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Rocky Mountain Bankruptcy Conference

Judges' Panel

Sarah Laybourne, Moderator
U.S. Bankruptcy Court (D. Utah) | Salt Lake City

Hon. Kevin R. Anderson
U.S. Bankruptcy Court (D. Utah) | Salt Lake City

Hon. Bruce A. Harwood (ret.)
San Francisco

Hon. Peggy M. Hunt
U.S. Bankruptcy Court (D. Utah) | Salt Lake City

Hon. Joel T. Marker
U.S. Bankruptcy Court (D. Utah) | Salt Lake City

Hon. Casey D. Parker
U.S. Bankruptcy Court (D. Wyo.) | Cheyenne

Hon. Michael E. Romero
U.S. Bankruptcy Court (D. Colo.) | Denver

Hon. William T. Thurman
U.S. Bankruptcy Court (D. Utah) | Salt Lake City

Hon. Kimberley H. Tyson
U.S. Bankruptcy Court (D. Colo.) | Denver

2025

TOPICS FOR JUDGES BREAKFAST Q&A SESSION

- Shifting Landscape of Bankruptcy Cases
  - Two years ago we saw mostly Subchapter V cases. With the debt limit lowered, has that trend continued or changed to regular Chapter 11s?
  - Have there been an uptick in other types of cases?
  - Do any types of industries seem to be affected more than others?
- Implementing Subchapter V
  - Has the Court or your Courtroom adopted any local rules or chamber procedures in order to more effectively implement Subchapter V?
  - Are there any local rules that you would like to see implemented to better implement Subchapter V?
  - What types of issues do you see most frequently come before you in Subchapter V cases?
- General Practice
  - What are some general practice pointers that you would like attorneys to know when practicing in front of you?
  - What are some of the biggest issues that you think are overlooked by attorneys?
  - What is the biggest challenge facing the Bankruptcy Court right now?
- Changes to the Bankruptcy Bar
  - With a number of practitioners in our bar getting older, what would you like to see from current attorneys to ensure that the bar has continuity in the future?
  - Do you anticipate that we will see a wave of cases in the next couple of years?
    - If so, how do you think attorneys can prepare younger attorneys or newer bankruptcy practitioners in order to be ready?
- Use of AI in Practice
  - Have you seen any instances of AI usage in cases in front of you?
  - What do you do when you believe that someone appearing in front of you has used AI to prepare a pleading or an argument?
  - Do you think there is an effective way to use AI in the practice of law?
  - Have you had any evidentiary issues related to the use of AI?
    - If so, what were the issues and how were they addresses?
  - What impact do you think AI will have on parties attempting to proceed pro se?
- Professionalism in the Courtroom
  - Have you seen any shifts in attorney attitudes towards one another in recent years?
  - How have you seen attorneys effectively balance zealous advocacy against professionalism in the practice?
  - Has an attorney’s professionalism ever impacted how you have allowed a case to proceed, i.e. requiring more in person hearings versus telephonic or zoom hearings?

ROCHELLE'S DAILY WIRE

Small Biz. Reorg. Act

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New York's Judge John Mastando saw no reason a Subchapter V plan couldn't enjoin lawsuits against nondebtors for the life of a five-year plan.

Purdue Doesn't Preclude Injunctions from Protecting Nondebtors for the Life of a Plan

Although nondebtor, third-party releases are no longer permissible in chapter 11 plans after *Purdue*, Bankruptcy Judge John P. Mastando, III, of New York decided that a Subchapter V plan may contain a preliminary injunction barring suits against a nondebtor for the five-year life of the plan.

The corporate debtor was a notable Broadway producer. An individual was the sole owner and president of the corporate debtor.

Claiming it had not received its share of the income from a pair of productions, an investor initiated an arbitration against the corporate debtor and the owner. The arbitrator gave the investor an award of $2.6 million against the debtor and the owner, jointly and severally. The district confirmed the award, which was automatically stayed for 30 days.

On the 29th day, the debtor corporation filed a chapter 11 petition under Subchapter V. The debtor filed an adversary proceeding and persuaded Judge Mastando to enter a preliminary injunction preventing the investor from enforcing the arbitration award against the owner.

The debtor filed a chapter 11 plan that would have given the owner a release from liability on the arbitration award. In return, the plan required the owner to supply $600,000 toward payments under the plan.

In an opinion in November 2023, Judge Mastando found authority to confirm the plan over objections by the investor and the U.S. Trustee. However, he read the Second Circuit's decision in *In re Purdue Pharma LP*, 69 F.4th 45 (2d Cir. May 30, 2023), *cert. granted sub nom. Harrington v. Purdue Pharma L.P.*, No. (23A87), 2023 WL 5116031 (U.S. Aug. 10, 2023), as requiring him to issue a report and recommendation to the district court regarding confirmation of the plan. *See In re Hal Luftig Co.*, 655 B.R. 508 (Bankr. S.D.N.Y. Nov. 22, 2023). To read about the bankruptcy court's rationale for imposing a nonconsensual, nondebtor release, click here.

The Rejected R&R

The U.S. Trustee and the investor objected to the report and recommendation. District Judge Denise Cote sustained their objections in an 11-page opinion in March 2024. *See In re Hal Luftig Co.*, 657 B.R. 704 (S.D.N.Y. March 19, 2024). To read ABI's report, click here.

Having issued her decision before the Supreme Court decided *Purdue*, Judge Cote stopped short of precluding nonconsensual, nondebtor releases in all Subchapter V cases. However, she found that the case failed one of the Second Circuit's *Purdue* factors, which required that the impacted class must have voted "overwhelmingly." *Purdue*, *supra*, 69 F.4th at 78-79. In the case before her, the affected class had rejected the plan.

Judge Cote remanded for "further proceedings consistent with this Opinion." She held, "Resolving these issues through a nonconsensual release within the Debtor's bankruptcy is not permissible." *Hal Luftig*, *supra*, 657 B.R. at 709.

On Remand

On return to bankruptcy court, the debtor dropped the idea of a nondebtor release, naturally. Instead, the revised plan extended the preliminary injunction protecting the owner until the closure of the chapter 11 case, dismissal, or the grant or denial of discharge. The injunction applied only to the investor's claims against the owner.

Both unsecured classes voted against the plan, including the class with the investor and its claim, which by that time had risen to $2.9 million.

Conceding that the plan satisfied the other confirmation requirements for a nonconsensual plan under Section 1129(a) as incorporated by Section 1191, the investor argued that the plan was not "fair and equitable" and thus failed to comply with Section 1191. More particularly, the investor contended that the plan was "untenable" under the Supreme Court's decision in *Harrington v. Purdue Pharma L.P.*, 602 U.S. 204 (2024). To read ABI's report, click here.

Dealing with the investor's confirmation objection in his February 24 opinion, Judge Mastando cited Second Circuit authority for the notion that a preliminary injunction may cover nondebtors under Sections 362(a) and 105(a). *Queenie, Ltd. v. Nygard Int'l.*, 321 F.3d 282 (2d Cir. 2003). Furthermore, he said that the "Supreme Court did not address the bankruptcy courts' authority to grant non-consensual third party automatic stay extensions in *Purdue Pharma*."

Judge Mastando said it was an issue of first impression as to whether a nondebtor preliminary injunction could be extended for the life of a chapter 11 plan. In part, he found the answer in Section 362(c)(4), where the Code provides that the automatic stay continues in a chapter 11 case until a discharge is granted or denied.

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Rochelle's Daily Wire

Given that the plan's stay extension was consistent with Section 362(c)(4), Judge Mastando held that the longer "duration [of the stay] does not render the relief facially impermissible." Next, he ruled that the extended stay satisfied the four requirements for a preliminary injunction.

Judge Mastando closed his opinion by examining whether the longer stay duration made the plan unfair and inequitable. As to the investor's idea "that *Purdue Pharma* prohibits bankruptcy courts from, as part of a plan, temporarily enjoining creditors' collection efforts against non-debtors," he said that the argument was "without merit." He also rejected the idea that the stay extension "'amounts to a discharge' over the life of the Third Amended Plan."

Judge Mastando explained that the investor was not left without recourse. The claim remains valid, he said, and the investor could pursue the claim after the debtor's discharge. He similarly "reject[ed] the argument that such relief 'goes against all concepts of fairness and equity.'"

Overruling the objection and awaiting submission of an order confirming the plan, Judge Mastando said it was "inappropriate to impose any requirement that would effectively allow an objecting unsecured creditor to derail an otherwise confirmable plan . . . solely because that creditor holds the largest unsecured claim against the estate."

The opinion is *In re Hal Luftig Co. Inc.*, 22-11617 (Bankr. S.D.N.Y. Feb. 24, 2025).

Bankruptcy Judge Paul Bonapfel differed with two judges in Houston by holding that a nonaccepting class in Subchapter V means that a plan must be confirmed in cramdown.

Another Bankruptcy Judge Decided that Sub V Classes with No Votes Aren't Accepting

Because he writes a leading treatise on bankruptcy, the world listens when Bankruptcy Judge Paul W. Bonapfel speaks.

In an opinion on August 6, Judge Bonapfel, of Atlanta, ruled that a plan with classes of creditors having no votes must be confirmed as a nonconsensual plan.

The debtor proposed a plan with three classes of creditors. Only one class voted in favor of the plan. No one in the other two classes voted. In a class by itself, the Small Business Administration did not vote, and no one among unsecured creditors voted. Quoting Bankruptcy Judge Kesha L. Tanabe, Judge Bonapfel said this "is an example of what one court has rightly characterized as the 'apathetic creditor problem.'"

The debtor had two theories for confirming the plan as a consensual plan under Section 1191(a) despite the lack of votes in two classes.

First, the debtor wanted Judge Bonapfel to believe that a class accepts the plan when no one votes. Second, the debtor wanted Judge Bonapfel to follow two bankruptcy courts in Texas by deciding that classes with no votes may be disregarded. *See In re Franco's Paving LLC*, 654 B.R. 107 (Bankr. S.D. Tex. 2023), and *In re Hot'z Power Wash, Inc.*, 655 B.R. 107 (Bankr. S.D. Tex. 2023)." To read ABI's reports on the two Texas cases, click here and here.

Citing the *Collier* treatise and *In re M.V.J. Auto World Inc.,* 2024 WL 3153327 (Bankr. S.D. Fla. June 21, 2024), Judge Bonapfel "decline[d] to accept either of these theories and conclude[d], as most courts do, that acceptance for purposes of § 1129(a)(8) requires affirmative acceptance by the class." To read ABI's report on *Auto World*, click here.

The debtor nonetheless prevailed, because no one objected to confirmation, and Judge Bonapfel could confirm the plan under Section 1191(b) as a so-called cramdown plan.

Judge Bonapfel made another noteworthy point. Utilizing Section 1194(b), the corporate debtor proposed making plan payments itself rather than through the Subchapter V trustee.

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Section 1183(c) does not specify when a trustee is terminated following confirmation of a cramdown plan under Section 1191(b). Thus, the question arose as to whether the trustee's services could be terminated on substantial consummation.

In a consensual plan under Section 1191(a), the trustee's services are terminated on substantial consummation. Judge Bonapfel saw "nothing in subchapter V [that] limits the court's authority to similarly terminate the services of a trustee upon substantial consummation of a cramdown plan confirmed under § 1191(b) when a subchapter V trustee will not be making payments to creditors and will have no postconfirmation duties to perform."

Judge Bonapfel therefore decided that the trustee's services would terminate on substantial consummation, with the understanding the trustee would be reappointed were services required, for instance, if the debtor wanted to modify the plan or sell estate property.

The opinion is *In re Florist Atlanta Inc.*, 24-51980 (Bankr. N.D. Ga. Aug. 6, 2024).

Disagreeing with two bankruptcy courts in Houston, Miami's Judge Isicoff holds that a Sub V plan with a nonvoting class can be confirmed only as a nonconsensual plan.

Courts Are Now Split on Ignoring Nonvoting Classes in Subchapter V Plans

A dissenting voice has been raised on the question of whether a Subchapter V plan can be confirmed *consensually* if there are no votes in a class.

Bankruptcy Judge Laurel M. Isicoff of Miami disagreed with two bankruptcy judges in Houston who decided that a class isn't counted if there are no votes in the class.

The Subchapter V debtor filed a chapter 11 plan with two creditor classes, both secured with one creditor in each. One secured class was populated by a bank, and the second secured class had the U.S. Small Business Administration.

