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Insights From Experience:
A Practical Guide to and Strategies for Protecting Trade Creditors in Subchapter V Cases

SUPPLEMENTAL MATERIALS/ARTICLES

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Lowenstein Sandler

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WHITE PAPER

SUBCHAPTER V:
Essential Insights for Credit Professionals

KEY POINTS

- Subchapter V makes Chapter 11 more attractive to the "small business" debtors that are eligible to file under Subchapter V, but in many respects do so at the expense of unsecured trade creditors. While Subchapter V provides small business debtors with most (if not all) of the same benefits of a "traditional" Chapter 11 filing, it strips away certain elements of traditional Chapter 11 that benefit unsecured trade creditors.

- Small business filings under Subchapter V dropped by 45% from June to July 2024 due to the reversion of the temporarily enhanced debt limit from $7.5 million to $3,024,725.

- While Subchapter V has been praised for its efficiency, there are concerns over whether it truly facilitates successful reorganizations or merely delays inevitable failures.

- Among the key differences between a traditional Chapter 11 and Subchapter V case that impact unsecured trade creditors are: the lack of a creditors' committee in Subchapter V (without a creditors' committee, trade creditors lose a platform for collective representation, influence over the reorganization process, and ability to investigate actions that may increase creditor recoveries); and the ability for the Subchapter V debtor to stretch out payment of administrative expense claims (e.g., claims for goods sold to the Debtor on credit during the bankruptcy case) over the three- to five-year life of the plan.

- It's key for unsecured trade creditors to stay informed and proactive in Subchapter V cases to effectively protect their interests.

OVERVIEW

With the Small Business Reorganization Act (SBRA) that went into effect on February 19, 2020, Congress amended the Bankruptcy Code to create a new subchapter to Chapter 11 for the reorganization of small business debtors. Unlike the existing small business provisions under Chapter 11, Subchapter V offers an alternative path that small businesses can elect to follow when filing for bankruptcy. This new subchapter was designed to address the unique challenges that small businesses face in traditional Chapter 11 cases, such as high costs, lengthy timelines and stringent requirements that often make reorganization unattainable.

Despite its benefits, Subchapter V also raises concerns. While it has been praised for its success in streamlining the bankruptcy process, questions remain about whether it truly leads to successful reorganizations or merely postpones inevitable business failures—with unsecured trade creditors paying the price.

This white paper will explore these issues in depth, examining the practical implications of Subchapter V for B2B trade creditors, who must navigate this new landscape while managing the risks associated with small business bankruptcies.

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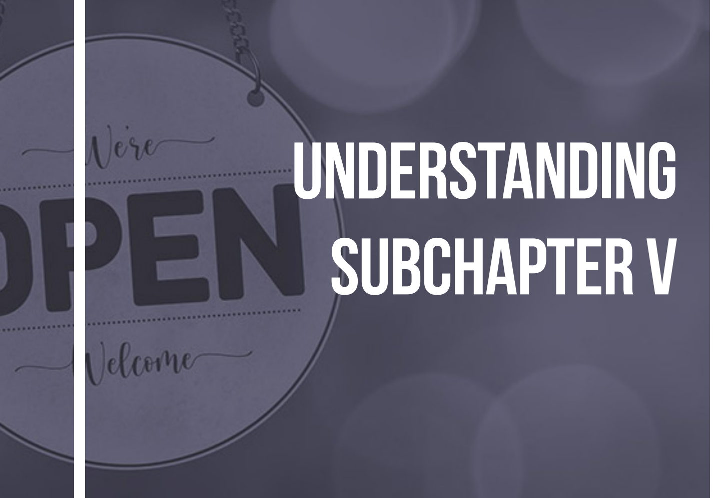


UNDERSTANDING SUBCHAPTER V

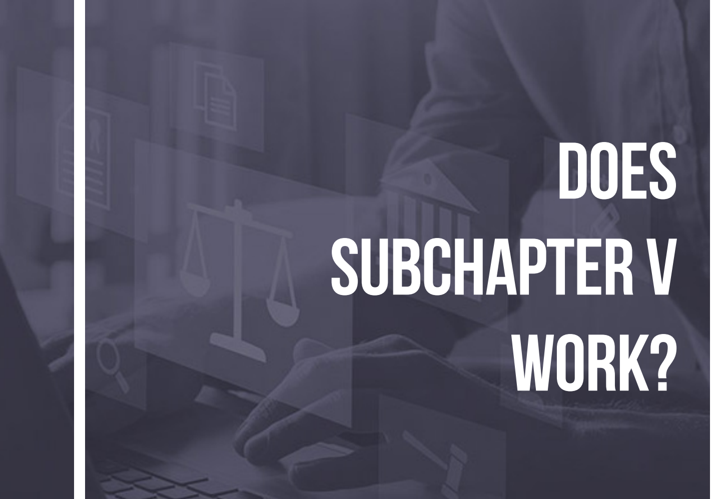
The SBRA did not repeal the previously existing small business debtor provisions of Chapter 11, but instead created an alternative process under Subchapter V that small business debtors may opt into through an election on the Chapter 11 petition.

What is a small business debtor? A small business debtor is one engaged in commercial or business activities that has aggregate non-insider, non-affiliate, non-contingent liquidated secured and unsecured debts, as of the date of the commencement of the bankruptcy, of no more than $3,024,725 (subject to increase for inflation every three years), with at least half of the debt arising from the commercial or business activities of the debtor.

In March 2020—shortly after Subchapter V's enactment—the maximum debt threshold was temporarily increased to $7.5 million, resulting in a tidal wave of Subchapter V filings over the first four years of its existence. Subchapter V filings have decreased significantly since the temporary debt threshold sunset and reverted to $3,024,725 on June 21, 2024. However, many bankruptcy professionals anticipate that Congress will eventually increase the debt threshold and make Subchapter V more prominent again.

The purpose of Subchapter V is to provide a Chapter 11 process that is more attractive and accessible for small businesses, since the requirements and costs associated with a "traditional" Chapter 11 make that process untenable for many small businesses. The Subchapter V process is intended to be more expedited, streamlined and cost-effective than a traditional Chapter 11 process.

Subchapter V also provides a path for equity holders to retain their interests without meeting the otherwise stringent requirements of doing so in a traditional Chapter 11, such as satisfying the absolute priority rule (e.g., paying all classes of claims in full or providing a "new value" contribution toward the Chapter 11 plan). Altogether, this makes for a bankruptcy process more appealing to small business owners.



DOES SUBCHAPTER V WORK?

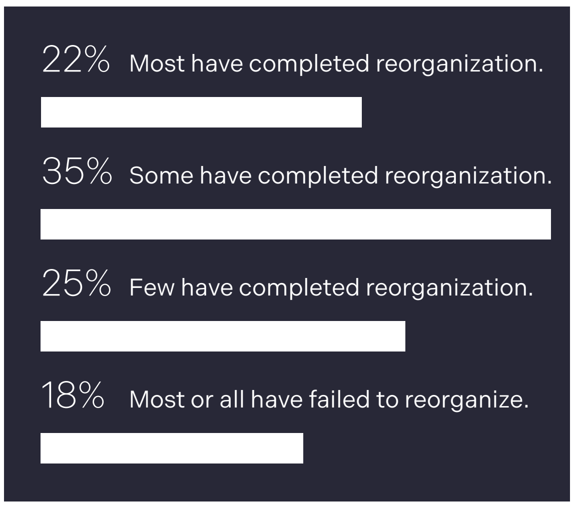
Trade creditors are the lifeblood of our economy, currently providing approximately $5.6 trillion in capital to businesses in the United States, most of which is extended on an unsecured basis. Prior to Subchapter V, many small businesses were resorting to state court receiverships, assignments for the benefit of creditors (ABC), UCC Article 9 sales or just going out of business because bankruptcy was too expensive, slow and not accommodating to small business owners. Subchapter V bankruptcy was an effort to get around those problems.

