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Move Over, § 363: Why Buyers May Prefer Plan Sales in Subchapter V

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Editor's Note: *To stay current on the effects of this legislation, bookmark ABI's SBRA Resources website at abi.org/sbra.*

Although business assets can be bought and sold through the chapter 11 plan-confirmation process, § 363 of the Bankruptcy Code has, in many cases, been the preferred mechanism for buyers due to its relative speed, greater simplicity and lower transactional costs. However, Congress may have shifted the playing field for asset sales in smaller business bankruptcy cases through the enactment of the Small Business Debtor Reorganization Act (SBRA), known as subchapter V of chapter 11.

When subchapter V took effect on Feb. 19, 2020, it accelerated the process and reduced the costs of reorganization for small businesses. Congress recently expanded those eligible for relief under subchapter V by nearly tripling the debt limit (from $2.7 million to $7.5 million) as part of its response to the coronavirus pandemic.

The equation has not only changed for small business debtors. On the other side of the deal table, when a debtor qualifies for and elects treatment under subchapter V, opportunistic buyers might find that they can achieve the benefits of a sale pursuant to a confirmed plan while avoiding some of the more burdensome aspects of the traditional chapter 11 plan-confirmation process. However, because subchapter V is only a few months old, there are still outstanding questions about how business debtors, opportunistic buyers and bankruptcy practitioners can leverage its unique features.

The Old Equation: Chapter 11 Plan Sales vs. § 363 Sales

Before getting into subchapter V, it is useful to review the traditional ways that buyers have purchased assets out of a chapter 11 case: sales under a confirmed chapter 11 plan, and sales pursuant to § 363. A primary benefit of chapter 11 plan sales from a buyer's perspective is that they can allow for a private sale without an auction. Plan sales may also offer more robust statutory protections to a buyer, since assets dealt with by a confirmed plan are cleansed of "all claims and interests" under § 1141(c), whereas only an "interest in property" may be stripped under § 363(f).[1] A plan sale may also provide additional shields against liability through releases and injunctions included in the plan. Other benefits include exemption from transfer taxes under § 1146(a). At the end of the day, the sheer weight and inclusiveness of the plan-confirmation process provides a broad base of justification for this type of sale.

However, the plan-confirmation process can be painfully slow, costly, and fraught with uncertainty and complexity from a buyer's perspective. It is rare for a plan to be confirmed in less than six months; it is more common for the process to take a year or longer. Many of the issues addressed in a typical chapter 11 plan (even a liquidating plan) relate only tangentially to the sale of the debtor's assets, yet any of those issues could become the subject of a dispute that threatens to derail confirmation.

That is a major reason sales under § 363 have become the norm in chapter 11. A hearing on a § 363 sale motion only requires 21 days' notice, and the sale itself is often completed within two months. It is also less expensive for buyers in terms of transaction costs, which are limited to those directly tied to the sale.

1 This advantage might be more theoretical than practical given the clear trend toward an expansive view of the kinds of "interests" assets that may be sold free and clear of under § 363(f), but the U.S. Bankruptcy Court for the Southern District of New York recognized as recently as August 2019 that "the 'free and clear' relief available to a debtor under section 363(f) is narrower than that afforded to a debtor under a confirmed plan because the relief is limited to 'interests' in property and only to the extent provided for under section 363(f)(1)-(5)." *In re Ditech Holding Corp.*, 606 B.R. 544, 581 (Bankr. S.D.N.Y. 2019).

In addition, § 363 sales tend to be simpler and more predictable for buyers because they do not involve the myriad other moving parts of a chapter 11 plan. There is no voting by creditors, and in many cases the thorny question of how the sale proceeds should be distributed among competing claimants can be shelved for another day. The primary areas of inquiry for the court are whether the debtor is receiving the highest and best price for the assets being sold, and whether the sale is proposed in good faith at an arm's length. By contrast, confirmation of chapter 11 plans requires navigating a much broader variety of competing interests and legal requirements.

There are downsides for buyers under § 363. Perhaps most problematic from a buyer's standpoint is the generally followed (if not statutorily mandated) practice of establishing competitive-bidding procedures, which expose a buyer to the risk of losing the deal after a substantial investment of time and money. This risk can be compensated to some extent through expense-reimbursement provisions and break-up fees for the initial or "stalking horse" bidder, but it is a substantial risk nonetheless. Judges may also view a sale of all or substantially all of the debtor's assets as an impermissible *sub rosa* plan: a proposed transaction that for all intents and purposes is (or effectively dictates the parameters of) a plan without providing creditors and other parties-in-interest with the procedural protections of the plan-confirmation process.