The bank accepted the plan, but the SBA did not vote. There were no objections to confirmation, but the U.S. Trustee, the Subchapter V trustee and the bank argued that the plan could not be confirmed as a consensual plan under Section 1129(a)(8) because the SBA class had no votes.

The resolution rested on the interpretation of Sections 1191(a) and 1129(a)(8).

Section 1191(a) says that the court "shall" confirm a Subchapter V plan "only if" all the requirements of Section 1129(a) have been met other than subparagraph 1129(a)(15), which applies to an individual debtor where an unsecured claimholder objects to confirmation.

Among the confirmation requirements, Section 1129(a)(8) requires that each class "has accepted" the plan or is "unimpaired."

When "an impaired class of creditors fails to cast a ballot at all," Judge Isicoff characterized the debtor as arguing that the "class should not be counted at all for purposes of section 1129(a)(8), citing two cases from the Southern District of Texas — *In re Franco's Paving LLC*, 654 B.R. 107 (Bankr. S.D. Tex. 2023), and *In re Hot'z Power Wash, Inc.*, 655 B.R. 107 (Bankr. S.D. Tex. 2023)." To read ABI's reports on the two Texas cases, click here and here.

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Both courts in Texas, Judge Isicoff said, "held that a non-voting class can be ignored for purposes of whether section 1129(a)(8) is satisfied." The two courts, she said, read Congress as having created "a streamlined chapter 11 process for small business debtors" and as having shown a "clear articulation of a preference for consensual plans confirmed under section 1191(a)."

To disregard a nonvoting class, Judge Isicoff understood the two Texas courts as believing that "Congress clearly never contemplated that there would be a class of impaired creditors where no creditor voted" and that Section 1126(c) created a "mathematical absurdity."

Judge Isicoff proceeded to explain why she disagreed and was concluding that Section 1129(a)(8) had not been met because "each class of impaired claims did not accept the Debtor's Plan." With regard to a nonvoting class, she said that "the Bankruptcy Code on this point is neither silent nor absurd, but, rather, unambiguous and consistent with the purposes of the Bankruptcy Code." She demonstrated how the Code envisions a nonvoting class.

First, Judge Isicoff said, Section 1126(a) says that a claimholder "may" vote to accept or reject. It does not say that a claimholder "shall" vote. Second, the mathematical formula in Section 1126(c) takes into account class members who do not vote.

"It is not absurd," Judge Isicoff said, "that no creditors in a class voting on a plan should be treated any differently than a situation where there is not a sufficient number of creditors voting in favor of a plan to satisfy section 1129(a)(8)."

Judge Isicoff held that "the Plan must satisfy section 1129(a)(8)" and that "Section 1129(a)(8) requires that each impaired class accept the plan." Although she could not confirm the plan as a consensual plan, she confirmed the plan as nonconsensual "because the Plan satisfies all of the other applicable provisions of section 1129(a)."

Observations

Except where statutory language in Subchapter V deviates from the norm, caselaw in "regular" chapter 11 should apply in Subchapter V, and *vice versa*. Not considering a nonvoting class in "regular" chapter 11 would be a notable development.

A requisite in both "regular" chapter 11 and Subchapter V, Section 1129(a)(8) requires that each class be unimpaired or "has accepted the plan." In this writer's view, not voting is not the equivalent of "has accepted," because "has accepted" is language that contemplates an affirmative act.

Given the lack of specific textual support for disregarding nonvoting classes, other courts may be inclined to believe that Section 1129(a)(8) should not be ignored in Subchapter V, akin to the majority's opinion nixing a creative interpretation of chapter 11 plans in *Harrington v. Purdue Pharma L.P.*, 23-124 (Sup. Ct. June 27, 2024).

The opinion is *In re M.V.J. Auto World Inc.,* 23-16612 (Bankr. S.D. Fla. June 21, 2024).

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The Code doesn't contain any rules specifying when a Subchapter V plan should have a five-year duration rather than three years.

Three Years Is the 'Default' Duration for a Subchapter V Plan, Judge Robinson Says

Subchapter V of chapter 11 does not prescribe when a "cramdown" plan must have a five-year duration as opposed to three years.

In terms of the duration of a plan, Bankruptcy Judge Shad M. Robinson of Austin, Texas, concluded that the bankruptcy court has "broad discretion" in deciding whether a plan satisfies the "fair and equitable" requirement contained in Section 1191(b) and (c)(2)(A). His May 24 decision could be read to mean that a debtor must proffer detailed evidence about the income and expenses of the business to establish that the plan is fair and equitable and how long the plan must run.

The debtor was a small medical clinic in a small town in west Texas. The clinic had been in operation about five years before filing a chapter 11 petition and electing treatment under Subchapter V. Annual income was slightly above $1 million a year. The debtor was an LLC owned by a couple who were the managers and were employed by the business.

The secured bank creditor had a bifurcated claim with about $55,000 secured and $280,000 unsecured. Including the bank's unsecured claim, there were some $475,000 unsecured claims.

The debtor proposed a three-year plan that would have paid unsecured creditors an estimated 8.2% of their claims. The three years of payments to unsecured creditors would have totaled about $39,000. From the total, the bank would have recovered $23,000 on its allowed, unsecured claim.

Neither the U.S. Trustee nor the Subchapter V trustee objected to confirmation. However, the bank voted its secured and unsecured claims against the plan. Because the bank was the only creditor in the secured class, the lack of acceptance by all classes invoked the so-called cramdown requirements for confirmation.

The bank contended that the plan was not proposed in good faith as required by Section 1129(a)(3) and was not fair and equitable under Section 1191(b) and (c)(2)(A).

Good Faith

As Judge Robinson explained, Section 1191(b) directs the court to confirm a cramdown plan if other requirements have been met and "if the proposed subchapter V plan does not 'discriminate unfairly' and is 'fair and equitable' with respect to each class of claims or interests that is impaired under, and has not accepted, the subchapter V plan."

The objection to confirmation raised two issues. Was the plan proposed in good faith under Section 1129(a)(3) and did the devotion of the debtor's disposable income for three years satisfy the fair and equitable test under Section 1191(b) and (c)(2)(A)?

The bank argued that the plan was not filed in good faith because the debtor could pay more were it a five-year plan. Applying a totality of the circumstances test, Judge Robinson found good faith.

To find good faith, Judge Robinson saw the plan as a "legitimate attempt" to reorganize and confirm a plan that would pay creditors more than liquidation. He also found that the plan was proposed with "honest and good intentions" coupled with "fundamental fairness" in dealing with creditors. He therefore overruled the bank's contention that the plan was not proposed in good faith.

Good Faith Doesn't Equal 'Fair and Equitable'

Nonetheless, Judge Robinson said that a finding of good faith "is not outcome determinative" with regard to the fair and equitable test under Section 1191(b) and (c) because "'good faith' under § 1129(a)(3) and 'fair and equitable' under § 1191(b) and (c) are separate and distinct confirmation requirements that must be satisfied." He therefore addressed the question of "whether the proposed three-year payment period under the Plan is fair and equitable."

Judge Robinson began his analysis by noting that "Congress provided no guidance or standards on how the bankruptcy court should fix the duration of a plan under 11 U.S.C. § 1191(c)(2)(A)." However, he accepted the idea that a three-year plan is the "default" period under Section 1191(c) but disagreed with the notion "that a three-year term is generally more reasonable than a five-year term absent 'unusual circumstances.'"

With no rules specified in Subchapter V, Judge Robinson held that "Congress intended to leave to the sound discretion of the bankruptcy courts the sole authority to fix the plan payment period in subchapter V cases." He observed that "the relevant statutes governing the applicable period for plan payments under other sections of the Code are so dissimilar to subchapter V that they do not provide any helpful guidance in determining the appropriate time period for fixing plan payments under § 1191(c)(2)(A)."

In exercising discretion, Judge Robinson said,

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> [T]he bankruptcy court should give appropriate deference to the debtor's business judgment and proposed period of payments in its subchapter V plan. Furthermore, this Court agrees that a baseline plan payment period of three years is consistent with the intent of Congress to create a quick, efficient reorganization process that would allow the debtor to obtain a discharge as soon as possible.

When there is no objection to the duration of the plan, Judge Robinson said it would be "uncommon" for the bankruptcy court to raise the issue *sua sponte*. When there is an objection to duration, he said that "the debtor's proposed period of plan payments is no longer given the same deference and the bankruptcy court is tasked with fixing the applicable period of plan payments in a subchapter V case."

Analyzing the debtor's projected income and expenses, Judge Robinson observed that the debtor was creating a $32,000 capital reserve over the course of a three-year plan that would be paying unsecured creditors $39,000. He said that the capital reserve might be reasonable, but "the Court does not have sufficient evidence to make that determination." Similarly, the debtor had not provided sufficient evidence to show whether the salaries to be paid to the debtor's owners were "fair market."

Overall, Judge Robinson said that evidence provided by the debtor was "insufficient . . . for the Court to determine whether the three-year plan payment period is fair and equitable under § 1191(b) and (c)(2)(A)." Similarly, he was given "insufficient evidence . . . for the Court to 'fix' a longer plan payment period not to exceed five years under § 1191(c)(2)(A)."

Concluding the opinion, Judge Robinson said that the three-year plan "may very well be" fair and equitable, but he found "that the Debtor has not met its burden to show by a preponderance of the evidence that the proposed three-year period of plan payments is fair and equitable." He also found "insufficient evidence for the Court determine if it should fix a plan payment period longer than three years but not exceeding five years."

In sum, Judge Robinson overruled the objection about lack of good faith but sustained the objection about failure to establish "fair and equitable." He denied confirmation of the plan but allowed the debtor three weeks to avoid dismissal by filing an amended plan.

The opinion is *In re Trinity Family Practice & Urgent Care PLLC*, 23-70068 (Bankr. W.D. Tex. May 24, 2024).

ROCHELLE'S DAILY WIRE

Differing with eight lower courts, the Fifth Circuit sided with the Fourth Circuit by holding that debts of corporate debtors in Subchapter V can be nondischargeable in nonconsensual plans.

Fifth and Fourth Circuits Hold that Debts in Sub V Can Be Nondischargeable

Taking sides with the only other court of appeals to decide the question, the Fifth Circuit reversed the bankruptcy court on direct appeal and held that debts of corporate debtors in Subchapter V of chapter 11 can be nondischargeable under Section 523(a) in nonconsensual plans.

Beyond the language of the statutes, the Fifth Circuit saw Subchapter V as an example of congressional compromise. In return for omitting the absolute priority rule from Subchapter V, the New Orleans-based appeals court followed the Fourth Circuit by saying that Congress, as a compromise, made some debts nondischargeable as to corporate debtors.

The Nondischargeability Complaint

The debtor was a corporation in Subchapter V of chapter 11. A secured lender filed a complaint contending that its claims were nondischargeable under Sections 523(a)(2)(A), 523(a)(2)(B), 1141(d) and 1192, because the debtor made a misrepresentation by not disclosing that bankruptcy was imminent.

In response to the complaint, the debtor filed a motion to dismiss for failure to state a claim under Rule 12(b)(6), contending that corporations in Subchapter V of chapter 11 may discharge debts that would be nondischargeable by individual debtors in Subchapter V.

The Fourth Circuit had already decided the issue in *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022), by holding that debts described in Section 523(a) can be nondischargeable as to corporate debtors, not just individual debtors, if the plan is nonconsensual. To read ABI's report on *Cleary*, click here.

Line by line, the bankruptcy court refuted *Cleary's* reasoning and granted the motion to dismiss. *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337 (Bankr. W.D. Tex. Nov. 10, 2022). To read ABI's report, click here. The bankruptcy court authorized a direct appeal, which the Fifth Circuit accepted and held oral argument on December 5.

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The Statutory Language

On the merits, Circuit Judge Stuart Kyle Duncan began his April 17 opinion by saying that "the dischargeability of its debts is governed by § 1141(d)" if "a debtor's bankruptcy plan is confirmed as a consensual plan under § 1191(a)." However, he said that the debtor's "plan was confirmed as a nonconsensual plan under § 1191(b), so the dischargeability of its debts is governed by § 1192."

Quoting Section 1192, Judge Duncan went on to say that confirmation discharges all debts in Section 1141(d)(1)(A) except, among other things, those "of the kind specified in section 523(a) of this title."

Judge Duncan identified a "textual conundrum," given that the preamble to Section 523(a) reads, "A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge *an individual debtor* from any debt . . . ." [Emphasis in opinion.] He said that the preamble was "critical" to the bankruptcy court's conclusion that nondischargeability in Subchapter V applies only to individual debtors.