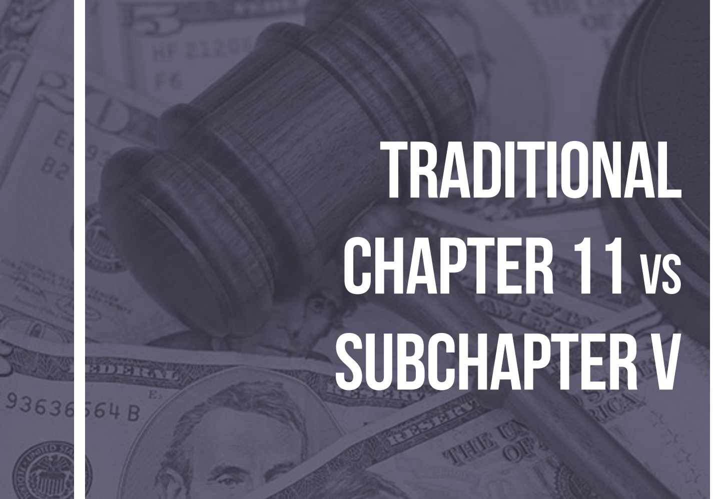
Subchapter V has been lauded by its proponents in the bankruptcy and restructuring industry as a massive success, since its streamlined and cost-cutting procedures have led to a significant amount of Subchapter V filings with plans being confirmed in most of them. Indeed, in 2023, 45% of all debtors that filed Chapter 11 cases used Subchapter V. Although there were only 171 small business filings in July 2024 (a 45% drop from June's record total of 308), that drop-off was due to the fact that fewer companies were eligible to file under Subchapter V after the maximum debt threshold dropped to $3,024,725 (and, despite the reversion of the debt threshold, Subchapter V filings were up 5% YoY in August 2024 vs. August 2023, and up 9% YoY in September 2024 vs. September 2023, per Epiq). Bankruptcy professionals have been lobbying Congress to increase the maximum debt threshold to $7.5 million again, in light of the apparent success of Subchapter V.

However, given the Subchapter V debtor may stretch payments of administrative expense claims and confirm a plan without any impaired consenting class (while equity holders retain their interests), it is unclear whether Subchapter V truly lends itself to a successful reorganization, as opposed to the debtor simply "kicking the can down the road." In other words, confirmation of a plan may not be the best barometer for "success" when evaluating Subchapter V cases; a better barometer would be the success of the plan itself—i.e., whether the debtor timely makes all its payments under the confirmed plan and the business survives thereafter.

According to an *eNews* poll, 22% of credit managers polled found that most small businesses that file under Subchapter V have successfully reorganized and 35% found that some have been successful. Conversely, 25% say that these filings have been minimally successful, and 18% found that most, if not all, have failed to reorganize.

HOW SUCCESSFUL HAVE SUBCHAPTER V REORGANIZATIONS BEEN FOR YOUR CUSTOMERS?





TRADITIONAL CHAPTER 11 VS SUBCHAPTER V

A primary concern of trade creditors is the inherent imbalance created by Subchapter V of the Bankruptcy Code. Subchapter V allows small businesses to avail themselves of substantially all of the benefits of (and in several instances, greater benefits than) a traditional Chapter 11 case through an extremely expedited process at a minimal cost to the debtor. However, the creditors who bear the burden of those benefits are left without the most significant protections of Chapter 11 and, to protect their interests, would have to incur the same, or even more, of the costs.

1. **Elimination of creditors' committee:** Unlike traditional Chapter 11, a creditors' committee is not automatically appointed in Subchapter V cases. This can save the debtor significant costs and reduce potential objections.
2. **Appointment of trustee:** A Subchapter V trustee oversees the case and monitors the debtor's progress, although they lack certain powers and economic incentives compared to a creditors' committee.
3. **No U.S. Trustee fees:** Subchapter V debtors are exempt from paying quarterly fees to the U.S. Trustee, resulting in significant savings.
4. **True exclusivity:** Only the debtor can file a plan in Subchapter V, unlike traditional Chapter 11 where non-debtors may file after 120 days.
5. **Expedited timeline:** Debtors must file a plan within 90 days of the petition date, speeding up the process.
6. **No disclosure statement required:** Subchapter V eliminates the need for a separate disclosure statement, streamlining the plan confirmation process.
7. **Less strict confirmation requirements:** Subchapter V allows for the confirmation of a nonconsensual plan without needing an impaired consenting class. A Subchapter V plan can be confirmed without adhering to the absolute priority rule with respect to general unsecured claims (as discussed below), if the plan is deemed "fair and equitable" and provides for the debtor's disposable income to be applied to payments over three to five years.
   - To be "fair and equitable," a Subchapter V plan must meet the following requirements: (1) the debtor will be able to make all payments under the plan; (2) there is a reasonable likelihood that the debtor will be able to make all payments under the plan; and (3) the plan provides appropriate remedies, which may include the liquidation of nonexempt assets, to protect the holders of claims or interests in the event that the payments are not made. (11 U.S.C. § 1191(c)(3)(A)-(B)(ii)).

- In addition, with respect to a class of secured claims, the plan must satisfy Section 1129(b)(2)(A), much like a traditional Chapter 11. (11 U.S.C. § 1191(c)(1)). However, with respect to non-priority general unsecured claims, the plan is "fair and equitable" so long as either: (1) all of the debtor's projected disposable income to be received in the three-year period (or up to five-year period, if the court directs) of the plan will be applied to make payments under the plan, or (2) the value of the property to be distributed under the plan during such period is not less than the debtor's projected disposable income. (11 U.S.C. § 1191(c)(2)(A)-(B)).
- This is a critical deviation from traditional Chapter 11, because it means that the absolute priority rule in traditional Chapter 11 is eliminated with respect to general unsecured creditors in Subchapter V cases—that is, equity holders may retain their interests under a confirmed Subchapter V plan, even if all classes of creditors are not paid in full and no new value is provided by the equity holder, so long as the debtor's projected disposable income is paid to creditors over the life of the plan.

8. **Payment plans:** In addition, Section 1191(e) of Subchapter V provides that administrative expenses and certain priority claims may be deferred and paid in installments during the term of the plan.
9. **No absolute priority rule benefiting general unsecured creditors:** The typical requirement in Chapter 11 bankruptcies, which mandates that general unsecured creditors must be fully paid before equity holders can maintain their equity, does not apply.
10. **Cramdown provision:** Subchapter V further specifies that a plan is "fair and equitable" if the debtor is providing all their "projected disposable income" (or its value) to fund plan payments over the three-to-five-year life of the plan.
11. **Non-dischargeability:** If a debt is deemed non-dischargeable, the debtor is still obligated to repay it, even after the bankruptcy process is completed. If a debtor company provided false financial information to secure credit, the creditor may have the power to block the discharge of that debt under bankruptcy.

IMPACT ON TRADE CREDITORS

Subchapter V places a larger burden on creditors to collect debt because it strips away certain elements of a traditional Chapter 11 that are beneficial to creditors. Here are just a few examples of how Subchapter V impacts B2B credit professionals:

1. **Elimination of creditors' committee:**
   Without a creditors' committee, credit professionals lose a platform for collective representation and influence over the reorganization process. The absence of a committee means less oversight, no investigation into prepetition liens or potential causes of action against insiders and third parties, and fewer objections to unfavorable terms in the reorganization plan—all of which may adversely affect creditors' recovery prospects.

2. **Appointment of trustee:**
   The appointment of a Subchapter V trustee introduces a neutral party responsible for overseeing the case and monitoring the debtor's progress towards a plan. However, because this trustee lacks many of the powers of a creditors' committee, unsecured trade creditors may find the trustee less aggressive in protecting creditors' interests.

3. **No U.S. Trustee fees:**
   The elimination of U.S. Trustee fees reduces the debtor's financial burden, potentially allowing more resources to be allocated toward paying creditors. While this may marginally increase the funds available for distribution, it also means that creditors cannot use the financial pressure of these fees as leverage during negotiations.

