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As a Professor of Finance at Boston College, my research focuses on empirical studies of corporate restructurings. I have written extensively regarding the efficiency of U.S. Chapter 11. My testimony will summarize the findings of my recent research paper examining the impact of Subchapter V (SubV) on reorganizations and survival of small businesses, addressing the following economic questions:

I. What is SubV intended to "fix" and why?
II. Has SubV achieved its goals thus far?
III. How can our research inform decisions about an appropriate liability threshold for SubV eligibility? What safeguards are important in avoiding abuse of eligibility requirements?

Summary: Subchapter V substantially increases the likelihood of reorganization for small businesses (under $7.5 million in non-contingent liabilities). We find no evidence that the gains to small business owners come at the expense of recoveries to unsecured creditors. Post-emergence survival rates for firms reorganized using SubV are significantly higher than for firms reorganized using a traditional Chapter 11.

I. Small business liquidation rates and the enactment of SubV.

An over-arching concern in designing bankruptcy law is to strike the "right" balance between enabling viable firms (i.e. those with a high going concern value) to avoid liquidation, while not enabling excessive continuation of firms worth more in a liquidation. Neither liquidation values or going concern values are observable ex-ante.

Subchapter V addresses the problem that a traditional Chapter 11 leads to too many liquidations of viable "small" firms (requiring a definition of "small"). It has been well documented in prior research that the majority of small firms in the U.S. attempting to reorganize in bankruptcy are unable to do so. This can also be seen from filing statistics from the Federal Judicial Center (FJC) for business bankruptcy cases:

- 70% of small businesses (less than $7.5M in <u>total</u> liabilities) entering bankruptcy from 2010 to 2019 filed directly for Chapter 7 liquidation.
- Among these small businesses that did enter Chapter 11, only about one-third successfully reorganized, with the other two-thirds either being liquidated in Chapter 7 or dismissed from court.
- At the other extreme, liquidations are rare for large, often public, U.S. corporations (Figure 1 below).

Figure 2 below shows pre-SubV plan confirmation rates for cases filed between 2017 and 2019 for firms with up to $15 in total liabilities. While confirmation rates rise somewhat over this size range, the overall confirmation rate is only 30%. At the same time, the number of Chapter 11 cases is substantially higher for relatively smaller firms in this size range.

Our study discusses the main explanations for the high liquidation rates of small businesses, and the specific provisions of SubV intended to reduce impediments to small firms' survival:

Chapter 11 bankruptcy is expensive. The high fixed costs, and costs which increase with the time in bankruptcy, can quickly dissipate the value of a small business. SubV removes costly and time-consuming requirements, such as the appointment of a creditors' committee and requiring a disclosure statement. Our study (further described below) shows that SubV cases reach reorganization plan 35% faster relative to traditional Chapter 11 cases.

Retaining pre-bankruptcy owners is often necessary to preserve the business. SubV allows for confirmation of a plan under which equity owners retain up to 100% of their ownership, even when dissenting creditors do not receive a 100% recovery.

Reaching consensus with creditors (sometimes a single bank) is often difficult for small businesses. Creditors who prefer even partial repayment in a liquidation have little incentive to negotiate an agreement and may disagree regarding the viability of a reorganized firm. SubV trustees can serve to mediate the process, reducing information and coordination problems.

The uptake in firms with less than $7.5 million in total liabilities that utilize SubV starting in 2020 is rapid and striking, substantially displacing traditional Chapter 11 filings (Figure 3). More than 75% of small businesses entering Chapter 11 elect to use SubV instead of a traditional Chapter 11. Filings are geographically widespread across 92 U.S. Bankruptcy courts.

II. Analysis of outcomes of SubV versus non-SubV small business cases.

Our research paper, "Can Small Businesses Survive Chapter 11" (see Appendix), is a comprehensive study of outcomes of 6,431 bankruptcy cases filed from 2017 to 2024. Our key findings, and interpretation, can be summarized as follows:

- Based on 999 Chapter 11 cases filed from 2020 to 2024 with non-contingent liabilities between $4 and $11 million, SubV more than doubles the probability of reorganization. SubV increases the likelihood of reorganization by between 32 and 49 percentage points, relative to firms just above the threshold which reorganize only 17% of the time.
- Expected recovery rates to unsecured creditors are 11.9% higher in SubV relative to similar non-SubV cases. Under unrealistically conservative assumptions about recoveries in dismissed cases, recoveries are not lower in SubV cases. This is consistent with unsecured creditors sharing in the benefits of value preserved from avoiding liquidation.
- Post-emergence survival rates are not lower, and arguably are 21% higher, for debtors using SubV. These findings are inconsistent with the concern that SubV enables excessive continuation of firms that are not viable, at the expense of pre-bankruptcy creditors. In other words, we find no evidence SubV tips the scales too far in favoring debtors' attempts to reorganize, relative to traditional Chapter 11 cases. The original owner retains at least some equity in the reorganized business for 91% of SubV cases, while in traditional Chapter 11 this is true only 65% of the time.