Buyers also have less post-closing protections under § 363. Some courts have ruled that even if the requirements of § 363(f) are satisfied in regard to the sale of assets free and clear of "interests" such as mortgages, Article 9 security interests, judgments and other types of liens, the purchased assets may remain subject to certain types of "claims" (such as successor-liability claims). Sales under § 363 are also generally subject to transfer taxes. Notwithstanding these potential drawbacks, the advantages tied to speed, cost and relative simplicity have caused § 363 to become the predominant method of selling all or substantially all of the assets of a debtor in chapter 11.

How Subchapter V Changes the Equation

Subchapter V may eliminate many of the downsides of purchasing assets through a plan. The plan-confirmation process is faster than in a traditional chapter 11 case, and the debtor has more control because of the absolute exclusivity given to debtors under § 1189(a).

A subchapter V plan must be filed within 90 days of the debtor's filing of the petition.[2] Thus, unlike a traditional chapter 11 case where debtors often obtain multiple extensions of the exclusivity period (with a concomitant delay in the actual filing of a plan), subchapter V plans could provide a confirmed sale within a comparable time frame as a § 363 sale. When selling a business, besides the parties' preference for a timely sale, a shorter time frame provides a buyer with a greater ability to ascertain the financial condition of a going-concern business at the time of the purchase.

From the perspective of a potential buyer or debtor alike, the aspect of control in a subchapter V plan might be attractive. In a § 363 sale, the debtor is generally required to hold an auction (or least solicit and entertain competing offers until the sale is approved) to ensure the highest and best price and recovery for creditors. Through a plan, a potential buyer might have more certainty that it will be the owner of the assets upon confirmation. Further, a plan sale may allow greater flexibility for creative payment terms for the assets. If the price paid is some combination of funds and alternate consideration (waiver of claims, etc.), this type of deal in the context of a plan is more easily understood by all and less likely to be disrupted by a higher bidder. Further, potential purchasers who are leery of being stalking-horse bidders — with the time and cost involved in that position — might prefer the certainty of a sale agreement incorporated into a subchapter V plan.

In addition, subchapter V does not allow for a creditors' committee, and the debtor has the exclusive right to file a plan.[3] Because a goal of subchapter V is to avoid drowning a small business in the procedural burdens and administrative costs of chapter 11, a subchapter V debtor — and, by proxy, its selected purchaser — should face less potential litigation with creditors. Subchapter V allows a judge to confirm a plan without any consenting creditors.[4] It specifically removes the absolute-priority rule in the required "fair and equitable" analysis for cramdown purposes.[5] As in a traditional chapter 11 case, a sale through a plan also does not require the consent of any junior lienholders.[6] These limitations on the ability of creditors (collectively or individually) to derail the process should greatly reduce the costs and delays often associated with chapter 11 plan sales.

Keys to Confirmation of a Liquidating Plan Under Subchapter V

A debtor seeking confirmation of a liquidation plan under subchapter V can avoid many of the usual hurdles to plan confirmation in a chapter 11 case, including having to negotiate (or litigate) with an unsecured creditors' committee and having to obtain the affirmative vote of an impaired class under § 1129(a)(10). As long as the court is satisfied that fair value is being paid for the assets and the plan otherwise satisfies the requirements of §§ 1190 and 1191 — including the "best interests of creditors" test of § 1129(a)(7) — there is no reason that a liquidation plan should not be approved by the creditors and the court (or the court over the objection of creditors in a cramdown scenario).[7] The keys to a smooth confirmation process will likely be (1) ensuring that the plan includes detailed information about the marketing efforts undertaken and/or valuation methods used to arrive at the proposed purchase price (which will be particularly important if the proposed sale is a private sale rather than an auction); and (2) gaining the support of the trustee, whose approval is not required but whose judgment is likely to be given a significant amount of deference by the court.

2 11 U.S.C. § 1189(b).

3 *See* 11 U.S.C. § 1189(a).

4 *See* 11 U.S.C. § 1191(a) and (b).

5 *See* 11 U.S.C. § 1191(b).

6 *Id.*

7 The question may arise as to whether a debtor with no projected disposable income post-confirmation (having sold its income-generating assets) can satisfy the requirements of § 1191(c)(2) in a cramdown scenario, but if projected disposable income is $0, that should render § 1191(c)(2) moot as a practical matter.

Furthermore, in a case where the only realistic source of a material recovery for unsecured creditors is the potential proceeds of avoidance actions, the plan could empower the trustee to pursue such claims post-confirmation in much the same manner as "liquidating trustees" are routinely empowered to do in traditional chapter 11 cases. Any recoveries might also provide an additional source of compensation for the trustee, adding to the potential appeal of this feature.