4. **True exclusivity:**
   This true exclusivity limits the ability of non-debtors (e.g., creditors) to propose alternative plans that might be more favorable to creditors. It also reduces the negotiating power of creditors, as they cannot threaten to file their own plan if they disagree with the debtor's proposal.

5. **Expedited timeline:**
   For credit professionals, this means less time to assess the debtor's financial situation, review the plan and prepare objections or negotiations. The expedited timeline can pressure creditors to make quick decisions, sometimes without sufficient information.

6. **No disclosure statement required:**
   Trade creditors may have less detailed information about the debtor's financial situation and the proposed reorganization plan, making it more challenging to evaluate the plan's impact on their claims. This can result in a higher risk of agreeing to terms that are not in their best interest.

7. **Less strict confirmation requirements (e.g., no requirement for an impaired consenting class):**
This lowers the bar for plan approval and reduces creditors' ability to block plans they find unfavorable. Trade creditors may face a higher likelihood of being bound by a plan that doesn't fully protect their interests, especially if they are unsecured creditors.

8. **Risk of stretching out administrative expense priority claims**:
The provision allowing administrative expenses and certain priority claims to be paid in installments over the term of the plan can delay trade creditors' recoveries on *post-petition* claims. Instead of receiving immediate payment on the effective date or in accordance with ordinary terms, creditors may have to wait three to five years, increasing the risk of non-payment and reducing cash flow. This deferred payment structure can be particularly challenging for businesses relying on timely payments to maintain their operations. Trade creditors have complained that Subchapter V debtors have failed to make all payments due under their confirmed plans, increasing the rate of failure.

9. **No absolute priority rule protecting general unsecured creditors:**
Unsecured trade creditors may find they have less leverage in negotiations, as the absence of the absolute priority rule means that their claims do not necessarily need to be fully satisfied before the owners of Subchapter V debtors can retain their equity interests.

10. **Cramdown provision (e.g., projected disposable income):**
The Subchapter V debtor's owner can retain the equity in the company without providing any contribution to the plan, so long as the Subchapter V debtor pays its projected disposable income over the life of the plan. Not only does this increase the risk of lower recoveries on account of trade creditors' unsecured claims, but it also raises a compelling question, what happens if the debtor's actual income over the life of the plan ultimately exceeds the amount projected at the time of confirmation; can the debtor be compelled to include a "true-up" provision in the plan that calls for the upward adjustment of plan payments accordingly? As discussed in the "case law" section below, different courts may have conflicting answers to this question.

11. **Nondischargeability:**
The ability to block the discharge of debts owed by non-individual Subchapter V debtors tied to various instances of debtor misconduct provides an essential safeguard for unsecured trade creditors, ensuring that they are not left without recourse if a debtor has engaged in wrongful conduct (see discussion in the "case law" section below).

RISK MITIGATION STRATEGIES

Credit professionals may be sitting on a ticking time bomb without even knowing it. In fact, as of 2023, 40% creditors did not know what percentage of their portfolio was made up of customers who qualify for Subchapter V bankruptcy, according to an *eNews* poll—and the 31% who do know the answer say 10% or more of their portfolio qualifies for Subchapter V.

Creditors must be aware of how many of their customers could file using this subchapter because it makes it much more difficult to collect debt. Trade creditors might even consider placing eligible customers in a higher risk category because there will be a lot more factors working against the creditor if the customer files. There is an additional layer of risk with Subchapter V that does not exist in the traditional Chapter 11 route, and debt recovery may not be as likely or timely.

From a creditor's perspective, the key is anticipating and mitigating risk immediately, especially when you know a customer is insolvent. Creditors should make sure to get alerts to customer red flags, such as a customer building up inventory after years of not buying much product.

Revisit your credit policy and credit agreements and try to secure collateral where possible using letters of credit, security deposits and secured interest. "Monitor your accounts receivable (AR) closely," said Mike Mandell, corporate collection manager at Ryder Truck Rental, Inc. (Miami, FL). "For a Subchapter V, I recommend people talk to the trustee. I would try to see who some of the other unsecured creditors are to band together to look at how you can get better oversight in the case . . . There, you can lobby to get some of the rules changed on Subchapter V because it has not gone well for unsecured creditors."

Trade creditors should roll up their sleeves instead of sitting back and relying on a Subchapter V trustee to vet the debtor's projections since, ultimately, the debtor's unsecured creditors will be adversely impacted by projections that provide for relatively minimal distributions. If the debtor's projected disposable income isn't properly vetted during the debtor's plan confirmation process, trade creditors may be stuck with receiving distributions on account of their claims that are far less than what the debtor may ultimately be able to provide—essentially putting the cost of the debtor's reorganization on creditors. As discussed below, case law is split as to whether a Subchapter V debtor can be compelled to include a "true up" provision in its plan that gives creditors the upside where the debtor's actual income exceeds the debtor's projections.

Nondischargeability is another risk mitigation strategy, referring to certain debts that cannot be eliminated through bankruptcy proceedings. For B2B credit professionals, this concept becomes especially relevant when dealing with customers who have provided false financial statements or other false information or engaged in fraudulent or abusive activities. Under Subchapter V, creditors may have the power to challenge the dischargeability of debts if they can prove that these debts were incurred through fraudulent means (as discussed further in the "case law" section below).

Credit professionals should conduct rigorous financial assessments of their customers before extending credit. By scrutinizing financial statements and verifying their accuracy, credit professionals can identify potential red flags early on. If a customer later files for Subchapter V and it's discovered that they provided false financial information, the creditor may challenge the dischargeability of the debt and retain the right to pursue full repayment.

"MONITOR YOUR ACCOUNTS RECEIVABLE CLOSELY. FOR A SUBCHAPTER V, I RECOMMEND PEOPLE TALK TO THE TRUSTEE. I WOULD TRY TO SEE WHO SOME OF THE OTHER UNSECURED CREDITORS ARE TO BAND TOGETHER TO LOOK AT HOW YOU CAN GET BETTER OVERSIGHT IN THE CASE . . . THERE, YOU CAN LOBBY TO GET SOME OF THE RULES CHANGED ON SUBCHAPTER V BECAUSE IT HAS NOT GONE WELL FOR UNSECURED CREDITORS."

—Mike Mandell

CASE STUDIES

NACM ADVOCACY

In early November 2023, several B2B credit professionals, representatives of the esteemed National Association of Credit Management (NACM) and attorneys from Lowenstein Sandler specializing in bankruptcy and creditors' rights recently convened with the American Bankruptcy Institute's (ABI) Subchapter V Task Force to exchange invaluable insights gleaned from their cumulative experiences in Subchapter V cases. These credit professionals played a pivotal role in creating this open dialogue, shedding light on important matters related to Subchapter V.

NACM members testified that with a $7.5 million debt ceiling, Subchapter V bankruptcies expanded to include medium-sized businesses rather than only small businesses. Some quotes from the trade creditor participants are provided below:

- "The Subchapter V plans that Ryder has been involved in have failed as the customer stops paying," Mandell said. "I have only seen one customer so far successfully complete their Subchapter V plan. Few of these cases have long-term success on the reorganization side, this is largely to be expected though. If you look at the success rate of Chapter 13 cases, it is similar. They confirm a plan and are not able to perform most of the time."
- Credit professionals testified that debtors should not be able to use Subchapter V to prolong the life of a company that cannot successfully reorganize. A primary concern of trade creditors is the inherent imbalance created by Subchapter V. Subchapter V allows small businesses to avail themselves of substantially all of the benefits of a traditional Chapter 11 case through an expedited process at a minimal cost to the debtor. However, the creditors who bear the burden of those benefits are left without the most significant protections of Chapter 11 and, to protect their interests, would have to incur the same costs. "The lack of disclosures and the reduction of available information for creditors in this subchapter is a major pain point," said Conrad Ragan, director of corporate credit risk at PepsiCo (Winston Salem, NC).
- "We do business with companies across all industries and sizes, so we have seen quite a few different types of bankruptcies, including many Subchapter V cases over the last few years," said Jeff Weber, director of credit at Uline (Pleasant Prairie, WI). "These claims can be made over three to five years, so it creates a burden for us to collect and ensure payments are being made."