The key statistics described here are based on firms in the $4 to $11 million *non-contingent* liability range, i.e. above the $7.5 million threshold in place during our sample period. This design specifically enables us to make causal statements about the impact of SubV. This well studied econometric method is based on demonstrating that firms above/below the eligibility threshold are similar in terms of observable characteristics. In other words, we can compare firms that do/do not have the ability to use SubV, controlling for firms' choice to use SubV, for firm-level characteristics, and for changes in outcomes or firm characteristics over time.

Our estimates are not affected by the Covid-19 period. In fact, dropping 2020 entirely from our analysis has no economic impact on our estimates.

III. Eligibility for SubV.

Because of our research design, our study also provides some insights in reviewing an appropriate eligibility threshold for SubV.

First, we see no “bunching” of filings just below the threshold. Although one can point to individual cases, this means that there is no empirical indication to date that a significant number of borrowers were able to manipulate their liabilities to be just below the threshold.

Second, there are only a small number of cases we study where the exclusion of non-contingent liabilities from the eligibility threshold enables firms to use SubV. Still, it is important to consider valid concerns of gaming of the threshold, which increase for larger, more sophisticated borrowers.

One concern is the ability to replace existing debt with insider debt close to the time of filing, strategically making the firm eligible for SubV. This valid concern applies largely to private equity owned firms, where capital may be available from the PE sponsor. From prior research, data from Pitchbook (covering a large portion of the PE industry) and Debtwire (more broadly covering the leveraged loan market) shows that the most highly leveraged PE-backed borrowers will have non-contingent liabilities well above $10 million.

A second concern is cases with judgement claims, including mass tort claims, well in excess of other liabilities. The most egregious example is the FSS Chapter 11 case (Alex Jones), where a SubV case was attempted but ultimately dismissed, but unsecured creditors - families of Sandy Hook victims – did not receive the representation they would have under a traditional Chapter 11. Such cases also raise the concern of larger borrowers strategically moving debt between entities prior to filing in order to shed certain liabilities using SubV but retaining equity ownership.

Although these cases have been infrequent thus far, they clearly are not consistent with the intended use of SubV and highlight the importance of an important guardrail, the discretion of the bankruptcy judge. With clarification of language within SubV, cases where insider debt or litigation claims are the “predominant” liability can be ineligible for SubV based on the court’s judgement of the intended use of SubV.

Conclusions and other safeguards important to SubV.

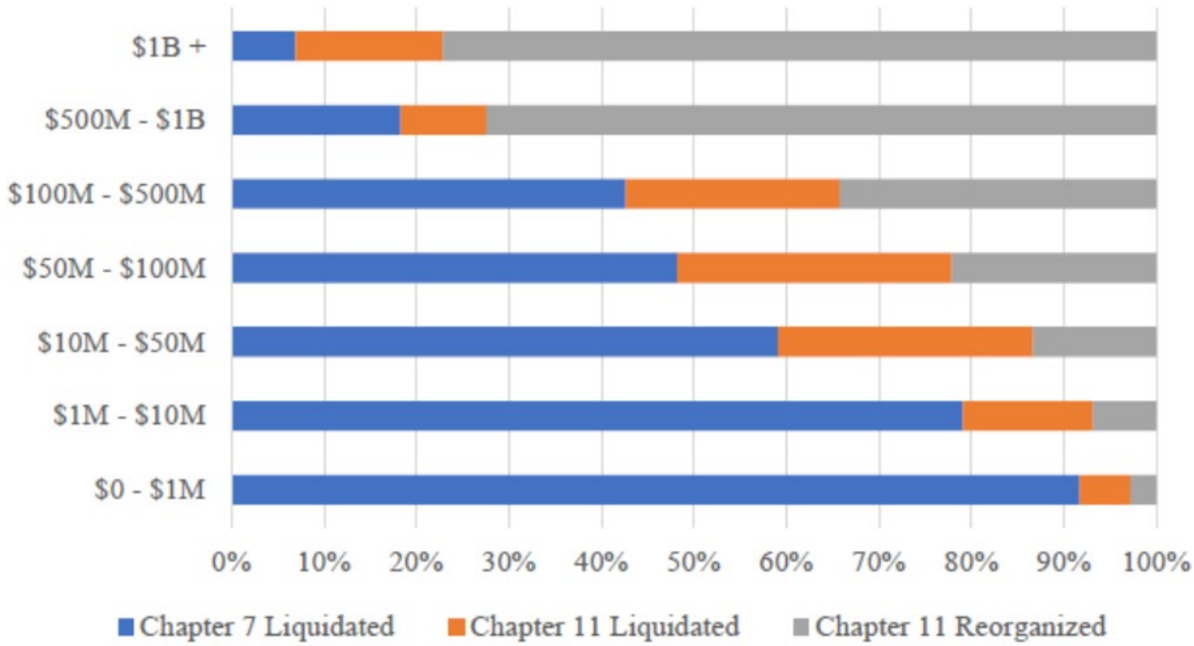
The most obvious impact of SubV to date has been the increase in confirmations of reorganization plans for small businesses that otherwise would have liquidated in or out of court. While it is impossible for many small firms to continue operating without the continued presence of the business owners, assessing the impact on creditors as well as the feasibility of reorganization plans is more difficult. Our examination of outcomes, focusing on firms close to the $7.5 million liability threshold during our sample period, suggests positive effects of SubV relative to traditional Chapter 11 cases beyond increasing the number of reorganizations. In fact, over the last 10 years, at least 11 countries including the U.S. have adopted simplified insolvency procedures for the reorganization of small businesses, showing the global need for this type of procedure.

