# Fix It or Fold It? Deciding Between a Chapter 11 Reorganization (Including Streamlined Options Under Subchapter V) and a Chapter 7 Liquidation

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**Business owners facing financial difficulties often wait too long to consider bankruptcy—sometimes out of fear, and sometimes out of confusion. But bankruptcy isn't always a last resort. It can be a strategic move to preserve value, restructure obligations, or wind down with dignity.**

Understanding the different types of business bankruptcy—and what each option means for operations, ownership, and financial obligations—is critical to making an informed and strategic decision. This article provides an overview of Chapters 7 and 11 of the Bankruptcy Code, including the streamlined rules for certain small businesses under Subchapter V (of Chapter 11), and explains how each can be used to either close a business or reorganize it for long-term viability.

### Traditional Chapter 11 Bankruptcy: Reorganization

Chapter 11 allows a debtor's business to continue operating while it develops a plan to reorganize its financial obligations. It is often used by larger businesses to restructure their balance sheets, shed unprofitable contracts, and emerge as more competitive and viable entities.

### When is a Traditional Chapter 11 Bankruptcy the Right Choice?

A traditional Chapter 11 bankruptcy is typically considered when a business is fundamentally sound yet weighed down by unsustainable debt. It offers a court-supervised framework to restructure debts and obligations without completely erasing them. This path is particularly beneficial when a business needs to renegotiate burdensome contracts or leases, such as those for real estate or equipment, as well as when the business needs to secure new financing or adjust existing debt repayment schedules.

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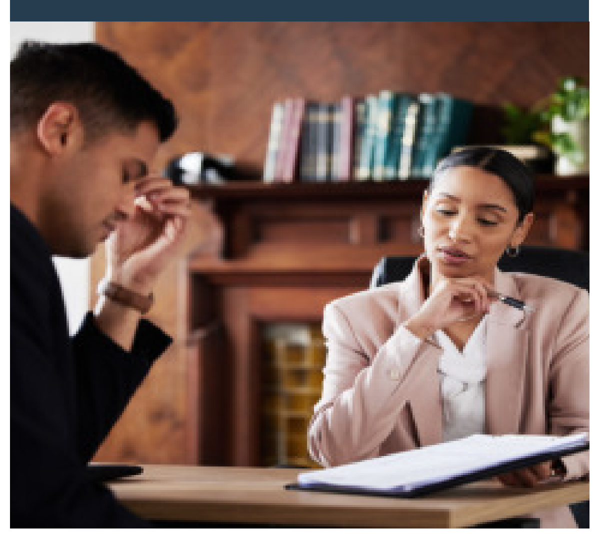

**Key Characteristics**

A traditional Chapter 11 bankruptcy case begins with the filing of a petition, which must include a comprehensive statement of financial affairs and a schedule of assets, liabilities, contracts, expenditures, and leases. Upon filing, the existing management usually remains in control of the business, operating as a "debtor-in-possession" (DIP), while the automatic stay immediately halts most collection efforts and lawsuits. Management may then review existing contracts and leases and choose to keep or reject those that negatively impact profitability. Ultimately, the business must propose a detailed reorganization plan that (1) satisfies the absolute priority rule, meaning senior creditors are paid in full before junior creditors or equity holders can receive any payments, and (2) is approved by a vote of impaired creditors and confirmed by the court.

If the proposed plan fails to secure the support of all impaired creditor classes, the DIP may still seek confirmation through what is known as a "cramdown." Under this mechanism, the court can approve the plan over the objection of dissenting classes if it determines that the plan does not "discriminate unfairly" and is "fair and equitable" with respect to each non-consenting, impaired class of claims. This process allows financially distressed businesses to move forward with reorganization even in the face of creditor resistance, provided the statutory requirements under the Bankruptcy Code are met.

**Rejection of Contracts or Leases and Valuing Collateral**

One of the most valuable features of Chapter 11 is the ability of a DIP to modify certain contractual obligations. Under section 365 of the Bankruptcy Code, a debtor can choose to assume (keep), assume and assign (keep and transfer to another party), or reject (terminate) executory contracts and unexpired leases, subject to court approval. For example, commercial real estate leases must generally be assumed or rejected within 120 days of filing a petition (which the court can extend by 90 days) to avoid automatic rejection. If a contract or lease is rejected at filing, it is treated as if the breach occurred immediately before the petition was filed. This operation of law converts a counterparty's claim into a pre-petition general unsecured claim for damages. The power to reject often gives debtors significant leverage to renegotiate key contract terms—such as lowering rent under a burdensome lease or adjusting service contracts—since counterparties generally prefer payments to be made under an ongoing lease or contract rather than as a result of an unsecured claim, which may be worth significantly less.

Another practical feature of Chapter 11 is the process for valuing the collateral of secured creditors. Section 506 allows the court to re-evaluate a creditor's status by determining the current market value of the collateral that secures its claim. After doing so, only the portion of the debt equal to the collateral's actual value remains secured, while the remainder is reclassified as unsecured debt, which is frequently repaid at a significant discount. This process can help businesses reduce their overall debt and increase the likelihood of a successful reorganization.