> "I HAVE ONLY SEEN ONE CUSTOMER SO FAR SUCCESSFULLY COMPLETE THEIR SUBCHAPTER V PLAN. FEW OF THESE CASES HAVE LONG-TERM SUCCESS ON THE REORGANIZATION SIDE."
>
> —Mike Mandell

- For Marlene Groh, CCE, ICCE, regional credit manager for US LBM Holdings, LLC (Buffalo Grove, IL), only two customers have filed under Subchapter V. Of the two, one was eventually converted to a Chapter 7 liquidation, while the other has been successfully working its way through the Subchapter V plan for reorganization. The success of the filing hinged on securing critical vendor status and having an experienced trustee at the helm of the reorganization. “By obtaining critical vendor status, we were able to recover about a third of the debt owed in the critical vendor approval process,” Groh said.

> “THE LACK OF DISCLOSURES AND THE REDUCTION OF AVAILABLE INFORMATION FOR CREDITORS IN THIS SUBCHAPTER IS A MAJOR PAIN POINT.”
>
> —Conrad Ragan

CASE LAW

Recent court decisions highlight differing interpretations of Subchapter V requirements that are of particular interest to trade creditors:

True-up provisions: In January 2023, the Middle District of Florida in *In re Staples* ruled that a Subchapter V debtor may be compelled to include a “true-up” provision in it’s Subchapter V plan that requires distributions to creditors to be adjusted in the event the debtor’s actual income exceeds the income the debtor projected at the time the plan was confirmed. However, in April 2024, the Western District of Texas in *In re Packet Construction, LLC* disagreed, holding the debtor cannot be compelled to include such a provision in its plan.

Applicability of individual exceptions to discharge with respect to non-individual Subchapter V debtors: Courts are split as to whether the exceptions to discharge under § 523(a) of the Bankruptcy Code—which traditionally only applies to individual (i.e., non-corporate) debtors—may be asserted against corporate Subchapter V debtors. The U.S. Courts of Appeals for the Fourth and Fifth Circuits (which collectively cover the federal district and bankruptcy courts in Maryland, Virginia, West Virginia, North Carolina, South Carolina, Louisiana, Mississippi and Texas) have held that they can be, thereby giving creditors a significant edge where an exception may be applicable—e.g., where the debt at issue was incurred via fraud. However, other jurisdictions may rule otherwise; for example, the Ninth Circuit’s Bankruptcy Appellate Panel has held that the exceptions to discharge under § 523(a) apply only to individual debtors, even in Subchapter V.

> “BY OBTAINING CRITICAL VENDOR STATUS, WE WERE ABLE TO RECOVER ABOUT ONE THIRD OF THE DEBT OWED IN THE CRITICAL VENDOR APPROVAL PROCESS.”
>
> —Marlene Groh, CCE, ICCE

RECOMMENDATIONS/ CREDIT PROFESSIONALS RESPOND

Ensuring proper notice and enhancing recovery mechanisms can improve the efficiency and fairness of the Subchapter V bankruptcy process, benefiting both creditors and debtors. Creditors may be hesitant to extend credit to customers that are at risk of filing, or have filed, Subchapter V bankruptcy due to the potential risks and uncertainties discussed above. Below are proposals aimed to create a more transparent and equitable bankruptcy process that may lead to better outcomes for all parties involved:

1. **Enhanced notice mechanisms:**
   Free access to ECF/PACER for Subchapter V cases, automatic ECF notices to creditors and comprehensive explanations about the roles of Subchapter V Trustees and U.S. Trustees/Bankruptcy Administrators.
2. **Improved disclosures:**
   Debtors must provide detailed financial disclosures under oath, including the financial difficulties that led to the filing, a strategy to rehabilitate the business, historical cash flow for the three years before the filing.
3. **Increased creditor involvement:**
   Requiring an impaired class or unsecured creditor class to vote in favor of the plan and appointing an official committee of unsecured creditors for cases exceeding certain debt thresholds.
4. **Administrative claims:**
   Restricting the ability of debtors to defer payment of administrative claims, ensuring they are paid in full on the plan's effective date.
5. **Role of Subchapter V Trustee:**
   Enhancing the diligence and oversight responsibilities of the Subchapter V Trustee, including vetting plan projections, the power to investigate and pursue causes of action against third parties or challenge prepetition liens and monitoring debtor compliance post-confirmation.
6. **Enforcement mechanisms post-confirmation:**
   General unsecured creditors and the Subchapter V trustee should have the right to request changes to the confirmed plan if the Debtor's actual disposable income turns out to be much higher than expected.
7. **Discharge for corporate Subchapter V debtors:**
   The current rules for discharging claims against corporate entities under Subchapter V should remain unchanged.

WHAT'S NEXT

These changes could lead to a more balanced approach to resolving financial distress, ensuring that everyone's interests are considered and that the process is more just and predictable.

- The $7,500,000 limit expired on June 21, 2024 and the debt limit under Subchapter V is currently reduced to $3,024,725. It's always possible that Congress revisits the debt limit in the future given the popularity of Subchapter V among debtors and bankruptcy professionals.
- It is critical for creditors to remember that even though their claims or prospects of a meaningful recovery in Subchapter V cases may often seem minimal compared to many traditional Chapter 11 cases, the Subchapter V debtor may still achieve virtually all of the same objectives with all of the same advantages as in a traditional Chapter 11, with creditors being bound by the terms of any confirmed plan just the same. Therefore, if feasible, creditors should closely monitor Subchapter V cases in which they have claims or are otherwise involved and protect their interests where necessary.

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PACE LLP was founded in 1991 when two individuals, a Democrat and a Republican, decided to collaborate on a joint project. They shared a common goal—the best possible representation for their client, and their different ideologies served to strengthen and expand the possibilities for that client. What evolved was a commitment to offering a service of the highest integrity. This drive for the highest ideals of professionalism has succeeded: while the breadth of issues and the reach of the firm's principals and associates have expanded in the last two decades, that first client for the two partners is still represented by the firm today.

Business CREDIT
JULY/AUGUST 2024

A BIG WIN FOR CREDITORS OF SMALL BUSINESS DEBTORS

Another US Circuit Court Holds Exceptions to Discharge Apply to Corporate Subchapter V Debtors

SINCE ITS ENACTMENT IN FEBRUARY 2020, SUBCHAPTER V OF CHAPTER 11 HAS BECOME A USEFUL VEHICLE FOR SMALL BUSINESSES THAT ARE LOOKING TO REORGANIZE OR OTHERWISE ADDRESS OPERATIONAL ISSUES, LIQUIDITY ISSUES, OR EXCESSIVE DEBT THROUGH INSOLVENCY PROCEEDINGS. CONGRESS ENACTED SUBCHAPTER V TO MAKE CHAPTER 11 MORE APPEALING FOR SMALL BUSINESSES THAT WERE PREVIOUSLY DETERRED FROM FILING DUE TO THE COSTS AND RISKS ASSOCIATED WITH THE "TRADITIONAL" CHAPTER 11 PROCESS. SUBCHAPTER V HAS BEEN A HIT AMONG ELIGIBLE DEBTORS: IN 2023, NEARLY HALF OF ALL CHAPTER 11 FILINGS WERE UNDER SUBCHAPTER V.

Why has Subchapter V been so well received by small business debtors? Well, because it provides a less expensive and more streamlined version of the traditional Chapter 11 process, yet gives debtors the ability to reap largely the same benefits of a traditional Chapter 11. So, it is no wonder that small business debtors have embraced Subchapter V. But everything comes at a cost, and in Subchapter V, unsecured creditor swept into a streamlined Chapter 11 process have borne that cost.