For Judge Duncan, "placing controlling weight" on the word "'individual' in § 523(a) disregards the plain language of § 1192(2)." He noted that Section 1192 deals with the discharge of debts of a "debtor," and that the word "debtor" in Subchapter V refers to "a person." In turn, "person" is defined in Section 101(41) to mean both an individual and a corporation.

"[P]utting all this together," Judge Duncan concluded that "§ 1192 applies to both individual and corporate debtors."

Next, Judge Duncan focused on the statutory language in "§ 1192[, which] excepts from discharge "any *debt . . . of the kind* specified in section 523(a)." [Emphasis in original.] He then said, "We must apply this precise language as written."

For Judge Duncan, "the most natural reading of § 1192(2) is that it subjects both corporate and individual Subchapter V debtors to the categories of debt discharge exceptions listed in § 523(a)." Like the Fourth Circuit "correctly reasoned," he said that "the reference to 'kind[s]' of debt in § 1192 serves as 'a shorthand to avoid listing all 21 types of debts' in § 523(a), 'which would indeed have expanded the one-page section to add several additional pages to the U.S. Code.'" *Cleary, supra*, 36 F.4th at 515.

In addition, he said that Section 1192(2) is "the more specific provision" that should govern the more general.

Like the Fourth Circuit, Judge Duncan said that nondischargeability "gains greater force when we situate § 1192 in the larger context of the Bankruptcy Code . . . . Even traditional Chapter 11

proceedings distinguish discharges for individual and corporate debtors." In addition, he said that Section 1192 is "virtually identical" to Section 1228(a), which courts have interpreted as allowing nondischargeability complaints as to corporate farmers.

"[M]ore importantly," Judge Duncan said, the debtor "misunderstands the compromises Congress made in Subchapter V," by which he was referring to the omission of the absolute priority rule in Subchapter V cases. "To counterbalance that benefit to debtors," he said, "Congress excepted from discharge 'any debt . . . of the kind specified in section 523(a).'"

Believing that accepting the debtor's arguments would "rewrite that compromise," Judge Duncan reversed and remanded, holding "that 11 U.S.C. § 1192(2) subjects both corporate and individual Subchapter V debtors to the categories of debt discharge exceptions listed in § 523(a)."

Observation

So far, eight lower courts, including the Ninth Circuit Bankruptcy Appellate Panel, have disagreed with *Cleary* and the result reached by the Fifth Circuit. To read ABI's report, click here.

The opinion is *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 25-50237 (5th Cir. April 17, 2024).

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The bankruptcy judge in Pensacola, Fla., is giving the Eleventh Circuit an opening to split with the Fourth and Fifth Circuits.

Judge Oldshue Splits with Two Circuits: No Nondischargeability for Sub V Corporations

Although the Fourth and Fifth Circuits have held that corporations in Subchapter V of chapter 11 can be saddled with nondischargeable debts in nonconsensual plans, Bankruptcy Judge Jerry C. Oldshue, Jr., sitting in Pensacola, Fla., swam against the tide by following the Ninth Circuit Bankruptcy Appellate Panel (BAP).

In his February 14 opinion, Judge Oldshue concluded that banning nondischargeability in Subchapter V for corporations "provide[s] the best statutory interpretation of §1192's incorporation of 523(a) by giving effect to all the statutory language, recognizing the long-standing application of §523(a) to only individual debtors, and comporting with the overall purpose of the [Small Business Reorganization Act]."

Companion Suits in State Court and Bankruptcy Court

Several creditors had sued a corporation in state court. Three years later, the corporation filed a petition under Subchapter V of chapter 11. The debtor removed the suit from state court, but Judge Oldshue had abstained because the lawsuit was far advanced, state law issues predominated, the claims were noncore, and a jury trial had been demanded.

In chapter 11, the creditors who had sued in state court filed a complaint seeking a declaration that the debt was nondischargeable under Section 523(a)(2), (4) and (6). The debtor responded with a motion to dismiss.

Sections 1192 and 523(a)

The outcome was controlled by Sections 1192 and 523(a). Applicable to nonconsensual plans, Section 1192 provides that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title . . . *except any debt* — . . . (2) *of the kind* specified in section 523(a) of this title." [Emphasis added.]

Section 523(a) provides that a "discharge under section . . . 1141 . . . does not discharge an *individual debtor*" from 19 types of debt. [Emphasis added.]

Judge Oldshue observed that the "juxtaposition of §1192(2) and the reference to 'individual debtor' in §523(a)'s preamble has resulted in differing opinions on the issue of whether the §523 exceptions to discharge apply to corporate debtors." He cited the Fourth and Fifth Circuits and a district court in Illinois for holding "that both individual and corporate debtors covered by §1192 are subject to the discharge exceptions of §523(a)." *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022). To read ABI's report, click here. *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 99 F.4th 223 (5th Cir. April 17, 2024). To read ABI's report, click here. *Chi. & Vicinity Laborers' Dist. Council Pension Plan, et al. v. R & W Clark Constr., Inc.*, 24 CV 1463, 2024 WL 4789403 (N.D. Ill. Nov. 14, 2024). To read ABI's report, click here.

"[T]he Fourth and the Fifth Circuits," Judge Oldshue said, "have disregarded the reference to 'individual debtor' in §523's preamble and construed the discharge exceptions to apply to both individual and corporate debtors under §1192(2)." The issue, he said, "is not well-settled as other courts have construed the same statutory provisions differently."

Judge Oldshue cited the Ninth Circuit BAP and "other bankruptcy courts, including those in the Eleventh Circuit, [that] have held that the §523 non-dischargeability provisions apply only to individual Subchapter V debtors." *See, e.g.*, *In re Off-Spec Sols., LLC*, 651 B.R. 862 (B.A.P. 9th Cir. 2023); *In re Hall*, 651 B.R. 62 (Bankr. M.D. Fla. 2023). To read ABI's reports, click here and here.

"These courts," Judge Oldshue said, "have found that the better interpretation of §1192 is that it incorporates §523(a)'s limited applicability to individuals." For instance, he said that the Ninth Circuit BAP decided that "adding §1192 to the list of discharge provisions to which [Section 523] applies, extracting only the list of nondischargeable debts from §523(a) without its limitation to individuals, would render the amendment surplusage."

Judge Oldshue found "the reasoning of the Ninth Circuit BAP and the bankruptcy courts in the Eleventh Circuit, holding the exceptions to discharge under §523(a) apply only to individual debtors under §1192(2), convincing. Such decisions provide the best statutory interpretation of §1192's incorporation of 523(a) by giving effect to all the statutory language, recognizing the long-standing application of §523(a) to only individual debtors, and comporting with the overall purpose of the SBRA."

Concluding that the exceptions to discharge in Section 523(a) "only apply to individuals in Subchapter V," Judge Oldshue dismissed the creditors' nondischargeability complaint for failure to state a claim.

Observations

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The question is a classic case for application of rules of statutory interpretation, worthy of review by the Supreme Court. Perhaps Judge Oldshue's case will go up on appeal, giving the Eleventh Circuit an opportunity to create a circuit split.

The opinion is *Spring v. Davidson (In re Davidson)*, 23-3005 (Bankr. N.D. Fla. Feb. 14, 2025).

Reversing the bankruptcy court, the Chicago district judge follows the Fourth and Fifth Circuits and rejects a contrary holding by the Ninth Circuit BAP.

Chicago District Judge Decides that Sub V Debtors Can Have Nondischargeable Debts

Reversing the bankruptcy court, a district judge in Chicago decided that corporate debtors in Subchapter V of chapter 11 can be saddled with nondischargeable debts.

In his November 14 opinion, District Judge Manish S. Shah followed the Fourth and Fifth Circuits and agreed with a different bankruptcy judge in Chicago, while disagreeing with the Ninth Circuit Bankruptcy Appellate Panel and eight bankruptcy courts.

A creditor held a judgment for more than $3 million against a corporation and its owner. The corporation filed a petition under Subchapter V of chapter 11. The judgment creditor responded with an adversary proceeding seeking a declaration that the debts owing to it were nondischargeable under Section 523(a)(2)(A), (a)(2)(B) and (a)(6).

Believing that nondischargeability does not apply to corporate debtors in Subchapter V just like in "regular" chapter 11, the bankruptcy court granted the debtor's motion to dismiss the complaint for failure to state a claim. *See Chicago & Vicinity Laborers' District Council Pension Plan v. R&W Clark Construction Inc. (In re R&W Clark Construction Inc.)*, 656 B.R. 628 (Bankr. N.D. Ill. Feb. 8, 2024). To read ABI's report on *R&W*, click here.

The creditor appealed to the district court and won a reversal.

Sections 1192 and 523(a)

Apart from a court's concept of policy, the outcome turns on the interpretation of Sections 1192 and 523(a). Applicable to nonconsensual plans, Section 1192 provides that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title . . . *except any debt* — . . . (2) *of the kind* specified in section 523(a) of this title." [Emphasis added.]

Section 523(a) provides that a "discharge under section . . . 1141 . . . does not discharge an *individual debtor*" from 19 types of debt. [Emphasis added.]

Believing there is no nondischargeability for corporations in Subchapter V, the bankruptcy court was persuaded by the Ninth Circuit Bankruptcy Appellate Panel's decision in *Lafferty v. Off-*

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Spec Sols., LLC (In re Off-Spec Sols., LLC), 651 B.R. 862 (B.A.P. 9th Cir. 2023), *appeal dismissed per stipulation*, 23-60034, 2023 WL 9291577 (9th Cir. Nov. 12, 2023). To read ABI's report on the BAP opinion, click here.

Concluding that nondischargeability did not apply to corporate debtors in Subchapter V, the BAP saw Section 523(a) and its limitation to individual debtors as being more specific and therefore controlling.

The bankruptcy court declined to follow *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022), where the Fourth Circuit held that corporate debtors in Subchapter V may not discharge debts "of the kind" specified in Section 523(a). To read ABI's report, click here. Subsequently, the Fifth Circuit came down the same way in *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 99 F.4th 223 (5th Cir. April 17, 2024). To read ABI's report, click here.

Notably, Chicago Bankruptcy Judge Deborah L. Thorne of Chicago decided in July that the Fourth and Fifth Circuits had the right idea. She ruled that corporate debtors in Subchapter V are subject to complaints for nondischargeability. *See Christopher Glass & Aluminum Inc. v. Premier Glass Services LLC (In re Premier Glass Services LLC)*, 661 B.R. 939 (Bankr. N.D. Ill. July 31, 2014). To read ABI's report, click here.

Section 1192 Controls

Ruling on the appeal, District Judge Shah decided that Section 1192(2) was "unambiguous" in that it "grants a debtor, either individual or corporate, discharge of all debts except for debts 'of the kind specified in section 523(a).'" On the other hand, he found "trouble" in the preamble to Section 523(a), which says, "A discharge under section . . . 1192 . . . of this title does not discharge *an individual debtor* from" 19 types of debt. [Emphasis added.] Judge Shah devoted 10 pages to explaining why the preamble to Section 523(a) is not controlling.

"When § 1192 refers to the kinds of debt specified in § 523(a)," Judge Shah said, "it is referring to the enumerated debts, not the preamble's reference to types of debtors." The judge said that his conclusion was "bolstered" by bankruptcy courts in Texas and Georgia that had decided in 1995 and 2009 that "virtually identical" language in chapter 12 opens the door to nondischargeability for corporations, not only individual debtors.

Judge Shah saw Congress as having "made a choice to change bankruptcy proceedings for small business debtors and chose to treat individual and corporate debtors the same. To hold that § 523(a) only applies to individuals discharging debt under § 1192 ignores the purposeful change Congress made to the statutory language."

Reversing the bankruptcy court, Judge Shah held that the "'most natural reading' of § 1192(2) applies the exceptions to discharge in the paragraphs of § 523(a) to both corporate and individual debtors."

The opinion is *Chicago & Vicinity Laborers' District Council Pension Plan v. R&W Clark Construction Inc. (In re R&W Clark Construction Inc.)*, 24-1463 (N.D. Ill. Nov. 14, 2024).

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The tide is turning against corporate Sub V debtors. Two bankruptcy judges now side with two circuits in holding that debts of corporate debtors can be nondischargeable.

Nondischargeability Is a 'Thing' for Corporate Subchapter V Debtors, Judge Thorne Says

The tide is turning. Bucking the trend in the lower courts, a second bankruptcy judge has held that debts can be nondischargeable as to corporations in Subchapter V of chapter 11.