In addition to sufficient discretion for eligibility for SubV, the SubV trustee plays an important role in working with debtors to develop a plan and understanding its feasibility. This highlights the need to ensure that SubV trustees are adequately compensated, particularly in cases where a reorganization is not achieved.

Finally, a caveat to our recovery rate analysis is that recoveries will be lower if debtors default on payments post-emergence. At present, there is no public information on post-emergence compliance with required payments, even when collected by the U.S. Trustee's Office. This information is critical to the ongoing assessment needed by judges and researchers to inform future decisions regarding SubV.

Figure 1

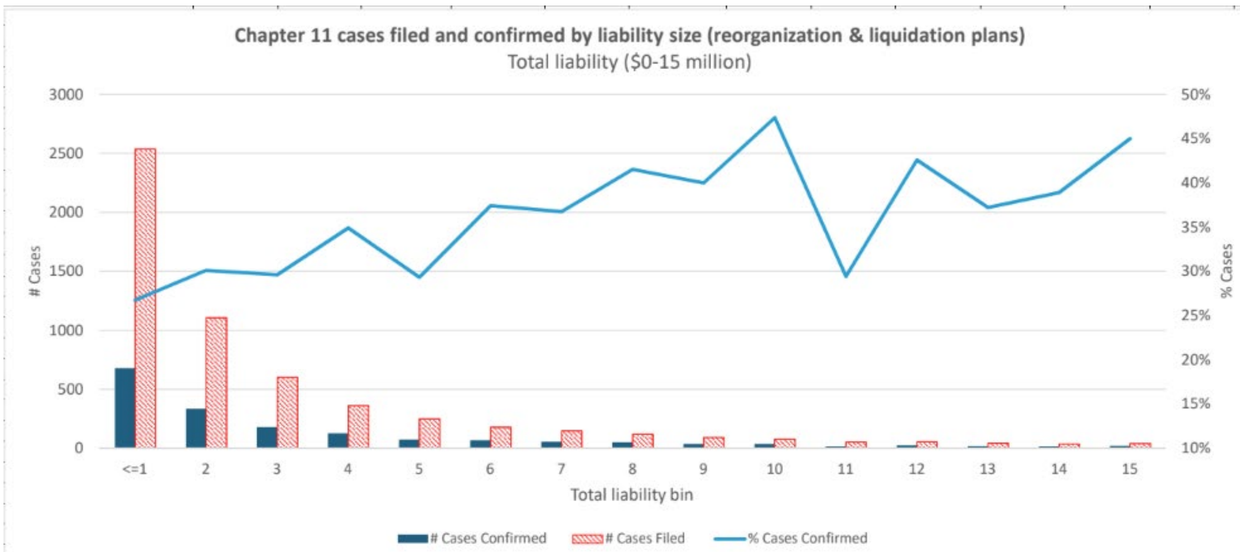
U.S. Chapter 11 Case Outcomes by Total Liabilities (through 2022)



Author's compilation from New Generation Research.