In a huge win for creditors that helps balance Subchapter V's pro-debtor provisions, the U.S. Court of Appeals for the Fifth Circuit has recently held that the Bankruptcy Code's exceptions to discharge apply where a nonconsensual plan is pursued by a corporate Subchapter V debtor (even though the exceptions do not apply to corporate debtors in "traditional" Chapter 11 cases). In doing so, the Fifth Circuit joined the only other Circuit-level court to address the issue, the Fourth Circuit, bucking what appeared to be a growing trend among lower courts that have held the exceptions to discharge do not apply to corporate Subchapter V debtors.

There may be an impending drop-off in Subchapter V filings because the debt limit for filing Subchapter V bankruptcy reverted to approximately $3 million on Friday, June 21, 2024 (a significant decrease from the temporary $7.5 million limit set in 2020 due to the financial distress caused by the pandemic). However, the possibility always exists that Congress will revisit the debt limit in the future given the popularity of Subchapter V among debtors and bankruptcy professionals.

In any event, creditors should remain mindful of the various advantages that Subchapter V provides to debtors. For example, in Subchapter V: (i) the debtor maintains the exclusive right to file a plan, (ii) the debtor may extend payment of administrative expense claims (e.g., claims for goods sold on credit during the bankruptcy case) over the 3-5 year life of the plan, and (iii) the absolute priority rule is abrogated in that equity holders may retain their equity interests in the debtor even if unsecured creditors are not paid in full so long as the debtor contributes its "projected disposable income" to fund plan distributions over the life of the plan. While the exceptions to discharge apply only with respect to certain, limited categories of debts, the advantages for a Subchapter V debtor will have an impact on the overwhelming majority (if not all) Subchapter V cases. Therefore, it is critical that creditors monitor and vigorously protect their interests in Subchapter V cases just as they would in a traditional Chapter 11.

KEY POINTS

- **Subchapter V offers a** less expensive and more streamlined version of the traditional Chapter 11 process.
- **Subchapter V has been a** massive hit among debtors, with nearly half of all Chapter 11 filings in 2023 being under this provision.
- **While Subchapter V offers** significant advantages to debtors—such as the exclusive right to file a plan, the lack of an official committee of unsecured creditors, the ability to defer payment of administrative expense claims over the life of the plan, and the ability to retain equity Interests even if unsecured creditors are not paid in full—these benefits come at a cost to the unsecured creditors who are swept into the streamlined process.
- **In a crucial win for creditors** that helps balance some of the above costs, the U.S. Court of Appeals for the Fifth Circuit ruled that the Bankruptcy Code's exceptions to the discharge of certain debts apply to corporate Subchapter V debtors pursuing a nonconsensual plan.

THE SPLIT REGARDING SECTION 523(A)'S EXCEPTIONS TO DISCHARGE

Section 523(a) of the Bankruptcy Code lists numerous types of debt that may be excepted from the discharge granted to a debtor in bankruptcy. Section 523(a) states that a discharge under Chapter 7, Chapter 11, Subchapter V, Chapter 12, and Chapter 13 of the Bankruptcy Code "does not discharge **an individual debtor** from any debt" for, among other things, debts that arise from a fraud, misrepresentation, materially false financial statements, defalcation in a fiduciary capacity, embezzlement, or a willful and malicious injury by the debtor. Section 523(a) specifically states that its exceptions to discharge apply to an "individual debtor" and the Chapter 11 provision that incorporates Section 523(a) into Chapter 11 cases (Section 1141(d)) does the same. As a result, corporate Chapter 11 debtors are usually not subject to Section 523(a)'s exceptions to discharge in traditional Chapter 11 cases.

CONGRESS ENACTED SUBCHAPTER V TO MAKE CHAPTER 11 MORE APPEALING FOR SMALL BUSINESSES THAT WERE PREVIOUSLY DETERRED FROM FILING DUE TO THE COSTS AND RISKS ASSOCIATED WITH THE "TRADITIONAL" CHAPTER 11 PROCESS.

Courts are split as to whether Section 523(a) applies to corporate debtors in small business Subchapter V cases. Although Section 523(a) specifically states that its exceptions only apply to "individual" debtors, Subchapter V's discharge provision, Section 1192, does not draw any distinction between individual and corporate debtors. Rather, Section 1192 states that where a nonconsensual plan is confirmed, "a debtor" is not entitled to a discharge of any debt "of the kind" specified in Section 523(a). In light of this, the U.S. Court of Appeals for the Fourth Circuit issued a decision in June 2022, in *Cantwell-Cleary Co., Inc. v. Cleary Packaging, LLC*, holding that Section 523(a)'s exceptions to discharge apply to individual and corporate debtors. The Fourth Circuit relied on Section 1192's broader language, further noting that Section 1192 is phrased virtually the same as Chapter 12's discharge provision, which has been interpreted to apply Section 523(a)'s exceptions to discharge to both corporate and individual debtors. The Fourth Circuit also reasoned that Congress had intended Subchapter V's small business provisions to generally apply to qualifying individual and corporate debtors alike, and Congress' intent would be frustrated if the discharge exceptions applied to one but not the other.

However, several courts, including in the Ninth Circuit, Michigan, Idaho and Maryland, have held the opposite—that the exceptions to discharge only apply to individual debtors, even in the Subchapter V context. For example, in its July 2023 decision in *Lafferty v. Off-Spec Solutions, LLC*, the Ninth Circuit Bankruptcy Appellate Panel (BAP) rejected the Fourth Circuit's ruling and held that Section 523(a)'s exceptions to discharge do not apply to corporate Subchapter V debtors. The Ninth Circuit BAP noted that while Section 1192 is silent on the types of debtors that are subject to Section 523(a), it says nothing to contradict that Section 523(a) is limited to individual debtors. In fact, when Congress amended Section 523(a) to include Section 1192 among the various discharge provisions to which Section 523(a)'s exceptions apply, Congress did not amend Section 523(a)'s limitation to individual debtors. The Ninth Circuit BAP concluded that Section 1192 should not be read as expanding Section 523(a)'s applicability to corporate debtors. As the Ninth Circuit BAP noted, limiting Section 523(a) to individual debtors is more consistent with the overall statutory scheme of Chapter 11.

In a win for creditors, the Fifth Circuit's decision in *GFS Industries* helps swing the tide in creditors' favor in Subchapter V cases, as it provides another Circuit court opinion that sides with the Fourth Circuit's holding that the exceptions to discharge apply to corporate debtors (where a nonconsensual plan is confirmed). [1]

BACKGROUND REGARDING THE *GFS INDUSTRIES* CASE

In April 2022, GFS Industries entered into a financing agreement with Avion Funding pursuant to which Avion Funding provided $190,000 to GFS in exchange for approximately $300,000 of GFS's future receivables. As part of the agreement, GFS represented that it had not filed and did not anticipate filing any Chapter 11 bankruptcy petition. Despite that representation, GFS filed a Subchapter V bankruptcy petition on Apr. 21, 2022—two weeks after entering into its agreement with Avion.

On July 25, 2022, Avion filed an adversary complaint against GFS seeking a declaration that the debt GFS owed Avion was nondischargeable under Section 523(a) because it arose from misrepresentations made by GFS. In response, GFS argued that Section 523(a) is inapplicable to corporate Subchapter V debtors. The bankruptcy court ruled in favor of GFS based on other court rulings that the discharge exceptions apply only to individual Subchapter V debtors. Avion appealed the decision directly to the U.S. Court of Appeals for the Fifth Circuit.