This time, it's a prominent bankruptcy judge in Chicago who believes in nondischargeability. She disagreed with another Chicago judge but took sides with the only two circuit courts to decide the question so far.

A creditor filed a complaint contending that a debt owing by the corporate Subchapter V debtor was nondischargeable under Section 523(a)(6). Allegedly, the debtor solicited employees and customers in violation of a noncompetition and nonsolicitation agreement.

To make nondischargeability an issue, the creditor contended that the plan could only be confirmed as a nonconsensual plan. The debtor filed a motion to dismiss the complaint for failure to state a claim, which Bankruptcy Judge Deborah L. Thorne denied in her July 31 opinion.

Sections 1192 and 523(a)

Judge Thorne explained that confirmation of nonconsensual plans is governed by Section 1191(b). On confirmation of a nonconsensual plan, Section 1192 provides that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title . . . *except any debt* — . . . (2) *of the kind* specified in section 523(a) of this title." [Emphasis added.]

Section 523(a) provides that a "discharge under section . . . 1141 . . . does not discharge an individual debtor" from 21 types of debt.

Courts believing there's no such thing as nondischargeability for Subchapter V debtors focus on the words "individual debtor" in Section 523(a) to conclude that nondischargeability applies only to individuals. Courts holding that debts can be nondischargeable as to corporations focus on "any debt . . . of the kind" in Section 1192.

Section 1192 Doesn't Refer to the 'Type of Debtor'

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Judge Thorne fell into the nondischargeability camp because, she said, "Section 1192(2) does not refer to the preamble but only to the kinds of debts listed in the section."

The Seventh Circuit has not taken sides, but Bankruptcy Judge Timothy A. Barnes of Chicago wrote an opinion in February holding that nondischargeability does not apply to a corporate Subchapter V debtor. *Chicago & Vicinity Laborers' District Council Pension Plan v. R&W Clark Construction Inc. (In re R&W Clark Construction Inc.)*, 656 B.R. 628 (Bankr. N.D. Ill. Feb. 8, 2024). To read ABI's report on *R&W*, click here.

Of course, Judge Thorne cited the Fourth and Fifth Circuits, which both held that corporate Subchapter V debtors can be saddled with nondischargeable debts. *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022); and *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 99 F.4th 223 (5th Cir. April 17, 2024). To read ABI's reports, click here and here.

Judge Thorne found the two circuits to be "persuasive" because "Congress did not add a provision to 1192(2) instructing that the list of nondischargeable debts was limited to only certain types of debtors — entities or individuals." Instead, what "section 1192(2) says is that discharge is not available for '*any debt* . . . of the kind specified in section 523(a).'" [Emphasis in original.]

Judge Thorne deduced that "[n]othing about the use of the phrase 'type of debt' suggests that the court need consider the type of debtor." She agreed with the Fourth Circuit that "Congress used this provision as a 'shorthand to avoid listing all 21 types of debts.'"

The language in Section 1192(2), Judge Thorne said, "closely echoes" Section 1228(a), which has been interpreted to mean that corporate family farmers can have nondischargeable debts.

Judge Thorne conceded that eight bankruptcy courts believe there is no nondischargeability. The eight include the two bankruptcy courts reversed by their circuits.

Also in Judge Thorne's camp is *Ivanov v. Van's Aircraft Inc. (In re Van's Aircraft Inc.)*, 24-06011, 2024 BL 200305 (Bankr. D. Ore. June 11, 2024). To read ABI's story on *Van's*, click here. Notably, the bankruptcy judge in Oregon disagreed with the conclusion reached on the identical topic by the Ninth Circuit Bankruptcy Appellate Panel. Evidently, the parties in the BAP settled because the appeal to the Ninth Circuit was withdrawn. *Lafferty v. Off-Spec Sols., LLC (In re Off-Spec Sols., LLC)*, 651 B.R. 862 (B.A.P. 9th Cir. 2023), *appeal dismissed per stipulation*, 23-60034, 2023 WL 9291577 (9th Cir. Nov. 12, 2023). To read ABI's report on the BAP opinion, click here.

Judge Thorne denied the debtor's motion to dismiss, saying it "is unnecessary to resort to the preamble of section 523(a) when section 1192(2) clearly states that the discharge is limited by the kinds of debts that are of the 'kind specified in section 523(a).'"

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The opinion is *Christopher Glass & Aluminum Inc. v. Premier Glass Services LLC (In re Premier Glass Services LLC)*, 24-00096 (Bankr. N.D. Ill. July 31, 2024).

Bankruptcy Judge Hercher agreed with the results in the Fourth and Fifth Circuits but disagreed with some of the appeals courts' logic.

Corporate Debts in Sub V Can Be Nondischargeable, Judge Says, Differing with His BAP

Taking sides with the results reached in the Fourth and Fifth Circuits, Bankruptcy Judge David W. Hercher of Portland, Ore., decided that the types of debts described in Section 523(a) can be nondischargeable for corporations in Subchapter V.

Although sitting in the Ninth Circuit, Judge Hercher disagreed with the Ninth Circuit Bankruptcy Appellate Panel, which ruled one year ago that there's no such thing as a nondischargeable debt for a corporation in Subchapter V. *See Lafferty v. Off-Spec Solutions LLC (In re Off-Spec Solutions LLC)*, 651 B.R. 862 (B.A.P. 9th Cir. July 6, 2023). To read ABI's report, click here.

Like a district court opinion, a BAP opinion is not binding on a bankruptcy judge in the same circuit unless the decision was made in the same case.

The Dischargeability Complaint

The creditor filed a complaint against a corporate debtor in Subchapter V of chapter 11. The complaint made two claims. One claim sought a declaration that the debt was nondischargeable under Section 523(a)(2) as having arisen from fraudulent misrepresentations. The second claim was for a money judgment arising from breach of contract.

The debtor moved to dismiss both claims. In his opinion on June 11, Judge Hercher dealt only with the motion to dismiss the nondischargeability claim and ruled in favor of the creditor by denying the motion to dismiss.

Before turning to the case before him, Judge Hercher laid out the similarities and differences regarding dischargeability in chapters 7, 11, 12 and 13. If the plan in Subchapter V is accepted by all classes, he said that all debts are discharged because Section 1141(d) applies and discharges virtually all debts when the debtor is a corporation.

In the case before him, the plan was a so-called cramdown plan confirmed over the objection of a creditor class. Therefore, discharge was governed by Section 1192. After confirmation and the completion of plan payments, the section provides that "the court shall grant the debtor a

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discharge of all debts provided in section 1141(d)(1)(A) of this title, and all other debts allowed under section 503 of this title and provided for in the plan, except any debt — . . . (2) *of the kind* specified in section 523(a) of this title." [Emphasis added.]

Applicable to Subchapter V cases, Section 523(a) provides that a "discharge under section . . . 1141 . . . of this title does not discharge an individual debtor from any debt" described in the following 20 subparagraphs.

Throughout the opinion, Judge Hercher referred to the phrase a "discharge under section . . . 1141 . . . of this title does not discharge an individual debtor" in Section 523(a) as the "preamble."

Analysis of the BAP and the Circuit Opinions

The debtor naturally urged Judge Hercher to follow *Off-Spec*, while the creditor wrapped itself in the flags flown by the Fourth and Fifth Circuits. *See Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022); and *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 99 F.4th 223 (5th Cir. April 17, 2024). To read ABI's reports, click here and here.

Judge Hercher described the Fourth Circuit in *Cleary* as holding that debts of corporate debtors in Subchapter V can be nondischargeable because the phrase "of the kind specified in section 523(a)" refers to the type of debt, not the type of debtor. He also mentioned how the Fourth Circuit adopted the positions of bankruptcy courts in two chapter 12 cases in 1995 and 2009 as having held that identical language in chapter 12 can give rise to nondischargeable debts of corporate debtors. He also observed that the Fourth Circuit saw nondischargeability as an offset to the easier confirmation of Subchapter V plans.

In *GFS*, Judge Hercher said that the Fifth Circuit "echoed the reasoning of the Fourth."

In *Off-Spec*, Judge Hercher described the BAP as seeing no conflict between Sections 523(a) and 1192 and deciding that Section 523(a) and its limitation to individual debtors was more specific and should control. He also cited the BAP for saying that the two lower courts' decisions on chapter 12 were "wrong."

Judge Hercher's Analysis

Judge Hercher decided that "debts of the kind" "refers to types of debt, not types of debtors." He therefore concluded that "the plain meaning of 1192(2) is that the discharge under a subchapter V plan confirmed nonconsensually excepts the debts listed in the 523(a) debt-type list — even when the debtor is not an individual."

To his way of thinking, "the 523(a) preamble — and its application only to the discharge of a debtor who is an individual — has no role in the discharge-narrowing work of the cross-references in the second category of discharge sections, including 1192(2)."

If Congress had meant for nondischargeability to apply in Subchapter V only to individuals, Judge Hercher said "it could easily have said so clearly and expressly by excepting in 1192(2) either 'any debt — (2) of an individual debtor of the kind specified in section 523(a)' or as it did in 1141(d)(2), 'any debt — (2) excepted from discharge under section 523.'"

Judge Hercher found no reason to adopt any policy arguments made by the circuits and the BAP because "the meaning of 1192(2) is clear both in isolation and when considered with other Code sections."

Parting Company with the Circuits

Although concurring in the outcome reached in the two circuits, Judge Hercher found two of the circuits' "rationales" to be "questionable."

First, Judge Hercher said that the "general-versus-specific rationale" does not apply because the statutes are not in conflict, since they can be read "in harmony." Second, he did not believe that Congress was following the two lower courts' chapter 12 cases because they were "nonprecedential, unpublished trial-court decisions," making it "unlikely that Congress was aware of them."

Denying the debtor's motion to dismiss the nondischargeability complaint, Judge Hercher predicted that the Ninth Circuit would follow the Fourth and Fifth Circuits to avoid creating a split of circuits.

Updates

In *Off-Spec*, the creditor appealed to the Ninth Circuit, but the parties later withdrew the appeal.

In the case before Judge Hercher, his order denying the motion to dismiss may not be a final order subject to appeal. With regard to jurisdictional issues in a similar circumstance, *see Kiviti v. Bhatt*, 80 F.4th 520 (4th Cir. 2023). To read ABI's report on *Kiviti*, click here.

The opinion is *Ivanov v. Van's Aircraft Inc. (In re Van's Aircraft Inc.)*, 24-06011 (Bankr. D. Ore. June 11, 2024).

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A creditor must control a class before its debt can become nondischargeable in Subchapter V.

Nondischargeability in Sub V Only Applies When It's a Nonconsensual, Cramdown Plan

If a corporate debtor under Subchapter V of chapter 11 confirms a *consensual* plan under Section 1191(a), there is no such thing as a nondischargeable debt under Section 523(a), for statutory reasons explained by Bankruptcy Judge Robert M. Matson of Albany, Ga.

In adopting the Bankruptcy Reform Act in 1978, Congress did away with nondischargeable debts for "ordinary" corporations in chapter 11. Why? Because a creditor with a nondischargeable debt in "old" Chapter XI under the former Bankruptcy Act could kill a plan, to the disadvantage of the larger creditor body that would benefit from reorganization.

Taking Judge Matson's January 31 opinion as gospel, a creditor with a nondischargeable debt can kill a Subchapter V plan only if the creditor controls a class that votes against the plan, thereby forcing the debtor to confirm a nonconsensual, cramdown plan under Section 1191(b).

The Consensual Plan

The debtor leased its employees. The lessor paid the employees' wages and could draw funds from the debtor's bank account to cover payroll. Eventually, the lessor's attempt to draw funds from the debtor's bank account failed.

According to the lessor, the debtor made intentionally false representations about the existence of funds in the account to cover the withdrawals. The representations proved false, because the lessor was stuck with $100,000 in bad debt. After the lessor filed suit in state court, the debtor filed a petition under Subchapter V.

However, the debtor did not schedule the lessor as a creditor. Unaware of the bankruptcy, the lessor obtained a default judgment in state court.

The lessor became aware of the bankruptcy when the debtor filed a suggestion of bankruptcy in state court. Because the lessor was unaware of the bankruptcy, the lessor had not filed a proof of claim before the bar date.

The lessor filed a complaint to except the debt from discharge under several subsections in Section

523(a). The debtor objected to confirmation of the debtor's plan, but the objection was resolved in a stipulation with the debtor.