Figure 2

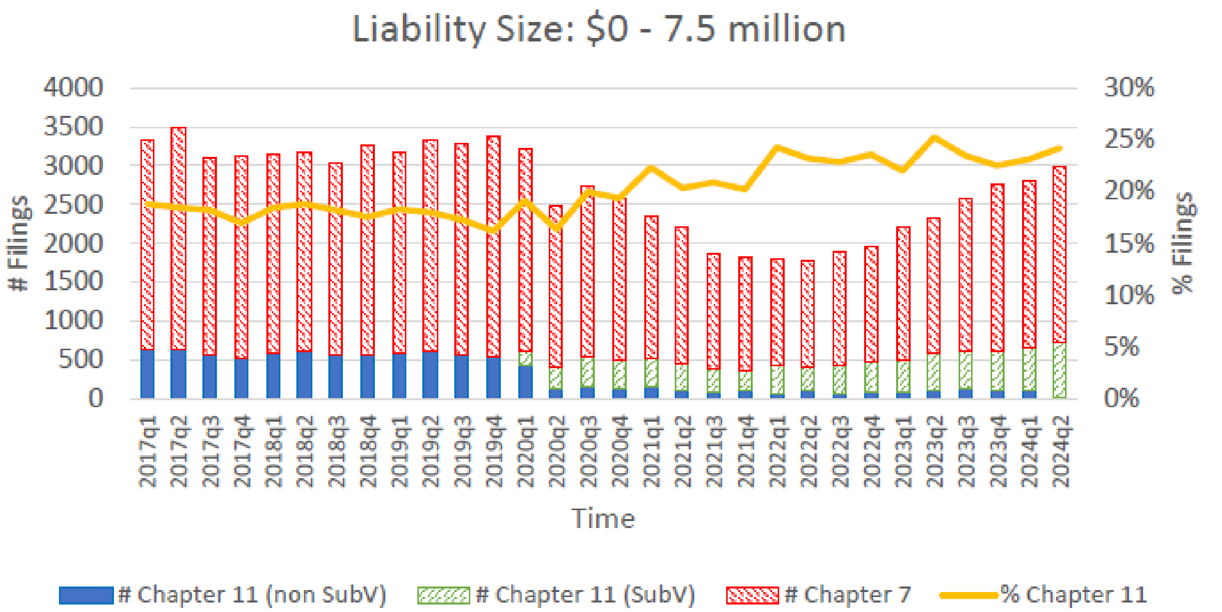
Confirmation rates for Chapter 11 cases (data from FJC)



Total liability bin	# Cases Confirmed Reorg Plan	# Cases Filed	% Cases Confirmed Reorg Plan		
5	59	253	23%	27%	ave
6	54	180	30%		
7	43	145	30%		
8	39	121	32%	32%	ave
9	29	93	31%		
10	31	78	40%		
11	11	53	21%		

Figure 3

Time trend of Chapter 11 and 7 bankruptcy filings



Reproduced from "Can Small Businesses Survive Chapter 11", Figure 1C. The figure plots the time trend of Chapters 11 and 7 filings from 2017 to 2024. The dark blue and striped green (striped red) histogram bars represent the number of Chapter 11 (7) filings. The orange line represents the percentage of Chapter 11 filings over total (Chapter 11+ Chapter 7) bankruptcy filings. The figure shown here is based on filings with liabilities between $7.5 million and $15 million. All filings exclude non-lead cases, cases transferred to another court, and non-business cases.

Appendix, Cover page and link to:

Can Small Businesses Survive Chapter 11?*

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Abstract

A majority of small U.S. businesses attempting to reorganize in bankruptcy fail to successfully do so. Subchapter V of Chapter 11 was introduced in 2020 for firms with less than $7.5 million in liabilities to streamline the process by reducing bankruptcy costs and negotiation frictions, and enabling entrepreneurs to retain their ownership. Employing regression-discontinuity and difference-in-differences designs, we show that many small businesses reorganize under the new procedures that otherwise would have been liquidated. Further, expected creditor recoveries and post-bankruptcy survival rates are at least as high in Subchapter V as in similar traditional small business reorganizations. Our results show that the increased ability to preserve small businesses is not associated with a bias toward continuing unviable firms, and that creditors are not harmed by a shift in bargaining power toward small business owners.

Link to SSRN: https://ssrn.com/abstract=4726391

Link to the paper: https://www.dropbox.com/scl/fi/j9jig6mp0flwazhpxuqcy/SubV-Draft-July-9-2025.pdf?rlkey=62vmj42n54w590iha3y86dkw3&dl=0

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