THE FIFTH CIRCUIT'S DECISION

The Fifth Circuit overruled the bankruptcy court, holding that Section 523(a)'s exceptions to discharge also apply to corporate debtors in Subchapter V cases with nonconsensual plans.[2] In so doing, the Court addressed a few key points:

- **Placing controlling weight on the word "individual" in Section 523(a) disregards Section 1192's plain language.** The Fifth Circuit noted Section 1192 governs the debts of any debtor without making any distinction between corporate and individual debtors. Also, Section

1192 excepts from discharge any debt "*of the kind* specified in [S]ection 523(a)." As the Fourth Circuit stated in *Cleary Packaging*, "[T]he combination of the terms 'debt' and 'of the kind' indicates that Congress intended to reference only the *list of nondischargeable debts* found in [Section] 523(a)." And, since Section 1192 is the more specific provision (in that it relates specifically to Subchapter V while Section 523(a) covers multiple Chapters), any ambiguity should be resolved in favor of Section 1192's language.

- **Section 523(a)'s usage of the word "individual" may be disregarded in Subchapter V cases, even though Congress left the word in the statute as is.** The Fifth Circuit disagreed with the Ninth Circuit BAP's view that courts should rely on Congress's failure to address (i.e., remove) the word individual when adding Section 1192 to the list of statutes impacted under Section 523(a). As the Fifth Circuit explained, Congress added the reference to Section 1192 via a "conforming amendment" and it would have been a significant task to heavily revise Section 523(a) to avoid any confusion with the broader impact of Section 1192. The Fifth Circuit noted that Chapter 11's relevant provision (Section 1141(d)) specifically states that a Chapter 11 discharge does not discharge a corporate debtor from certain kinds of debts in Section 523(a); if it were a given that Section 523(a) only applies to individuals across all chapters of the Bankruptcy Code, it would have been unnecessary for Section 1141 to clarify that point further in its own provisions.
- **Chapter 12's discharge provision is virtually identical to Section 1192 and has been interpreted to apply Section 523(a)'s discharge exceptions to corporate debtors.** The Fifth Circuit agreed with the Fourth Circuit that Section 1192 should be construed the same as Section 1228, which is generally interpreted as applying the exceptions to discharge to both corporate and individual Chapter 12 debtors.
- **Applying the exceptions to discharge to corporate debtors is consistent with the intent behind Subchapter V.** Critically, the Fifth Circuit viewed its interpretation as upholding an important compromise made in exchange for benefits given to a Subchapter V debtor over a traditional Chapter 11 debtor. Subject to certain limited exceptions, a nonconsensual plan cannot be confirmed in a traditional Chapter 11 case unless the plan complies with the "absolute priority rule"—i.e., each class of creditors is paid in full before any junior class receives a distribution. As a result, equity holders cannot retain their interests unless unsecured creditors are paid in full (subject to certain exceptions), which is a huge deterrent for small business owners.

Congress eliminated this deterrent in Subchapter V through Subchapter V's abrogation of the absolute priority rule in the context of nonconsensual plans. Equity holders may retain their interests, even if unsecured creditors are not paid in full, so long as the debtor's projected disposable income is paid to creditors over the three-to-five year life of a plan. The compromise? According to the Fifth Circuit, it is to subject corporate Subchapter V debtors with nonconsensual plans to Section 523(a)'s exceptions to discharge. BC

1. Notably, less than a month after issuance of the GFS Industries *opinion, a bankruptcy court in Oregon, in* Ivanov v. Van's Aircraft*, followed the Fourth and Fifth Circuits' rulings that the exceptions to discharge apply to corporate Subchapter V debtors. This further solidifies this creditor-friendly view on the issue, particularly since Oregon is within the Ninth Circuit and still did not follow the Ninth Circuit BAP's prior ruling.*

2. Subchapter V debtors with consensual plans are subject to Section 1141(d), where Section 523(a)'s exceptions to discharge apply only to individual debtors.

IT IS CRITICAL THAT CREDITORS **MONITOR AND VIGOROUSLY PROTECT THEIR INTERESTS IN SUBCHAPTER V CASES** JUST AS THEY WOULD IN A TRADITIONAL CHAPTER 11.

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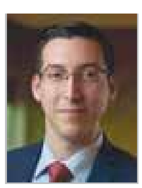

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BANKRUPTCY

SUBCHAPTER V CRAMDOWN PLAN PAYMENTS:

True-Up to Actual Disposable Income or Stay True to Projected Disposable Income?

SUBCHAPTER V OF CHAPTER 11 HAS BEEN VERY POPULAR AMONG SMALL BUSINESS OWNERS THAT NEED TO REORGANIZE OR LIQUIDATE THEIR BUSINESS THROUGH BANKRUPTCY. SUBCHAPTER V BECAME EFFECTIVE IN FEBRUARY 2020 WITH THE CLEAR PURPOSE OF MAKING CHAPTER 11 A MORE VIABLE OPTION FOR SMALL BUSINESS OWNERS. SUBCHAPTER V IS MORE STREAMLINED AND LESS EXPENSIVE THAN THE TRADITIONAL CHAPTER 11 PROCESS, YET GIVES DEBTORS VIRTUALLY ALL OF THE SAME BENEFITS OF A TRADITIONAL CHAPTER 11 CASE—AND THEN SOME.

KEY POINTS

- **Cramdown Advantage:** Allows plan confirmation without all creditors' consent if it's "fair and equitable."
- **Income Use**: Requires using all projected disposable income for plan payments, allowing owners to retain equity.
- **True-Up Provision**: Courts are split on requiring income adjustment if actual income exceeds projections.
- **Creditor Vigilance**: Creditors must vet income projections to avoid minimal distributions and potential losses.

One of the most significant advantages of Subchapter V is found in its "cramdown" provision. Cramdown is the process by which a debtor confirms a Chapter 11 plan when the debtor does not have the consent of all impaired classes of creditors that are eligible to vote on the plan. In both traditional Chapter 11 and Subchapter V cases, cramdown requires that the plan does not "discriminate unfairly" and is "fair and equitable" with respect to each non-consenting, impaired class of claims. However, unlike traditional Chapter 11, Subchapter V further specifies that a plan is "fair and equitable" if the debtor is providing all of its "projected disposable income" (or its value) to fund plan payments over the three-to-five-year life of the plan. Regardless of whether such payments pay unsecured creditors in full, the debtor's owner can retain the equity in the company without providing any contribution to the plan. This is a significant deviation from the "absolute priority rule" in traditional Chapter 11 cases, which generally requires the full payment of all claims before owners can retain equity interests, and makes reorganizing in bankruptcy a much more viable option for small business owners.

So, then, what happens if the debtor's actual income over the life of the plan ultimately exceeds the amount projected at the time of confirmation? Can the debtor be compelled to include a "true-up" provision in the plan that calls for the upward adjustment of plan payments accordingly? The case law on this issue is sparse, with courts having reached conflicting holdings. In January 2023, the United States District Court for the Middle District of Florida held, in *In re Staples*, that the court may require a Subchapter V plan to include a true-up provision under which creditors would be entitled to any upside in the event that the debtor's actual disposable income exceeds its projected disposable income. However, in its decision in *In re Packet Construction, LLC* in April 2024, the United States Bankruptcy Court for the Western District of Texas declined to follow *Staples*, and instead held that Subchapter V does not require the inclusion of a true-up provision in the plan.

Trade creditors should roll up their sleeves and not sit back and rely on a Subchapter V trustee to vet the debtor's projections since, ultimately, the debtor's unsecured creditors will be adversely impacted by projections that provide for relatively minimal distributions. If the debtor's projected disposable income isn't properly vetted during the debtor's plan confirmation process, trade creditors may be stuck with receiving distributions on account of their claims that are far less than what the debtor may ultimately be able to provide—essentially putting the cost of the debtor's reorganization on creditors. As shown by the *Packet Construction* ruling, trade creditors may never get a second bite at the "projected disposable income" apple.

Read on for a deeper dive!

CRAMDOWN IS THE PROCESS BY WHICH **A DEBTOR CONFIRMS A CHAPTER 11 PLAN WHEN THE DEBTOR DOES NOT HAVE THE CONSENT OF ALL IMPAIRED CLASSES OF CREDITORS** THAT ARE ELIGIBLE TO VOTE ON THE PLAN.