**Limitations**

While Chapter 11 offers significant advantages, it remains a complex and oftentimes expensive ordeal. The proceedings may take several years to conclude, and the business will incur professional fees to engage lawyers, financial advisors, and accountants. Additionally, creditor committees may form to represent the interests of unsecured creditors, and those committees may oppose the management's proposed restructuring plan, leading to further negotiation and conflict. Therefore, thorough preparation and experienced legal counsel are essential for a successful Chapter 11 reorganization.

**Subchapter V (of Chapter 11) Bankruptcy: Streamlined Reorganization for Small Businesses**

Enacted under the Small Business Reorganization Act of 2019, Subchapter V offers a simplified and more cost-effective option for reorganizing eligible small businesses. It allows these businesses to restructure debt and continue operations (retaining the core benefits of Chapter 11) while reducing some of the associated complexity and expense.

**Eligibility**

To be eligible under Subchapter V, a business must have aggregate non-contingent, liquidated, secured, and unsecured debts totaling no more than $3,424,000 (which is adjusted every three years for inflation). Additionally, the business must be engaged in commercial or business activities, with over 50 percent of its total debt arising from these activities. Eligible debtors generally include small business corporations, partnerships, and individuals who operate commercial enterprises, but not those specifically excluded under the Bankruptcy Code, such as single-asset real estate owners and publicly traded companies.

**When is Subchapter V the Best Choice?**

Subchapter V is an ideal choice for businesses that meet the debt limits and seek to restructure rather than liquidate. It is particularly appealing for businesses seeking a faster, less adversarial process. For example, owners interested in retaining equity in the company may be able to do so without obtaining creditor consent, a significant advantage over a traditional Chapter 11 bankruptcy.

**Key Characteristics and Benefits**

Subchapter V introduced several important changes designed to streamline the reorganization process for small businesses. In every Subchapter V case, a trustee is appointed and tasked with facilitating a consensual reorganization plan between the debtor and creditors. Further, the Bankruptcy Code requires the court to hold a status conference within the first 60 days of the commencement of the case, and the debtor is required to file a detailed report outlining efforts to obtain creditor consent to a plan no less than 14 days prior to the meeting.

A key benefit of Subchapter V is the reduced administrative burden: a formal disclosure statement is typically not required, and there is generally no unsecured creditors' committee (unless the court orders that one be organized). Additionally, only the debtor can file a reorganization plan, which must be submitted within 90 days of the petition date; however, extensions may be granted when "the need for an extension is attributable to circumstances for which the debtor should not justly be held accountable." Debtors in Subchapter V cases are also exempt from paying quarterly fees to the United States Trustee, further reducing overall costs.

Reorganization plans, like those in traditional Chapter 11 cases, can be confirmed either by the consent of the creditors or through the "cramdown" process. However, in the context of a Subchapter V case, a plan is considered "fair and equitable" if the debtor commits all of their "projected disposable income" (or its value) to payments over the life of the plan. Therefore, Subchapter V plans do not need to comply with the traditional Chapter 11 "absolute priority rule" and may provide for owners to retain equity even if creditors are not paid in full.

**Limitations**

While Subchapter V cases are designed to be affordable, simplified, and efficient, the debt limit, stricter timeline, and lack of judicial precedent may pose challenges for some debtors, limiting flexibility and creating uncertainty in how certain issues are resolved.

**Chapter 7 Bankruptcy: Liquidation**

When a corporate debtor files for bankruptcy under Chapter 7 of the Bankruptcy Code, the business generally ceases operations. A Chapter 7 Trustee ("the trustee") then takes control of the business's non-exempt assets, sells them, and distributes the cash proceeds to creditors following the priority rules set out in the Bankruptcy Code. Unlike reorganization under a traditional Chapter 11 or Subchapter V (of Chapter 11) reorganization, Chapter 7 focuses solely on winding down the business in an orderly manner rather than attempting to continue operations.

**When is Chapter 7 the Best Choice?**

A Chapter 7 bankruptcy is often chosen when the business has no viable path forward, has few or no valuable assets to use to reorganize, or when management concludes that reorganization is not economically feasible. For many, the primary goal in any liquidation becomes an orderly wind-down of the business's affairs and addressing its outstanding debts as best as possible.

**Key Characteristics**

Under Chapter 7 procedures, there is no plan of reorganization; instead, the trustee sells assets and distributes the proceeds to creditors. Notably, because equity holders stand last in the order of repayment, small business owners usually do not receive any proceeds.

**Limitations**

One of the most significant limitations of a Chapter 7 bankruptcy is that a business entity does not receive a discharge of its debts. As a result of the filing, creditors may still pursue any other individuals or entities that personally guaranteed the debts. Further, certain liabilities—such as trust fund taxes and debts incurred through fraud—remain the responsibility of the individuals involved.

We know the ins and outs of bankruptcy can be overwhelming, but Frost Law's team of seasoned professionals are ready to help your business every step of the way.

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