The debtor confirmed a consensual plan under Section 1191(a), evidently because the class including the lessor had voted in favor of the plan. Just after confirmation, the debtor filed a motion to dismiss the nondischargeability complaint.

Although courts are not in agreement, most courts have decided recently that a corporate debtor in Subchapter V can be saddled with a nondischargeable debt. Those cases, though, involved cramdown plans. To read some of the ABI reports on nondischargeability in Subchapter V, click here and here.

When Section 1141(d) Does and Does Not Apply

Addressing the merits of the motion to dismiss, Judge Matson didn't leave the reader in suspense. He stated this holding: "[T]he discharge provisions of § 1192 (and thus the discharge exceptions on which [the lessor] relies) do not apply to a debtor whose plan was confirmed [as a consensual plan] under § 1191(a)."

Judge Matson then rummaged through several statutory provisions to explain how he arrived at his conclusion. He began by saying that a Subchapter V plan can be confirmed in two ways: (1) If the plan is consensual, it's confirmed under Section 1191(a); and (2) if it's nonconsensual or cramdown, it's confirmed under Section 1191(b).

Generally speaking, the breadth of discharge is controlled by Section 1141(d). Broadly, it says that confirmation "discharges the debtor from any debt that arose before such confirmation." The words "any debt," Judge Matson said, mean that "confirmation of a Chapter 11 plan generally results in discharge of debts of the sort identified in § 523(a)."

However, there are exceptions in Section 1141(d). For example, Section 523(a) nondischargeability applies to individuals in chapter 11, and corporations that liquidate don't receive a discharge. In addition, some types of debts owed to a governmental unit are not discharged. *See* Section 1141(d)(2), (3) and (6).

"[M]ost relevant to this case," Judge Matson said, "§ 1141(d) does not apply when the debtor confirms a plan under § 1191(b), but rather § 1192 does." He drew his conclusion from Section 1181(c), which says, "If a plan is confirmed under section 1191(b) of this title, section 1141(d) of this title shall not apply, except as provided in section 1192 of this title."

Judge Matson translated the statutes into intelligible English as follows:

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> [T]he discharge provisions of § 1141(d) apply when the debtor confirms [a] consensual plan under § 1191(a) but do not apply when the debtor confirms a nonconsensual plan under § 1191(b). In those cases, § 1192 governs the debtor's discharge instead of § 1141(d).

As authority for his conclusion, Judge Matson cited the Fifth Circuit and a decision by Bankruptcy Judge Joseph G. Rosania, Jr., of Denver. *See In re GFS Indus., LLC*, 99 F.4th 223, 227 (5th Cir. 2024); and *In re Palmer Drives Controls & Sys., Inc.*, 657 B.R. 650, 654 (Bankr. D. Colo. 2024).

For failure "to state a claim upon which relief may be granted," Judge Matson granted the debtor's motion to dismiss the lessor's dischargeability complaint, "[b]ecause § 1192, and by extension the exceptions to discharge, do not apply to the Debtor."

Observations

Judge Matson's decision inferentially explains why it makes sense to have nondischargeability in some Subchapter V cases.

Compared to "regular" chapter 11, corporate debtors in Subchapter V are relatively small. A corporate debtor cannot file in Subchapter V to discharge a nondischargeable debt if that's the primary reason for chapter 11. In those circumstances, a creditor with a comparatively large nondischargeable debt likely would control a class, requiring confirmation of a cramdown plan where nondischargeability is a "thing."

On the other hand, if the nondischargeable debt is small and does not control the class, the creditor with a nondischargeable debt should not be able to kill a chapter 11 case to the disadvantage of other creditors who are in favor of confirmation.

The opinion is *Halo Human Resources LLC v. American Dental of LaGrange LLC (In re American Dental of LaGrange LLC)*, 24-1485 (Bankr. M.D. Ga. Jan. 31, 2025).

A decision by a district judge in Idaho may or may not be irreconcilable with a Ninth Circuit BAP decision that a finding of eligibility for Sub V is interlocutory and not appealable.

An Order Finding *In*eligibility for Sub V Is a Final, Appealable Order

Differing with a nonprecedential opinion from the Ninth Circuit Bankruptcy Appellate Panel, a district judge in Idaho held that an order finding the debtor ineligible for Subchapter V is a final, appealable order. It is possible, however, that the outcome in Idaho is reconcilable with the BAP decision, because the results in the two bankruptcy courts were the polar opposites of one another.

On the merits after finding an appealable order, District Judge B. Lynn Winmill of Boise, Idaho, affirmed the late Chief Bankruptcy Judge Joseph M. Meier of Boise, Idaho, by holding that student loans obtained to attend medical school are not debts arising from "commercial or business activities" making someone eligible for Subchapter V.

The Student Loan Debt

The debtor had been an addiction counselor who decided to attend medical school to enhance her financial wellbeing and better serve her patients. After obtaining her medical degree and serving a residency, the debtor practiced medicine as an employee for several organizations for most of 13 years before bankruptcy.

More than 10 years after obtaining her medical degree, the debtor for the first time opened her own practice, but it failed within months. She was an employee on filing a chapter 11 petition and electing to proceed under Subchapter V.

All obtained to attend medical school, the debtor's student loan debt had grown from $325,000 to almost $650,000 with interest. The student loans were substantially more than half of the debtor's total debt.

The U.S. Trustee objected to confirmation of the debtor's chapter 11 plan, arguing that the debtor was not entitled to proceed under Subchapter V. According to the objection, the student loan debt did not arise from "commercial or business activities."

Aside from the question of eligibility for Subchapter V, Bankruptcy Judge Meier decided that the debtor had satisfied all requisites for confirmation of a chapter 11 plan.

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However, Judge Meier concluded that the debtor was ineligible for Subchapter V because there was no nexus between the medical school student debt incurred years earlier and the commercial activity in which the debtor engaged while operating her own practice. *In re Reis*, 22-00517, 2023 BL 148604 (Bankr. D. Idaho May 2, 2023). To read ABI's report, click here.

Appealability

On the debtor's appeal, the U.S. Trustee took the position that the order finding ineligibility was not final and was not subject to appeal under 28 U.S.C. § 157(a)(1).

In his June 20 opinion, District Judge Winmill naturally took counsel from the two controlling Supreme Court decisions on finality in bankruptcy, *Bullard v. Blue Hills Bank*, 575 U.S. 496 (2015), and *Ritzen Group, Inc. v. Jackson Masonry, LLC*, 589 U.S. 35 (2020). He explained how *Bullard* decided that an order denying confirmation was not a final order because only confirmation or dismissal fixes the rights and obligations of the parties.

On the other hand, denial of a motion to modify the stay was found to be appealable in *Ritzen*, because denial of stay relief gave the bankruptcy court nothing more to do.

From the two cases, Judge Winmill distilled two controlling questions: (1) Was the order made in a "distinct procedural unit"; and (2) did the order "terminate" the "distinct proceeding"?

In the realm of Subchapter V, Judge Winmill said there was "a dearth of authority on whether an order sustaining a trustee's objection to a debtor's election to proceed under Subchapter V is a final, appealable order." He found only one case of import, the Ninth Circuit Bankruptcy Appellate Panel's unreported order in *NetJets Aviation, Inc. v. RS Air, LLC (In re RS Air, LLC)*, 21-1053 (B.A.P. 9th Cir. May 26, 2021).

The bankruptcy court had decided in *RS* that the debtor was eligible for Subchapter V. The BAP dismissed the appeal, finding that the order was interlocutory and not appealable because the "determination of whether a debtor qualifies for subchapter V relief under 11 U.S.C. § 1182(1)(A) is part of the Chapter 11 confirmation process and as such, does not definitively dispose of a discrete issue within the bankruptcy case."

Judge Winmill "respectfully" disagreed with *RS Air*. He said that "Subchapter V eligibility determination is a discrete procedural unit that occurs before, and separately from, plan-confirmation proceedings."

In the case before him, Judge Winmill said that "the entire outcome of this case will be affected, given that the Debtor will be pushed into proceeding as an ordinary Chapter 11 debtor . . . as opposed to under Subchapter V[, which has] many advantages over proceeding as a regular chapter 11 debtor."

"If a debtor is going to be vaulted into a different chapter of the bankruptcy code, with all the different rules that will apply," Judge Winmill decided, "the bankruptcy court's order denying Dr. Reis's Subchapter V election was a final, appealable order."

The Merits

Turning to the merits, Judge Winmill was faced with deciding whether review would be *de novo* or a search for clear error, in terms of the finding that medical school debts were not commercial.

Judge Winmill found the answer in Judge Meier's refusal to "lay down a categorical rule" saying that debts incurred before opening a business are never commercial debts.

Because Judge Meier did not announce a "per se" rule, Judge Winmill concluded that "the bankruptcy court did not clearly err in determining that [the debtor's] student loan [debt] did not arise from commercial or business activities." He affirmed Judge Meier's order sustaining the U.S. Trustee's objection to the debtor's eligibility for Subchapter V.

Observations

The decisions by Judge Winmill and by the Ninth Circuit BAP are not necessarily irreconcilable, because the outcomes differed in bankruptcy court. In the BAP appeal, the debtor had been found eligible for Subchapter V. In the case before Judge Winmill, the debtor had been found ineligible.

In the BAP appeal, eligibility was but one of more than a dozen issues along the road to confirmation. In the appeal to Judge Winmill, the finding of ineligibility meant "game over" in Subchapter V.

A finding of eligibility is akin to denial of a motion to dismiss a chapter 11 petition. By analogy to denial of dismissal, a finding of eligibility is interlocutory.

A finding that a debtor has no commercial debts is similar to a finding that the debtor has too much debt for Subchapter V. Findings of too much debt or too little commercial debt are both "game over."

In this writer's view, both opinions point in the same direction. The effect of the order in the progress of the case should illuminate the dividing line between final and interlocutory.

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ROCHELLE'S DAILY WIRE

The opinion is *Reis v. Garvin (In re Reis)*, 23-00279 (D. Idaho June 20, 2024).

Bankruptcy Judge Christopher Bradley disagreed with a district court in Florida that required a 'true up' if actual disposable income in Sub V exceeds projected disposable income.

Sub V Plan Doesn't Require Automatic Increases Based on *Actual* Disposable Income

Differing with a decision by a district judge in Florida 16 months before, Bankruptcy Judge Christopher G. Bradley of Austin, Texas, found "no general requirement for a subchapter V debtor to 'true up' its payments to its creditors when its actual income exceeds its projected disposable income."

The corporate debtor in Subchapter V of chapter 11 proposed a "cramdown" plan requiring payments starting out at $36,000 in the first year and rising to $216,000 in the fifth and last year of the plan. The Subchapter V trustee did not object to the debtor's calculation of "projected disposable income."

The Subchapter V trustee did object to confirmation because, as Judge Bradley said in his April 30 opinion, the plan "did not provide that the debtor had to pay more if actual disposable income exceeded projections."

There was a non-accepting class of unsecured creditors, meaning that the plan must comply with the cramdown requirements in Section 1191(b). The subsection permits confirmation if "the plan does not discriminate unfairly, and is fair and equitable." Under Section 1191(c)(2)(A), the plan is "fair and equitable" if, "as of the effective date of the plan," the "plan provides that all of the projected disposable income of the debtor . . . will be applied to make payments under the plan."

Judge Bradley paraphrased the statute as requiring "the debtor to devote its *projected* disposable income . . . to plan payments for three to five years." [Emphasis in original.] He went on to say that projected disposable income "accords with the 'forward-looking approach' that the Supreme Court has endorsed" in *Hamilton v. Lanning*, 560 U.S. 505, 519 (2010).

"To require a 'true up,'" Judge Bradley said, would "eliminate the future-looking element indicated by the word 'projected'" and "read the word 'projected' out of the statute." He found only one case requiring a "true up," *In re Staples*, 22-157, 2023 WL 119431 (M.D. Fla. Jan. 6, 2023). To read ABI's report on *Staples*, click here.

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Judge Bradley observed that the district court in *Staples* found authority for a true-up in the All Writs Act and Section 105(a), which enables the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." He nonetheless said that the "*Staples* opinion does not support imposition of a true up either as a general rule or in this case."

First, Judge Bradley said that "the *Staples* opinion does not purport to announce a general rule requiring true ups." Second, he said that "the *Staples* opinion simply does not provide enough factual detail about that case to assess its similarities or differences with this Debtor's situation." He concluded that *Staples* does not provide "persuasive weight in favor of imposition of a true up."