RELEVANT BACKGROUND ON THE SUBCHAPTER V "CRAMDOWN" REQUIREMENTS

The issue of whether a court can require a plan to include a true-up provision arises only in Subchapter V cases where the debtor is confirming a plan via "cramdown"—i.e., where the proposed plan is non-consensual because at least one voting class of creditors has not accepted the plan. One of the requirements for cramming down a non-consensual Subchapter V plan is that the plan must be "fair and equitable" with respect to each class of claims that is impaired and has not accepted the plan. Subchapter V specifically states that to be fair and equitable:

- The plan must provide that all of the debtor's projected disposable income over the three-to-five-year life of the plan will be used to make payments to creditors under the plan, or, alternatively, the value of the property to be distributed under the plan over such three-to-five-year period must not be less than the debtor's projected disposable income;
- The debtor must be able to make all plan payments; and
- The plan must provide appropriate remedies to protect claimants and interest holders in the event that plan payments are not made.

With respect to the projected disposable income requirement, the term "disposable income" means income that "is not reasonably necessary to be expended" for: (a) "the maintenance or support of the debtor or a dependent of the debtor", (b) a domestic support obligation that arose after the bankruptcy filing, or (c) "the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor."

THE STAPLES AND PACKET CONSTRUCTION DECISIONS

The *Staples* and *Packet Construction* holdings addressed the question of whether the court can require increased payments under a Subchapter V plan if the debtor's actual disposable income exceeds the projected disposable income determined when the plan was confirmed. Specifically, in *Staples*, the debtor appealed the bankruptcy court's confirmation order because it included a paragraph stating that the distributions to unsecured creditors "shall fluctuate based upon the Debtor's actual disposable income" based on quarterly post-confirmation reports to be filed before the 21st day of each month, but in no event will distributions be less than the disposable income projected at confirmation. In *Packet Construction*, the Subchapter V trustee objected to confirmation of the debtor's proposed plan because the plan did not provide for any upward adjustment in plan payments if the projected disposable income ultimately proved too pessimistic. The ability to require an upward adjustment to plan payments based on the debtor's actual disposable income was at issue in both cases—but the similarity ends there.

In *Staples*, the Florida district court held that the bankruptcy court can require a true-up and increased distributions based on the actual disposable income the debtor earned over the life of the plan. The court relied on the All Writs Act, which provides "The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law." The court also relied on section 105(a) of the Bankruptcy Code, which grants the court authority to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]."

The *Packet Construction* court held the opposite—that a Subchapter V debtor cannot be required to "true up" its payments to its creditors under a confirmed plan when its actual disposable income exceeds its projected disposable income. The court rejected the *Staples* ruling since the *Staples* court did not set forth any specific authority that would support the imposition of a true-up in Subchapter V.

The *Packet Construction* court analyzed Subchapter V's projected disposable income requirement by comparing and contrasting Subchapter V's provision with similar provisions of Chapter 12 (covering family farmers and fishermen) and Chapter 13 (covering an individual debtor's restructuring). The court noted:

Generally speaking, the term "projected" means "[e]stimated or forecast on the basis of current trends or date." The court concluded this meaning is consistent with the "forward-looking approach" that the United States Supreme Court endorsed when it interpreted "projected disposable income" in the Chapter 13 case of *Hamilton v. Lanning* (2010). Requiring a true-up based on actual disposable income would eliminate the forward-looking element of the term "projected" and effectively read the word "projected" out of the statute.

The decision historically relied on for requiring a true-up in Chapter 12 cases—an opinion issued in 1994 by the United States Court of Appeals for the Eighth Circuit, in *Rowley v. Yarnall*—rests on an "unsteady foundation." In that case, the Eighth Circuit held that while requiring a true-up conflicts with the

TRADE CREDITORS SHOULD ROLL UP THEIR SLEEVES AND NOT SIT BACK AND RELY ON A SUBCHAPTER V TRUSTEE TO VET THE DEBTOR'S PROJECTIONS SINCE, ULTIMATELY, **THE DEBTOR'S UNSECURED CREDITORS WILL BE ADVERSELY IMPACTED BY PROJECTIONS THAT PROVIDE FOR RELATIVELY MINIMAL DISTRIBUTIONS**.

plain language of the statute, doing so is appropriate because, otherwise, debtors could simply propose a plan that projects no disposable income. The *Packet Construction* court rejected this argument, stating that the prospective assessment of projected disposable income provides a meaningful check on the bankruptcy process since a court can deny confirmation of a plan when projected disposable income is not well supported. The *Packet Construction* court also noted, as other courts have, that the *Rowley* decision contradicts the Supreme Court's and other courts' holdings in the Chapter 13 context.

Moreover, the *Packet Construction* court noted that after the *Rowley* decision was issued, Chapter 12 was amended to include the requirement that is also in Subchapter V's cramdown provisions—that projected disposable income *or the value of it* must be provided to fund plan payments. By adding the alternative option of providing "value" based on projected disposable income, rather than just requiring payment of the projected disposable income itself on an ongoing basis, the Bankruptcy Code gives debtors the option of making a lump sum payment of projected disposable income. In such a scenario, the debtor's actual disposable income is entirely irrelevant in determining plan payments.

The *Packet Construction* court also observed that, in Subchapter V, only the debtor may seek to modify the plan post-confirmation. This is a clear deviation from Chapters 12 and 13 where unsecured creditors may seek to modify the confirmed plan for higher or lower plan payments. This suggests that projected disposable income is intended to be the "ceiling" in Subchapter V.

The *Packet Construction* court further noted that the determination of projected disposable income as part of the process of confirming a non-consensual Subchapter V plan via cramdown should be based on objective evidence. In light of this, the court concluded with the following suggestion directed toward creditors in Subchapter V cases:

> "Vigilant creditors can and should evaluate and, if necessary, challenge projections before plans are confirmed. But construed properly, this aspect of subchapter V also provides incentive for debtors to exceed projections, because they get to keep the surplus. Perhaps Congress structured the statute this way precisely to induce small business growth and to provide yet another incentive for parties to bargain on consensual plans."[1] BC

1. The Packet Construction *court noted that it was not ruling out the possibility that a true-up may be an appropriate means of ensuring a plan is "fair and equitable" under certain circumstances. However, the court held there is certainly no general rule that would require a true-up, and did not find sufficient circumstances existed for imposing one in its case.*

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BANKRUPTCY

SUBCHAPTER V TRUSTEE'S LIMITED POWERS

Do Not Fill Void Arising From Absence of Creditors' Committee

Business CREDIT
FEBRUARY 2025

SINCE ITS ENACTMENT IN FEBRUARY 2020, SUBCHAPTER V OF CHAPTER 11 HAS BECOME A POPULAR VEHICLE FOR ELIGIBLE SMALL BUSINESSES THAT ARE LOOKING TO REORGANIZE OR OTHERWISE ADDRESS OPERATIONAL ISSUES, LIQUIDITY ISSUES AND EXCESSIVE DEBT. CONGRESS ENACTED SUBCHAPTER V TO MAKE CHAPTER 11 MORE APPEALING FOR SMALL BUSINESSES THAT WERE PREVIOUSLY DETERRED FROM FILING CHAPTER 11 DUE TO ITS COSTS AND RISKS. SUBCHAPTER V PROVIDES A LESS EXPENSIVE AND MORE STREAMLINED PROCESS YET GIVES DEBTORS THE ABILITY TO REAP LARGELY THE SAME BENEFITS AS CHAPTER 11.

From a trade creditor's perspective, perhaps the biggest difference between Subchapter V and the pre-existing Chapter 11 process is that no official committee of unsecured creditors is appointed in a Subchapter V case. A creditors' committee plays a critical role as a fiduciary for all the debtor's unsecured creditors. Among other things, a committee is empowered to investigate and potentially commence litigation to challenge the security interests of a debtor's prepetition lenders and prosecute prepetition causes of action that a debtor may have against third parties, including the debtor's lenders and insiders (e.g., owners, affiliates, spouses and directors and officers). A committee can leverage these powers through negotiations or litigation to potentially increase distributions for unsecured creditors. And the best part? The fees and expenses a committee incurs in fulfilling its duties are paid by the debtor's estate!

