

What Turnaround Professionals Need to Know About Subchapter V

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UPDATE: Congress extended the increased debt limit for Subchapter V through March 2022.

SUBCHAPTER V

As most turnaround professionals know, federal legislation in response to the coronavirus pandemic created a limited window for more businesses to qualify for what is intended to be a faster, less costly, and simpler route through bankruptcy. This route exists through the Small Business Reorganization Act, which created a new subchapter of the Bankruptcy Code, Subchapter V, effective February 19 of last year.

Subchapter V originally applied only to small businesses with aggregate secured and unsecured debts of less than \$2.7 million. However, the CARES Act temporarily increased the aggregate debt level for an entity eligible to participate in those streamlined bankruptcies to \$7.5 million. That portion of the CARES Act is set to expire on March 26 of this year, although there are ongoing discussions on Capitol Hill about extending the increased debt limit for at least another year.

Struggling small businesses, opportunistic buyers, and their advisers should all familiarize themselves with the advantages of Subchapter V for companies that qualify. Simply put, the new law accelerates the process and reduces the costs of reorganization for small businesses. On the other side of the table, buyers may find that Subchapter V's streamlined plan confirmation process offers greater speed, efficiency, and certainty than the traditional but often cumbersome stalking horse/auction process under Section 363 of the Bankruptcy Code.

However, because of how new Subchapter V is and the immense uncertainty the pandemic has created, questions remain about how turnaround professionals and others in this space can best use it.

More Efficient, Less Costly

The goal of Congress in creating Subchapter V was to make it easier for small businesses to reorganize. Lawmakers essentially built a new lane that is more efficient and less costly than going through a

traditional Chapter 11 bankruptcy and lacks the value-destroying fire sale aspect of a Chapter 7 liquidation.

Small businesses looking to reorganize can use Subchapter V to exercise greater control and bypass many of the hurdles in a typical Chapter 11 case. That's because there is no creditors' committee, and the debtor has the exclusive right to file a plan. The debtor must move quickly, though, as a plan must be filed within 90 days of the petition date. Subchapter V allows a judge to confirm a plan without any consenting creditors, as opposed to a traditional Chapter 11 case, in which the affirmative vote of at least one impaired class of creditors is required.

Subchapter V also does away with the absolute priority rule, which prevents business owners from retaining their interest unless dissenting creditors are paid in full in contested confirmation cases. There is a trustee, who like a Chapter 7 trustee is appointed by either the United States Trustee or Bankruptcy Administrator. But absent unusual circumstances, the Subchapter V trustee's role is mostly limited to facilitating plan confirmation by acting as a sort of mediator between the debtor and its creditors.

The paradigm for Subchapter V is the small business hoping to reorganize by committing its projected disposable income to making payments to creditors over a three- to five-year period. However, it is worth noting that there is nothing in Subchapter V prohibiting the sale of all or substantially all of the small business's assets through a confirmed plan.

Potential Advantages in a Post-Pandemic Economy

As the country emerges from the pandemic and the economy begins to recover, bankruptcy judges, Subchapter V trustees, and even creditors will likely be more receptive to more modest disposable income projections given the uncertain economic outlook and the grim historical numbers from 2020



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The upsides of a faster turnaround, greater control, and fewer administrative headaches and costs make it worth exploring for businesses that qualify.



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in many sectors. This should result in more manageable payments for debtors, since projected disposable income is the primary source of funding for creditors under a plan of reorganization in Subchapter V.

Likewise, small businesses looking to accomplish going concern sales under the protective umbrella of bankruptcy will likely find it easier to negotiate and obtain approval of privately negotiated deals with arm's length buyers without having to jump through the hoops of a competitive bidding process. As long the judge (with deference to the trustee) believes the assets are being sold for fair value, and certain other requirements are met, there is no reason a liquidating plan cannot be confirmed under Subchapter V, even over the objection of creditors.

Opportunistic buyers—many of whom have been sitting on the sidelines for the last 12 months due to COVID-19 uncertainty—may also find that the streamlined plan confirmation process under Subchapter V presents a smooth and cost-effective vehicle for acquiring distressed business assets in the post-pandemic economy, without some of the disadvantages of a sale under Section 363. Specifically:

- A Chapter 11 plan can provide for the sale of a debtor's assets without the delay, expense, and uncertainty of competitive bidding. In a Section 363

sale, the generally followed (if not statutorily mandated) rule is that the debtor must hold an auction, or at least solicit and entertain competing offers right up until a sale is approved, to ensure the highest and best price and recovery for creditors. Notwithstanding the prevalence of breakup fees and other court-fashioned protections for stalking horse bidders under Section 363, this risk of losing a deal after what is often a substantial investment of time and money is a deterrent to many potential buyers.

- Under Section 1141(c) of the Bankruptcy Code, all property dealt with by a confirmed plan is free and clear of all "claims and interests" of creditors, equity security holders, and general partners in the debtor. Although Section 363(f) offers asset buyers similar protections from post-closing claims by the debtor's aggrieved creditors when certain conditions are satisfied, some courts have cautioned that the kinds of "interests in property" that may be scrubbed and transferred to sale proceeds in a Section 363 sale may not include certain types of claims, such as successor liability claims.
- A sale pursuant to a confirmed plan is exempt from transfer taxes under Section 1146(a).

There are two keys to emphasize in teeing up a sale of assets pursuant to a Subchapter V plan. First, the plan

should include detailed information about the marketing efforts or valuation methods used to determine the purchase price. Second, the debtor will need to gain the support of the Subchapter V trustee, which is a unique aspect of Subchapter V. While the trustee's approval is not required in Subchapter V, judges will likely put significant stock in his/her opinion.

The Early Results

Because Subchapter V is only a year old—and that clock started less than a month before the coronavirus pandemic derailed the U.S. economy—there is limited evidence of how it has worked in practice. However, a recent analysis of available data by the director of the Executive Office for U.S. Trustees suggests that Subchapter V is working as Congress intended, in that the percentage of small business cases with confirmed plans under Subchapter V is six times higher than the percentage of confirmed plans for small business cases that did not proceed under Subchapter V during the same time frame.¹

There still appear to have been few Subchapter V cases involving the sale of all or substantially all of a debtor's assets, either through a confirmed Subchapter V plan or under Section 363. The bulk of the reported Subchapter V cases have involved qualifications to be a debtor under Subchapter V, the new standards for confirmation of plans under Subchapter V, the duties of Subchapter V trustees, and whether and under

what circumstances a case originally filed under a different chapter can be converted to a Subchapter V case.

Takeaways

The bottom line is that Subchapter V may end up an ideal sweet spot between other bankruptcy options for small businesses and opportunistic buyers. The upsides of a faster turnaround, greater control, and fewer administrative headaches and costs make it worth exploring for businesses that qualify. For businesses with aggregate secured and unsecured debts between \$2.7 million and \$7.5 million, that review needs to happen quickly if Congress does not act to extend the increased limit.

But for now, those upsides are largely theoretical rather than proven. Turnaround professionals should keep tabs on how Subchapter V continues to play out so they can determine how to make the most of it. ■



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¹ Clifford J. White III, "Small Business Reorganization Act: Implementation and Trends," 40 *ABI J.* 54 (January 2021).

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