Judge Bradley found support for his conclusion in cases under chapters 12 and 13, where, he said, the definition of "disposable income" is "substantially the same." In chapter 13, where there is "much more case law," he said that courts have "overwhelmingly ratified a prospective interpretation, that is, an interpretation requiring debtors to devote their projected income to plan payments, but not to 'true it up' if their actual income proves to be higher."

Judge Bradley cited the Eighth Circuit for taking a contrary position in a chapter 12 case, *Rowley v. Yarnall*, 22 F.3d 190 (8th Cir. 1994). He said that the "*Rowley* court admitted that its result was contrary to the text's plain meaning."

Citing "numerous courts and commentators," Judge Bradley said that *Rowley* "is not convincing." Furthermore, he said that *Rowley* "runs contrary to the Supreme Court's 2010 decision in *Hamilton v. Lanning*."

Judge Bradley also found it "telling that subchapter V provides no opportunity for any party other than the debtor to seek to modify the plan . . . . The debtor may be able to modify the plan to decrease the payments if reality falls short of expectations, but the projected income may be the ceiling for creditors in subchapter V cases."

Closing the opinion, Judge Bradley said that his decision "does not necessarily rule out the possibility that circumstances could arise under which a court would have the power to impose a true up." He saw no reason to address the question because "[n]o special circumstances have been alleged, and therefore no true up is warranted."

Judge Bradley overruled the objection and confirmed the plan.

The opinion is *In re Packet Construction LLC*, 23-10860 (Bankr. W.D. Tex. April 30, 2024).

ROCHELLE'S DAILY WIRE

The definition of 'small business' uses the word 'activities,' not 'operations,' making nonoperating small business eligible for Subchapter V.

A Business that Never Generated Income Is Eligible for Subchapter V, Judge Norman Says

Because the statutory definition of "small business" refers to "business activities" not "business operations," Bankruptcy Judge Jeffrey Norman of Houston held that the corporate debtor was eligible for Subchapter V of chapter 11 even though the debtor had never generated income.

The LLC debtor was a holding company that owned patented piping technology. As Judge Norman said in his November 20 opinion, the debtor had raised $4 million from bridge loans and by selling secured notes. However, the debtor had not landed a contract to sell pipe.

Three creditors filed an involuntary petition. The debtor consented to entry of an order for relief in chapter 11 and elected to proceed under Subchapter V. The petitioning creditors objected to Subchapter V designation, contending that the debtor was never a "business," never generated income and was never engaged in commercial or business activities.

Judge Norman explained that the creditors were aiming to file a plan of their own, an impossibility unless the case was under "regular" chapter 11.

Defined in Section 101(51D)(A), a "small business debtor"

> means a person engaged in *commercial or business activities* . . . that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than" $7.5 million. [Emphasis added.]

Judge Norman said that the Bankruptcy Code "does not provide a definition for 'commercial or business activity.'" To decide whether the debtor qualified, he looked at the totality of the circumstances.

From testimony by the debtor's chief operating officer, Judge Norman found that the debtor had a lease, maintained a bank account, continually attempted to generate business, provided marketing materials to potential investors and retained attorneys to protect intellectual property.

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Rochelle's Daily Wire

For caselaw precedent, both sides relied on *In re Port Arthur Steam Energy LP*, 629 B.R. 233 (Bankr. S.D. Tex. July 1, 2021), where Bankruptcy Judge Christopher M. Lopez of Houston held that collecting accounts receivable and maintaining the physical assets qualified as being engaged in commercial activities, even though the historical business was no longer operating. To read ABI's report, click here.

Judge Norman also took counsel from *In re Offer Space LLC*, 629 B.R. 299 (Bankr. D. Utah April 22, 2021), where Bankruptcy Judge William T. Thurman held that a nonoperating business qualified for Subchapter V if it had a bank account and was managing its few remaining assets. To read ABI's report, click here.

If Section 101(51D)(A) had used the word "operations" in the definition rather than "activities," Judge Norman said he would have found the debtor ineligible for Subchapter V, because the business was no longer functional or operational on the filing date.

Judge Norman held that the debtor "was engaged in 'commercial or business activities'" and qualified for Subchapter V because there was a lease, a bank account and marketing materials for investors, plus "attempts to generate business" and attorneys to protect intellectual property.

The opinion is *In re GCPS Holdings LLC*, 24-32646 (Bankr. S.D. Tex. Nov. 20, 2024).

Bankruptcy Judge Larson administratively closed a Sub V case after substantial consummation.

Sub V Trustee May Be Discharged When the Debtor Makes Plan Payments

When a nonconsensual plan is confirmed in Subchapter V, the bankruptcy court has discretion to discharge the Subchapter V trustee and close the case after substantial consummation, according to an opinion by Bankruptcy Judge Michelle V. Larson of Dallas.

The corporate debtor in Subchapter V confirmed a nonconsensual chapter 11 plan and gave notice of the effective date of the plan one month later. The plan called for the debtor to make plan payments, not the trustee.

Two months after the effective date, the debtor gave notice of substantial consummation of the plan and filed a motion seeking entry of a final decree and discharging the trustee. The Subchapter V trustee lodged the only objection.

When a plan is nonconsensual, the Bankruptcy Code does not say whether the court may close the case before the completion of plan payments. In her August 22 opinion, Judge Larson said the question was an issue of first impression in the district.

Unlike a consensual plan, the debtor with a nonconsensual plan does not receive a discharge until after the completion of plan payments, as provided in Section 1192.

The Statute

Section 350 and Bankruptcy Rule 3022 say that the court "shall" close the case when it has been "fully administered" and "the court has discharged the trustee." The Advisory Committee Note says that closing the case "should not be delayed solely" because all plan payments have not been made.

Under Section 1101(2), a chapter 11 case has been "substantially consummated" when all property has been transferred under the plan, the debtor or the successor has assumed management and plan payments have commenced.

For Subchapter V plans that were confirmed consensually under Section 1191(a), Section 1182(c)(1) provides that "the services of the trustee shall terminate when the plan has been

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substantially consummated." In a nonconsensual case confirmed under Section 1192(b), "the Code is silent regarding termination of the Subchapter V trustee's service," Judge Larson said.

The *Subchapter V Trustee's Handbook*, prepared by the U.S. Trustee program, says that the Subchapter V trustee under a nonconsensual plan should remain in place for the life of the plan, even when the debtor is making plan payments.

Persuasive Authorities

To answer the question, Judge Larson identified three cases on the topic. One held that the trustee should remain in place until all payments have been made and the trustee files the final report. *In re Gui-Mer-Fe*, 21-01659, 2022 WL 1216270, at *8 (Bankr. D.P.R. Apr. 15, 2022).

Judge Larson was persuaded by *In re DynoTec*, 21-30803, 2024 WL 2003065 (Bankr. D. Minn. April 5, 2024), and *In re Florist Atlanta*, 24-51980, 2024 WL 3714512 (Bankr. N.D. Ga. Aug. 7, 2024).

In *DynoTec*, Bankruptcy Judge Kesha L. Tanabe decided that the Code "provides sufficient flexibility to allow for the discharge of a Subchapter V trustee prior to completion of the plan payments, even where such a case was confirmed non-consensually," Judge Larson said.

Judge Larson then went on to say that she found *Florist Atlanta* to be "most persuasive." To read ABI's report on *Florist Atlanta*, click here.

In *Florist Atlanta*, Judge Larson described Bankruptcy Judge Paul W. Bonapfel as having held that "the Bankruptcy Code gives bankruptcy courts discretion to determine, based upon the specific facts of each case, whether, when, and how a non-consensual Subchapter V case should be closed prior to entry of discharge."

The Trustee May Be Discharged

Turning to the facts of the case before her, Judge Larson said the three elements of "substantial consummation" had been shown. Under "traditional analysis," she said that "this case can be considered fully administered."

Next, Judge Larson analyzed whether the trustee could be discharged before completion of her statutory duties. Even if the case where closed and the trustee had not filed her final report, Judge Larson said that the case could be reopened.

In the case before her, Judge Larson said that the trustee was neither administering assets nor making plan payments. She concluded that "the Trustee's statutory duty to file a final report in this case is not sufficient cause to keep these cases open, and it is thus appropriate to order the termination of the services of the Subchapter V Trustee." Also, closing the case could allow the debtor to avoid incurring some administrative expenses.

Judge Larson held that the debtor had "fulfilled both the predicate statutory requirements under the Bankruptcy Code and this Court's specific requirements under the Confirmation and Post-Confirmation Orders for issuance of a final decree."

"Nevertheless," Judge Larson said, issuing a final decree would be "inappropriate," based on the debtor's "stated intention" to reopen the case three years later to allow entry of discharge. She therefore decided that the "best approach" was "for the case to be 'administratively closed' subject to reopening when the case is ripe for entry of discharge."

Judge Larson ended her opinion by directing the trustee to file her final report within two weeks and for the debtor to pay the trustee's fees in full. She directed that the case be closed administratively when the trustee has been paid.

The opinion is *In re Lager*, 22-30072 (Bankr. N.D. Tex. Aug. 22, 2024).

Legislative Update

By Heidi J. Sorvino, Andrew E. Arthur and Michael Ingrassia

The $7.5 Million Subchapter V Debt Limit Should Be Reinstated

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In 2019, Congress introduced the Small Business Reorganization Act (SBRA)[1] to the Bankruptcy Code. The SBRA, codified as subchapter V of chapter 11, became effective on Feb. 19, 2020. Since its enactment, subchapter V has served as a streamlined, cost-effective and efficient bankruptcy option for small businesses and a new opportunity for practitioners. Instantly popular, the newly enacted subchapter V aimed to provide eligible business debtors (*i.e.*, those under the statutory debt limit) with a quicker and cheaper way to reorganize, which was an appealing alternative to the vastly more expensive traditional chapter 11 filing.

Subchapter V's debt limit was initially set to $2,725,625, but due to the financial stress of the COVID-19 pandemic,[2] Congress raised it to $7.5 million. The increased debt limit showed subchapter V's full potential, with filings reaching record levels in 2023 and accounting for 44 percent of all chapter 11 cases in 2023,[3] more than 25 percent of all cases filed since February 2020,[4] and a 79 percent increase in filings from November 2022 to November 2023.[5] Despite its rapid and proven success, Congress allowed the subchapter V debt limit to sunset on June 21, 2024, resulting in its reversion from $7.5 million to an adjusted $3,024,725.[6]

Subchapter V has become a bankruptcy success story for debtors and the insolvency industry. Small businesses have found a viable alternative to a traditional chapter 11 filing that adequately addresses the unique needs of small business debtors. Thus, subchapter V's proven utility for small businesses should not be ignored when the alternative of a traditional chapter 11 filing requires high costs and a slower process.

Restructuring professionals and ABI have urged and recommended that Congress reinstate and make permanent the heightened debt limit. Subchapter V is a tool that needs a debt limit expansion to maximize its purpose and bring back the previous volume of filings for the benefit of debtors and practitioners. For several reasons, the $7.5 million debt limit should be reinstated.

Negative Impact of the Decreased Debt Limit

The repercussions of reverting back to the previous debt limit are well-documented. Since the sunset of the $7.5 million debt limit, subchapter V filings have dropped significantly.[7] To illustrate the immediate effects, in the month immediately preceding the debt limit's expiration there were 321 subchapter V filings, but the number of monthly filings fell *by almost half* after the expiration to 175 subchapter V filings.[8] This sudden decrease after the expiration demonstrates that fewer businesses see subchapter V as an available option.

Further, subchapter V is presently needed in our economic climate as small business bankruptcies continue to grow. In September 2024, subchapter V small business elections increased 9 percent to 167, compared to 153 from September 2023.[9]

While there is still more data to be documented from this debt limit sunset, the aforementioned numbers are trending in the same direction (*i.e.*, lower subchapter V filings, higher filings holistically[10]). As has been consistently shown, subchapter V is a desired reorganization option for small businesses. Economic headwinds and market cycles create an absolute need for a small business reorganization path. Having to satisfy a lower debt limit is an unnecessary hurdle to small businesses across the U.S. that are already enduring economic strife.