Subchapter V does away with the creditors' committee, instead relying on a Subchapter V trustee to serve as a check against the debtor and its secured lender and insiders. However, it is questionable whether a Subchapter V trustee can truly fill the void left by the absence of a creditors' committee, particularly in light of the limited scope of a Subchapter V trustee's powers. A Subchapter V trustee is not automatically bestowed with the power to investigate causes of action and, in *In re Ghatanfard*, the U.S. District Court for the Southern District of New York held the bankruptcy court cannot grant a Subchapter V trustee the power to prosecute estate causes of action. This removes a significant protection for unsecured creditors and makes it less likely that a Subchapter V plan will achieve optimal outcomes for unsecured creditors—especially if the creditors in the case don't roll up their sleeves and protect their own interests!

THE SUBCHAPTER V TRUSTEE

Section 1183 of the Bankruptcy Code provides for the appointment of a standing trustee—i.e., the Subchapter V trustee—in any case filed under Subchapter V of Chapter 11. Section 1183 sets forth the duties and powers of the Subchapter V trustee. Among other things, a Subchapter V trustee shall:

- Facilitate the development of a consensual plan;
- Ensure the debtor commences timely payments under the plan;
- Perform certain duties that a Chapter 7 trustee would have, such as examining proofs of claim, opposing the debtor's discharge and making a final report and accounting of the administration of the debtor's bankruptcy estate; and
- Appear and be heard at any hearing concerning (i) the value of property subject to a lien, (ii) confirmation of the plan, (iii) modification of the plan or (iv) the sale of property of the debtor's bankruptcy estate.

SUBCHAPTER V DOES AWAY WITH THE CREDITORS' COMMITTEE, INSTEAD **RELYING ON A SUBCHAPTER V TRUSTEE TO SERVE AS A CHECK AGAINST THE DEBTOR AND ITS SECURED LENDER AND INSIDERS.**

THE *GHATANFARD* DECISION STATES THAT **A SUBCHAPTER V TRUSTEE CANNOT BE ENLISTED TO PURSUE AVOIDANCE ACTIONS**—SUCH AS PREFERENCES—AGAINST TRADE CREDITORS.

Section 1183 also states that the court may grant a Subchapter V trustee additional powers that are held by a debtor-in-possession (or Chapter 11 trustee, if appointed) in a Chapter 11 case. One of these additional powers is the power to "investigate the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business and any other matter relevant to the case or to the formulation of a plan." However, these additional powers may only be granted by the bankruptcy court, "for cause." And, conspicuously, the enumerated powers do not include the ability to commence a lawsuit to recover an estate cause of action.

RELEVANT BACKGROUND REGARDING THE *GHATANFARD* DECISION

The Debtor, Davoud Ghatanfard, was a restauranteur who had owned and operated several restaurants. On June 22, 2022, the lead plaintiff, in a class action brought on behalf of former employees of the Debtor's businesses obtained an approximately $5 million judgment against the Debtor and commercial entities that operated the Debtor's restaurants. Throughout their post-judgment collection efforts, the class members discovered that the Debtor had rendered himself insolvent through various transfers to the Debtor's "lifetime partner." The class members alleged these transfers were fraudulent conveyances valued at approximately $6.7 million. On July 5, 2023, the U.S. District Court for the Southern District of New York issued an order temporarily restraining transfers of funds or assets by the lifetime partner outside of the ordinary course. The District Court thereafter extended the terms of the temporary restraining order, in light of "the suspicious nature of the activity between Debtor and [his lifetime partner], including that Debtor still lived in the Southampton property and enjoyed the funds he transferred to [his partner] by using her credit card for personal expenses."

On Nov. 13, 2023, the Debtor commenced a Subchapter V bankruptcy case with approximately $50,000 in assets and $6 million in liabilities (including the approximately $5 million judgment in favor of the class members—who were the Debtor's most significant unsecured creditors). The Debtor proposed a Subchapter V plan under which distributions to creditors would be funded by $1,700 in monthly payments by the Debtor and $500,000 from the Debtor's partner.

The lead plaintiff, on behalf of the class member creditors, opposed confirmation of the plan and filed a motion to convert the Subchapter V case to a liquidating case under Chapter 7, arguing that the Debtor was acting in bad faith in proposing a plan based on settling the approximately $6.7 million in fraudulent transfer claims against his partner—an "insider" as defined by the Bankruptcy Code—for merely $500,000. In response, the Debtor sought to authorize the Subchapter V trustee to pursue the fraudulent transfer claims on the Debtor's behalf to address the apparent conflict of interest in the Debtor's pursuit of such claims. The lead plaintiff opposed this request, contending that that there is no basis under the Bankruptcy Code or existing case law for giving a Subchapter V trustee the authority to pursue avoidance actions against third parties. The Subchapter V trustee supported the lead plaintiff's request stating that, based on his research, the trustee's duties could only be expanded to include investigative powers and reporting to the court—not the power to prosecute claims or administer assets.

The bankruptcy court agreed, holding that it lacked authority to authorize the Subchapter V trustee to commence litigation to recover on the fraudulent transfer claims absent the consent of the parties. The bankruptcy court further concluded that expanding the trustee's powers just to allow an investigation and report, as allowed under section 1183, would be a half-measure and cause needless delay. In light of this, the Bankruptcy Court decided to convert the case to Chapter 7 so a Chapter 7 trustee may investigate and pursue the claims. The Debtor appealed the decision to the U.S. District Court for the Southern District of New York.

THE DISTRICT COURTS'S DECISION

The District Court affirmed the Bankruptcy Court's decision to convert the case to Chapter 7. That included affirming the Bankruptcy Court's holding that the court lacked authority to permit the Subchapter V trustee to prosecute the estate's fraudulent transfer claims.

The District Court explained that the Debtor had failed to cite any case law supporting his position that a Subchapter V trustee has the power to commence litigation to recover on estate causes of action. For example, in *In re Corinthian Communications*, the U.S. Bankruptcy Court for the Southern District of New York expanded the powers of a Subchapter V trustee, but only to investigate the affairs of the debtor and report to the bankruptcy court as permitted by the Bankruptcy Code section 1183.

The District Court was also influenced by a previous decision by the U.S. Bankruptcy Court for the Southern District of Texas in *In re Turkey Leg Hut & Co. LLC*. In that case, a Subchapter V trustee had filed a complaint on behalf of the debtor's estate to enjoin the spouse of the debtor's representative from interfering with the debtor's affairs. The Houston-based bankruptcy court

reviewed all of the duties bestowed on a Subchapter V trustee under section 1183 of the Bankruptcy Code and concluded that "[n]one of the subchapter V trustee's general duties authorize the Subchapter V Trustee to pursue claims belonging to the estate, [or] on behalf of the estate." Rather, the Houston bankruptcy court held that the debtor-in-possession has exclusive standing to pursue estate causes of action.

The *Ghatanfard* decision isn't all bad for creditors. The decision states that a Subchapter V trustee cannot be enlisted to pursue avoidance actions—such as preferences—against trade creditors. The decision also shows that interested creditors may put pressure on a debtor by seeking to convert the Subchapter V case to Chapter 7 in the event they believe there are valuable estate causes of action that the Subchapter V debtor will not diligently pursue. But regardless, the *Ghatanfard* case illustrates the adverse impact the absence of a creditors' committee may have on unsecured creditors in a Subchapter V case. A creditors' committee might have uncovered the significant fraudulent transfer claims via an investigation funded by the debtor's estate and might then have had a path to negotiate a Chapter 11 plan under which the committee could have appointed a litigation trustee with funding to pursue the estate's fraudulent transfer claim against the debtor's insider. However, in the absence of a creditors' committee, the individual creditors had to expend their own time and resources representing their interests in the case. BC

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