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An 'Affiliate' of a Public Company Is Barred from Reorganizing Under the Bankruptcy Code's New Subchapter V

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The Small Business Reorganization Act of 2019 (SBRA) aims to simplify and shorten the Bankruptcy Code's reorganization process for small-business debtors, making Chapter 11 more accessible.[1] Effective as of February 2020, SBRA—also known as Subchapter V—eligibility requires, in part, that (i) the total small-business debt must not exceed $7.5 million[2]; and (ii) debtors not be affiliates of "issuers," as defined by the Securities Exchange Act of 1934. A recent memorandum opinion in *In re Serendipity Labs, Inc*.[3] provides an early interpretation of what constitutes an "affiliate" for Subchapter V eligibility purposes. The *Serendipity* court was asked to consider whether the percentage of "voting shares" should be measured by the total voting shares controlled by an entity, or only the shares "with the power to vote on the matter before the [Bankruptcy] Court." Based on the plain meaning of the statute and implications of interpreting it otherwise, the court found that "voting shares" are measured by percentage of *total* voting shares and revoked the Debtor's Subchapter V election.

Serendipity Labs (the Debtor) is the parent company of several entities in the business of managing and owning co-working spaces. Due to COVID-19 shutdowns and a looming debt refinance, the Debtor filed for Chapter 11 protection in July, electing to proceed under Subchapter V. A secured lender challenged the Debtor's eligibility under Subchapter V, arguing that the Debtor's largest stockholder, Steelcase, Inc., was an issuer under the Securities Exchange Act of 1934. In turn, the Debtor was not eligible for the benefits of Subchapter V if it was an "affiliate" of Steelcase, an issuer.

The Bankruptcy Code defines an affiliate as an entity that "owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor." 11 U.S.C. § 101(2)(A). At the time of the filing, the Debtor had three classes of stock, all with voting rights. In the aggregate, Steelcase owned 27.7 percent of Debtor's voting shares; however, only 6.51 percent of Steelcase's shares were authorized to vote on the Debtor's bankruptcy filing. In support of its Subchapter V eligibility, the Debtor argued that the correct measure was the percentage of shares that could authorize the reorganization or liquidation of the Debtor. Conversely, the secured lender argued that the plain language of the Bankruptcy Code rendered the Debtor an affiliate of Steelcase because Steelcase owned or controlled 20 percent or more of the debtor's voting securities.

Citing *In re Interlink Home Health Care, Inc*.,[4] the court agreed with the secured lender. Voting securities contain the inherent "opportunity to control" through voting. A finding to the contrary would contradict the plain language of Subchapter V, the court said, as well as lead to "absurd" results. The court quoted *Interlink* and pointed out that voting trusts or parent-of-a-parent owners would circumvent the affiliation restriction and "invite manipulation of bankruptcy powers." Because Steelcase owns over 27 percent of the Debtor's voting shares, the Debtor was an affiliate of an issuer, and the court accordingly revoked the Subchapter V election.

Particularly given the CARES Act's expansion of SBRA eligibility, defining "affiliate" for Subchapter V purposes seems likely to become a common issue. It remains to be seen whether courts will follow *Serendipity* or be persuaded that "opportunity to control" is a separate criterion for determining the percentage of voting shares.

ENDNOTES

[1] For background on the SBRA, please see http://www.rc.com/publications/upload/Distressed-Companies-and-Special-Situations-Legal-Update-6-16-20.pdf.
[2] The SBRA itself sets the cap at $2,725,625; however, the Coronavirus Aid, Relief and Economic Security Act (CARES Act) has temporarily raised the limit to $7.5 million. 11 U.S.C. § 1182(1)(A).
[3] Chapter 11 Case No. 20-68124-sms (Bankr. N.D. Ga.) [Docket No. 168].
[4] 283 B.R. 429 (Bankr. N.D. Tex. 2002).

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