A Heightened Subchapter V Debt Limit Increases the Probability of Successful Reorganization

In addition to increasing the pool of eligible debtors, a higher subchapter V debt limit also

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1 P.L. No. 116-54 (2019).
2 P.L. No. 116-136 (2020), as amended by Pub. L. No. 117-5 (2021), as further amended by Pub. L. No. 115-151 (2022) (extending debt limit).
3 *See* Final Report and Recommendations of the ABI Subchapter V Task Force (2024), subvtaskforce.abi.org. ABI is also continuing its study of subchapter V by collecting experiences from those involved, which can be shared at abi.org/subvstories. Unless otherwise specified, all links in this article were last visited on Dec. 27, 2024.
4 *Id.*
5 *See* "November Commercial Chapter 11 Filings Increase 141 Percent over 2022," Epiq Global (Dec. 4, 2023), epiqglobal.com/en-us/resource-center/news/november-commercial-chapter-11-filings-increase-141-percent-over-2022-propelled-by-wework-bankruptcy. *See also* Joy Kleisinger, "The Expiration of the Increased Subchapter V Debt Limit and Its Impact on Small Business Debtors," XLIII *ABI Journal* 3, 8, 48, March 2024, abi.org/abi-journal/the-expiration-of-the-increased-subchapter-v-debt-limit-and-its-impact-on-small-business.
6 11 U.S.C. § 104, as adjusted for inflation.
7 *See* Alexander Lugo, "Subchapter V Bankruptcy Filings Plummeted After Congress Let Its Qualification Threshold Sunset," *ALM Global* (Oct. 18, 2024), law.com/dailybusinessreview/2024/10/18/subchapter-v-bankruptcy-filings-plummeted-after-congress-let-its-qualification-threshold-sunset/?slreturn=20241206164715 (subscription required to view article).
8 *Id.* (providing number of filings in June 2024 and July 2024, respectively).
9 *See* "Bankruptcy Statistics," ABI, abi.org/newsroom/bankruptcy-statistics.
10 *Id.*

resulted in an increase of post-confirmation business viability. The survival rate for organizations with confirmed subchapter V plans in December 2023 is 86 percent higher than the 70 percent survival rate of nonsubchapter V cases.[11] As such, businesses reaching plan confirmation in subchapter V maintain strong chances of continued viability upon emergence from bankruptcy.

Even more importantly, subchapter V *more than doubles* the probability of successful reorganization for organizations "near the $7.5 million threshold."[12] This documented correlation between businesses near the $7.5 million debt limit and successful subchapter V reorganizations suggests that those same businesses would not survive post-confirmation if limited to a traditional chapter 11 process.

The Simplified Procedures Provide Broader Access to Reorganization for Small-Business Debtors

Returning to pre-pandemic debt adjustments has been disruptive to an already successful tool. The SBRA was a product of diligent research and studies of small business reorganizations, and the simplified procedures are meant to match the needs of small business debtors. Subchapter V is aimed at, among other things, addressing the costly nature of a traditional chapter 11 filing for a small business debtor. Subchapter V removes the (1) disclosure statement requirement, (2) appointment of a creditors' committee(s), and (3) need for U.S. Trustee quarterly fees, which are usually paid by traditional chapter 11 debtors.

Further, subchapter V allows small business equityholders to retain their interests in the debtor entity by eliminating the so-called absolute-priority rule, which expands avenues for plan confirmations.[13] Such procedures have removed barriers to create greater access for small business debtors and remove the costly aspects of chapter 11 (including related litigation). Increasing the debt limit would similarly expand access to those debtors who are above the current threshold, but who could successfully reorganize under subchapter V.

Proven Successful

Subchapter V's success is generally withheld in the entities that have filed and confirmed their plans. Such reorganized entities were able to reap the benefits of a bankruptcy process that works and was created for their needs. From 2020 through June 30, 2024, there were 8,498 subchapter V cases filed,[14] a quarter of all chapter 11 cases filed. As compared to traditional chapter 11 small business cases, subchapter V cases have enjoyed nearly double the percentage of confirmed plans, half the percentage of dismissals, and a shorter path to plan confirmation.[15]

11 Edith Hotchkiss, Benjamin Iverson & Xiang Zheng, "Can Small Business Survive Chapter 11?," March 12, 2024, papers.ssrn.com/sol3/papers.cfm?abstract_id=4726391.
12 *Id.*
13 11 U.S.C. § 1181(a).
14 *See* "Chapter 11 Subchapter V Statistical Summary Through November 30, 2024," U.S. Trustee Program, justice.gov/ust/page/file/1499276/dl?inline.
15 *Id.*

Moreover, the ability of distressed small businesses to survive reorganization serves a broader economic purpose. Small businesses are vital to the American economy. As of 2023, the U.S.'s 33.2 million small businesses employ more than 61 million people.[16] Unfortunately, about half of small businesses close within their first five years of opening.[17]

Subchapter V's increased debt limit would augment the number of those small businesses that may qualify for subchapter V's protections. The businesses of many subchapter V debtors continue to operate after bankruptcy. For example, a recent study found that the survival rate for companies that emerge from chapter 11 with subchapter V confirmed plans as of December 2023 is 86 percent, or 16 percent higher than traditional chapter 11 cases.[18]

As previously highlighted, subchapter V has proven to be a vehicle that works exceedingly well for businesses that are on the higher end of the eligibility threshold. As filings grow, it is imperative for those businesses to be availed of the opportunity of choosing a bankruptcy process specifically tailored with those needs in mind.

A Majority of the Industry Supports a Heightened Subchapter V Debt Limit

Bankruptcy professionals have long valued expediency and efficiency,[19] and subchapter V's heightened debt limit proved to be just that. While critics of a higher limit have focused on debtors that have sought to abuse the process by disputing the debts owed to stay under the debt limit, the majority of the insolvency industry generally favors a permanent increase. Importantly, ABI created the Subchapter V Task Force, which unveiled its final report of recommendations. The key recommendation was establishing a permanent filing eligibility debt limit of $7.5 million in aggregate, noncontingent, liquidated debt to reorganize under subchapter V.[20]

ABI recognized bankruptcy professionals' and judges' repeated compliments on subchapter V. Hon. **Michael E. Romero** of the U.S. Bankruptcy Court for the District of Colorado remarked that subchapter V "has opened up the ability for financial rehabilitation to entities previously priced out of the more standard Chapter 11 process. The value of extending a survival opportunity to financially challenged but valuable members of our communities can never be underestimated."[21]

Moreover, the lower debt limit not only reduces the amount of eligible debtors, it is bad for those practitioners who have gained specialty experience in subchapter V fil-

16 "Frequently Asked Questions About Small Businesses," Small Bus. Admin. (March 2023), advocacy.sba.gov/wp-content/uploads/2023/03/Frequently-Asked-Questions-About-Small-Business-March-2023-508c.pdf.
17 *See* "Small Business Statistics," Chamber of Commerce (July 24, 2024), chamberofcommerce.org/small-business-statistics.
18 *See* Hotchkiss, *et al.*, *supra* n.11.
19 *See* Christopher D. Hampson & Jeffrey A. Katz, "The Small Business Prepack: How Subchapter V Paves the Way for Bankruptcy's Fastest Cases," 92 *Geo. Wash. L. Rev.* 851 (2024).
20 *See* ABI Final Report, *supra* n.3.
21 Written Statement of Hon. Michael E. Romero, at 6, ABI Subchapter V Task Force Hearing (Operation of the Case) (July 28, 2023), subvtaskforce.abi.org/hearings/july-28-2023-virtual-public-hearing.

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Legislative Update: The $7.5M Sub V Debt Limit Should Be Reinstated

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ings. According to **Steven Weiss**, a frequent subchapter V trustee, "nearly half of his subchapter V cases fell out of eligibility due to the debt limit."[22] The majority of financial restructuring and bankruptcy professionals, as well as judges, are urging Congress to restore the increased debt limit. As the ABI Subchapter V Task Force reinforced in its report, small businesses are at the core of the American economy, and a permanent increased debt limit would maximize predictability and trust in small business reorganizations.

Conclusion

Despite being relatively new and growing, subchapter V has had an impact on the financial restructuring and bankruptcy industry. Notably, subchapter V has been tested through one of the most devastating economic recessions in recent history: the beginning and aftermath of a global pandemic. Subchapter V consistently offered the essential bankruptcy option for distressed small business debtors in the U.S. with their unique concerns in mind.

The $7.5 million debt limit was in place for the majority of subchapter V's lifetime, covering a period of all but the first six weeks after its effective date (Feb. 19 to March 26, 2020) and two months in 2022 (March 27 to June 21, 2022).[23] The $7.5 million limit is part of subchapter V's success, and such a heightened debt limit must stay, as (1) the sunsetting of the $7.5 million debt limit caused negative effects on the small business community; (2) a heightened subchapter V debt limit increases the probability of successful reorganizations; (3) subchapter V has greater reorganization access to small business debtors through simplified procedures; (4) subchapter V has proven its success; and (5) subchapter V has been broadly supported by professionals in the bankruptcy industry. abi

22 *See* Steven Weiss, "Has Subchapter V Solved the Problems of Small Business Bankruptcies? Views and Reflections of Subchapter V Trustees on the First Two Years of the New Law: Thoughts on Subchapter V," 31 No. 3 *Norton J. Bankr. L. & Prac.* Art. 1 (2022).

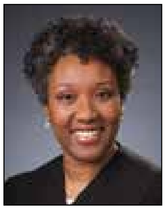
23 *See* ABI Final Report, *supra* n.3.

Dicta

By Hon. LaShonda A. Hunt

Mirror, Mirror on the Wall

Observations on Trial Practice from the Other Side of the Bench



Hon. LaShonda A. Hunt
U.S. Bankruptcy Court (N.D. Ill.); Chicago

Hon. LaShonda Hunt is a U.S. Bankruptcy Judge for the Northern District of Illinois in Chicago. She previously was general counsel of the Illinois Department of Central Management Services, chief legal counsel of the Illinois Department of Corrections, and an Assistant U.S. Attorney in Chicago.

I am a proud unicorn: one of those bankruptcy judges who did not practice bankruptcy before her appointment to the bench. The last four years have been a wild and sometimes bumpy ride, as I've struggled to learn a foreign language filled with acronyms, jargon and Bankruptcy Code sections. Still, I like to believe that some aspects of my generalist background helped prepare me to serve as a trial judge. After all, I was a commercial litigator at a national law firm, a federal law clerk on the district court and appellate levels, an in-house lawyer for a major utility company (where I had some exposure to mega-cases), and general counsel for a couple of state agencies. A jack-of-all-trades who knows a little about a lot is an accurate description of me.

One past position that has proved most helpful, though, is as Assistant U.S. Attorney in the Civil Division. We were trial lawyers representing the Department of Justice in defense of the federal government and agencies in a variety of cases. I handled the full range of civil lawsuits and did everything from drafting pleadings to trying cases to arguing appeals. It was a great way to learn how to master all aspects of the civil litigation process. Knowing how to manage discovery, engage experts, apply the rules of evidence and present a case definitely comes in handy as a new trial judge.

I was fortunate to attend several of the Department of Justice's nationally recognized training programs on trial advocacy. Because so few civil cases make it to trial anymore, opportunities for any lawyer to learn by doing are limited. Mock trial exercises fill a critical gap, especially for new lawyers who want to hone their skills and develop into effective litigators.

One of my most memorable experiences as a new Assistant U.S. Attorney involved videotaping my mock trial performance and having experienced faculty members — practitioners and federal judges — offer criticism. That was when I discovered my tendency to blink a lot, make strange faces and gesture extensively with my hands. It was unnerving, to say the least, to see on the screen my every imperfection. I wondered whether a jury could even focus on what I was saying or whether they were too distracted by my nervous tics. Fast-forward to today, a world filled with Zoom trials, and now my face is front and center for everyone to see up close and personal. Even worse, Zoom has a mirror feature that allows me to see myself. At least in the courtroom wearing reading glasses, I could shield my expressions from the litigants at the podium. Suffice it to say, I was not blessed with a poker face. (Thankfully, a kind colleague has since shown me how to hide the self-view.)

But remembering that video of myself years ago and constantly seeing my own reflection today prompted me to consider what others take away from our performances in the courtroom. Now, sitting on the bench as a trier of fact gives me a unique vantage point to observe lawyers at trial. Having had many bench trials, simple and complex, in person and virtually, and given my own experiences as a trial lawyer, I have a few pointers to share. I call them the four Ps of trial practice.

Preparation

Prepare for the long game and assume that the dispute will be decided after a trial. I was warned before taking the bench that bankruptcy lawyers avoid trials like the plague (although perhaps this is not the best metaphor these days). I have certainly received that last-minute call to chambers explaining that the parties have suddenly settled. Usually, that is the best result for everyone involved. Indeed, it is far more economical to settle than to roll the dice with a judge who is not familiar with the particulars of the situation.