Wildcard: The Subchapter V Trustee

A unique feature of subchapter V is the appointment of a trustee to facilitate the negotiation and confirmation of a consensual plan.[8] The subchapter V trustee is appointed by the U.S. Trustee (or, with a nod to North Carolina and Alabama, the Bankruptcy Administrator) from a panel of potential trustees.[9] While largely modeled after chapter 12 and 13 trustees, the obligations of the subchapter V trustee differ greatly in key functions.[10]

Naturally, the facilitator role of the trustee implies a strong business angle to the subchapter V role, and the governing code provisions provide for some duties akin to those of a financial consultant or chief restructuring officer (CRO).[11] For example, upon request, a subchapter V trustee may investigate the conduct and financial condition of the debtor and any other matter relevant to the case, and file a report.[12] Pursuant to §§ 1183 and 1185, a court may task the subchapter V trustee with running the debtor's business and filing all operating reports.[13] These are tasks often performed by a financial consultant or a CRO in chapter 11.

The point is that to have a successful subchapter V trustee panel, the bench should be stacked with experienced and savvy business finance experts. Such expertise could be leveraged by a debtor and/or potential purchaser to maximize consideration on both sides of the table and provide the financial evidence to the court of an optimal outcome in the sale for creditors.

Potential Policy Implications of a Liquidating Plan in Subchapter V

The policy behind the SBRA's formulation and enactment was to make it easier for small businesses to reorganize.[14] However, there is nothing in subchapter V that prohibits the sale of all or substantially all of a debtor's assets through a confirmed plan. To the extent that subchapter V enables a qualifying business to quickly and efficiently realize going-concern value for the benefit of all of its creditors through a court-approved sale — without the administrative costs and inefficiencies of a traditional chapter 11 case or the value-destroying fire-sale aspect of a chapter 7 liquidation — all creditors will benefit, including employees who stand to retain their jobs and vendors/customers who stand to retain an ongoing business relationship.

Addressing this policy issue in a different context, Chief Judge **Helen E. Burris** of the U.S. Bankruptcy Court for the District of South Carolina recently denied the U.S. Trustee's motion to strike an individual debtor's subchapter V designation on the grounds that the debtor was not "a person engaged in commercial or business activities" where the businesses owned and operated by the debtor had ceased operating and their assets had been liquidated.[15] Citing *Collier on Bankruptcy* for the proposition that "the definition of a 'small business debtor' is not restricted to a person who at the time of the filing of the petition is presently engaged in commercial or business activities *and who expects to continue in those same activities under a plan of reorganization*,"[16] Judge Burris held that the debtor's efforts to address residual business debt constituted engagement in commercial or business activities for purposes of § 101(51D).

Conclusion

Subchapter V might provide an ideal sweet spot for buyers who want the advantages of a chapter 11 plan sale combined with the speed and relative simplicity of a sale under § 363. Subchapter V likely gives buyers greater control, fewer potential headaches with dissenting creditors, and greater protection from successor-liability claims than § 363.

The authors say "likely" because the rubber is just beginning to meet the road with subchapter V. It was only implemented last February, so the earliest plans were due in late May. The expansion of eligibility tied to the pandemic began on March 27, so plans for those cases were due in late June. (This article was written in mid-June.) The case law is very much in its infancy but will expand quickly through the rest of this year. Bankruptcy professionals should keep tabs on that case law to see whether the theoretical benefits of subchapter V become practical benefits for their clients. abi

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8 11 U.S.C. § 1183(b)(7).
9 11 U.S.C. § 1183(a).
10 *See* 11 U.S.C. § 1183(b).
11 *Id.*
12 *See* 11 U.S.C. § 1106(a)(3), (4) and (7).
13 In the scenario pursuant to § 1185 when the subchapter V trustee is tasked with running the business, the only logical outcome (barring a change in career path by the trustee) is a sale of the business.
14 The Report from the House Committee on the Judiciary (Report No. 116-171) states that "[n]otwithstanding the 2005 Amendments, small business chapter 11 cases continue to encounter difficulty in successfully reorganizing" and that legislation was needed "to improve the reorganization process for small business chapter 11 debtors." The SBRA allows these debtors "to file [for] bankruptcy in a timely, cost-effective manner, and hopefully allows them to remain in business, which not only benefits the owners, but employees, suppliers, customers, and other who rely on that business."
15 *In re Charles Christopher Wright*, No. 20-01035-HB (Bankr. D.S.C. April 27, 2020).
16 *Id.* at *3 (emphasis added).