 2023 Bankr. LEXIS 1551 (Bankr. E.D. Va. June 14, 2023).

[6] 620 B.R. 544 (Bankr. D. Md. 2020).

[7] In re Macedon at *10. Notably, in the context of an involuntary petition, at least one other court has also held that future rents are not contingent. In re Miller, 489 B.R. 74, 87 (Bankr. E.D. Tenn. 2013)

[8] In re Macedon at *10.

[9] Id.

[10] 11 U.S.C. 365(g).

[11]11 U.S.C. 502(b).

[12] 11 U.S.C. 101(12); In re King, 9 B.R. 376, 378 (Bankr. D. Or. 1981).

[13] E.g., In re Lindsey, Stephenson & Lindsey, 995 F.2d 626, 628 (5th Cir. 1993).

[14] Bankruptcy Threshold Adjustment and Technical Corrections Act, Pub. L. No. 117-151.

[15] See In re Orion Pictures Corp., 4 F.3d 1095, 1098 (2d Cir. 1993).

[16] Relatedly, certain leases may contain liquidated damages or early termination clauses that provide for how to calculate the amount owed in the event of an early termination. Arguably, if a debtor had terminated such a lease immediately before filing for bankruptcy, the liquidated amount under the lease would have been the amount provided for in the liquidated damages clause, rather than simply the amount of rent remaining. This may encourage some debtors to employ a strategy outside of bankruptcy that is otherwise addressed in the Bankruptcy Code.

[17] See, e.g., Parking Management at 554 (nothing that considering lease rejection claims as contingent debt as of the petition date "has the very real benefit of providing certainty to the [Subchapter V] process"); In re Free Speech Sys., LLC, 649 B.R. 729, 734 (Bankr. S.D. Tex. 2023) (noting that "limiting eligibility challenges to the debtor's statement of election

also makes practical sense in [the context of Subchapter V's] streamlined chapter 11 process").