Although our job as judges is to rule on disputed issues, I urge litigants to sit down and talk first. Stop fighting and see if there are areas of agreement you can use to build consensus. Parties tend to be happier with the deals they broker themselves than with decisions a court imposes. Wise attorneys also recognize the danger in pressing the unfortunate combination of bad facts and unfavorable law.

That said, counsel should always proceed on the assumption that the matter will go to trial. Why? Because a case usually has three potentially dispositive stages — motion practice, settlement or trial — and each involves a different case-management strategy. Of these, trials require the most forethought, the most case assessment.

How does case assessment work? Consider a common nondischargeability adversary proceeding alleging that the debtor fraudulently induced the creditor to lend money that the debtor never intended to repay.

- First, start with the complaint and answer, along with the relevant case law or statutory provisions, and identify your theory of the case. Usually an adversary like this hinges on the debtor's intent to defraud.

• Next, think about whether *you* have to prove your theory, and if so, how you will do that. Determine the elements of the claim and who bears the burden of proof. If any affirmative defenses are raised, ask the same questions: What are the elements, and who has the burden?

• Now, examine the evidence and consider whether it supports or contradicts each element. As you proceed in discovery, continue to assess the evidence and whether it fits into the analytical framework. If the facts are unfavorable to your theory, how will you explain them away?

All of this information should be organized neatly in your trial notebook, which is nothing more than a fancy binder with tabs. The goal is to ensure that if you get to trial, you will be able to tell a compelling story, one consistent with the evidence. And if you find that those unfavorable facts can't be explained, that tells you that settlement might be something to consider seriously. If you approach preparation in a strategic and focused manner, you will be in a better position to understand the issues along the way and pivot if necessary.

Pursuit

Pursue every form of discovery. With limited exceptions, the civil discovery rules apply in contested matters and adversary proceedings in bankruptcy. These rules give litigants powerful tools to investigate and uncover relevant information about the claims and defenses. Discovery also offers a chance to assess the strength of the evidence as you prepare for trial or settlement discussions. Without discovery, parties are flying blind.

Except in the largest cases, written discovery can be quick and inexpensive. Carefully drafted document requests can force your opponent to produce every potentially harmful or beneficial piece of paper in the case. Interrogatories can help you come to understand the factual support for the claims and defenses, as well as identify witnesses with knowledge who might need to be deposed.

Requests to admit are another gem too often overlooked. If drafted properly, requests to admit can eliminate factual disputes and ease problems of proof at trial.

Oral depositions are more expensive, but they, too, are a worthwhile tool for locking in an opponent's story. Transcripts let you hold witnesses to their stories under oath and subject them to impeachment if they deviate. Too often, I have seen cross-examination go awry when an unexpected answer from an undeposed witness takes counsel by surprise. As a former litigator, I am shocked at the number of bankruptcy matters that proceed to trial after limited or no discovery. Even in smaller-dollar cases, the opportunity to nail down the witness and eliminate wiggle room should not be overlooked. Judges' rulings often hinge on witness credibility determinations.

Remember that your opponents have no reason to share their version of the facts, but they can be made to through discovery. Discovery is an integral part of trial preparation that can make or break a case.

Positioning

Position your client for success by developing a solid plan for getting your evidence into the record and keeping out your opponent's. Determine which witnesses and documents will be needed to prove the claims or defenses, and consider potential barriers to admissibility. Often, parties simply assume that their evidence will be admitted. Better to make the opposite assumption and anticipate the objections your opponent might raise. I have lost count of the number of times counsel, faced with unanticipated objections, appear to be at a loss for words or, even worse, flash that "deer in the headlights" look.

To avoid evidentiary squabbles, some judges enter detailed pretrial orders requiring parties to exchange witness and exhibit lists (as well as proposed exhibits) and identify objections before the trial. But not all do, and if your document is rejected, the one critical to proving an element of your claim, you may fail to meet your burden of proof. So be ready — and have a backup plan to get the information into the record. Review the rules of evidence before the objection arises at trial. Comb through the discovery responses to find other admissible evidence that can also prove the point.

In addition, don't do a data dump, where parties try to have admitted into the record every piece of paper produced in discovery for fear of missing something. Instead, go back to your trial notebook and decide what is relevant to the contested legal issues. By this point, you should know the critical testimony and documents well, particularly what helps and what hurts your case. That way, you can easily adjust your trial strategy if certain evidence is allowed in or kept out.

Performance

To perform well at trial, tie together the facts and the law to show that your client should win. Trials are like stage plays. There is an opening act, development of the story in the middle scenes, then the final act before the curtain closes. Human minds are wired to remember stories and themes. So use the opening statement and closing argument to underscore your theory of the case. Some repetition is helpful; too much detracts from the presentation. Every witness and every exhibit should fall in line with your theme. And take the time to prepare your witnesses for the big event.

This is solid advice, and I wish I could say I always heeded it as a practitioner. But, true confession: I bombed in the first trial I first-chaired. I had a supportive and experienced supervisor as co-counsel. I had received some of the best trial advocacy training around. And still I failed to execute.

What happened? I had made assumptions that caused me to prepare badly. It was a wrongful-death case with a plaintiff whose theory struck me as so far-fetched that I just knew the judge would reject it outright. In other words, I prepared for trial with tunnel vision — and that limited thinking caused me to minimize the shortcomings of my own case. Then I made a tactical error: I decided not to depose the doctor whose handwritten notes turned out to be critical because I figured his testimony would not matter. But the judge saw it differently, overruling all of my evidentiary objections and

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sustaining all of my opponent's. The judge also rejected my expert witness, torpedoing my defense. On the last day of trial, I tried to salvage the case by waiving closing argument and instead submitting a stellar post-trial brief that would surely save the day. It did not.

But I learned some important lessons that I put to use in my other cases — and I am happy to say that following the four Ps produced better results thereafter. I did not win all of those cases — no one wins them all — but I never found myself unprepared again.

Conclusion

A final point: Lawyers learn to try cases by trying them. As trials decline in number, *pro bono* work can allow you to apply the principles I've discussed and obtain invaluable trial experience you might not otherwise gain, and those in need get legal representation that they could not otherwise afford. I encourage all lawyers to take on *pro bono* assignments: They are a great way to advance the administration of justice, serve the public good, and put into practice the four Ps. That, in my humble opinion, is a win-win for everyone. abi

Practice & Procedure

By J. Scott Bovitz[1]

Meeting a Judge's Expectations

An Interview with Hon. Barry Russell

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Hon. **Barry Russell** has been on the bench since 1974 (that is not a misprint). He has the longest tenure of any bankruptcy judge in the U.S. From January 2003 to December 2006, Judge Russell was chief judge of the U.S. Bankruptcy Court for the Central District of California. From September 1999 to December 2001, he was chief judge of the Bankruptcy Appellate Panel for the Ninth Circuit. He has also been an ABI member since 1985 and served on ABI's Ethics Standards Task Force.

Judge Russell has presided over thousands of bankruptcy cases, contested matters and adversary proceedings. His expectations are simple. In this article, he shares his expectations for lawyers engaged in contested matters and adversary proceedings.

Review Your Judge's Public Materials

If your judge has posted procedures on the court's website, study these procedures before you file a pleading or show up in court. Does your judge allow self-calendaring? If so, when does the judge schedule hearings on your type of contested matter? Does your judge require a paper courtesy copy of briefs, two-hole punched, with exhibit tabs, on blue paper?

Read the Rules — All of the Rules

Study and cite to the relevant parts of the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, the Federal Rules of Civil Procedure, the Local Bankruptcy Rules, the posted procedures on the court's website and the *Court Manual* (if any).[2]

Is There a Court-Approved Form for Your Motion?

The U.S. Bankruptcy Court for the Central District of California has posted "fillable" forms for common motions and filings. These include PDF forms for filing a bankruptcy case, loan-modification forms, Local Bankruptcy Rule forms, mediation forms, official bankruptcy forms, proof-of-claim forms and miscellaneous forms.[3] If your court posted a form, use it. If necessary, file a supplemental document to support your "form" motion.

Study Binding Appellate Case Law

Hon. Barry Russell
U.S. Bankruptcy Court (C.D. Cal.); Los Angeles

Has the U.S. Supreme Court, court of appeals, bankruptcy appellate panel or district court issued an opinion on the substantive law? If so, synthesize these opinions into your motion, complaint or brief. Before drafting a nondischargeability complaint, start with the following cases: *Husky Intern. Elecs. Inc. v. Ritz*,[4] *Lamar, Archer & Cofrin, LLP v. Appling*,[5] *Bullock v. BankChampaign NA*,[6] *Kawaauhau v. Geiger*[7] and *Rimini Street Inc. v. Oracle USA Inc.*[8]

Read Your Judge's Published Opinions

If your judge has written a decision on the relevant substantive law, carefully study that decision. Read all cases citing the judge's opinion. When Judge Russell publishes an opinion, he really cares about the topic.

Know When (and Whom) to Call, and What Not to Say

Most judges have an active website, which will usually list the proper contacts for calendaring, emergencies and (if needed) "second call" requests. Do not try to argue your case with the bankruptcy judge's staff. *Ex parte* advocacy will not help your case.

Speaking of "Second Call," Do Not Be Late to Court

This author was in Judge Russell's courtroom when a tardy lawyer said, "Siri said it would only take an hour to get to court." Really? Judge Russell mounts the bench on time. Put the clerk's number in your cell phone (now!) so that you can find the number when you are stuck behind a protest march near the courthouse. (Judge Russell's clerk might be in the courtroom with the judge, so call his clerk at least 30 minutes before the scheduled hearing.)

1 The author thanks Judge Russell for his advisory opinions. Judge Russell's advisory opinions (as interpreted by the author) are not binding in his courtroom.
2 *Court Manual*, U.S. Bankruptcy Court for the Central District of California, *available at* cacb.uscourts.gov/court-manual (unless otherwise specified, all links in this article were last visited on Feb. 26, 2020).
3 "Forms," U.S. Bankruptcy Court for the Central District of California, *available at* cacb.uscourts.gov/forms.
4 136 S. Ct. 1581 (2016) (11 U.S.C. § 523(a)(2)(A)).
5 138 S. Ct. 1752 (2018) (11 U.S.C. § 523(a)(2)(B)).
6 569 U.S. 267 (2013) (11 U.S.C. § 523(a)(4)).
7 523 U.S. 57 (1998) (11 U.S.C. § 523(a)(6)).
8 139 S. Ct. 873 (2019) (costs).

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If You Want to Withdraw a Motion, Call the Clerk, then File a Stipulation

What if the moving party wants to withdraw the motion or dismiss the complaint? Contested matters do not just go away. A stipulation (and court approval) might be required. When you have an adversary proceeding, refer to Rule 7041 of the Federal Rules of Bankruptcy Procedure and Rule 41 of the Federal Rules of Civil Procedure.

Telephonic Appearances

Some judges are comfortable with telephonic appearances. However, Judge Russell very rarely authorizes active telephonic appearances. He will allow passive telephone links — for listening only. He believes that lawyers "get more things done" in the hallway of the courthouse. If Judge Russell authorizes a telephonic appearance, that lucky lawyer should put his/her dog in the basement (without the dog's favorite squeaky toy) before calling in.

Tentative Rulings

Some judges post extensive tentative rulings. If there is a tentative ruling, focus your oral argument on the judge's written points; do not waste time on anything else. At times, a judge will issue a final ruling and excuse appearances by counsel. Do not show up for a non-hearing.

Judge Russell does not issue tentative rulings. This means that each lawyer must be fully prepared to argue the law, recite the facts and explain the procedural posture of the case. Earn the judge's trust with each appearance, and take responsibility for your procedural errors, if any. This author likes the challenge of oral argument, as the client gets to see the best work in the courtroom.

Affirmative Defenses

Do not assert 19 affirmative defenses in your answer to a complaint. Stick with a few. To underscore this point, Judge Russell advises, "Please study Federal Rule of Bankruptcy Procedure 9011." Ouch!

Consider Mediation

Your client can avoid the risks and costs of litigation by participating in a mediation (supervised settlement) and reaching a settlement. Judge Russell founded and still manages a very successful mediation program in the U.S. Bankruptcy Court for the Central District of California. Volunteer mediators are available at no charge.[9] A few retired bankruptcy judges are also available for paid mediation work.[10] (Of course, Judge Russell cannot formally promote paid mediators.)

9 *See* "Mediation Program," U.S. Bankruptcy Court for the Central District of California, *available at* cacb.uscourts.gov/mediation-program (mediation program details). The mediation program settles almost two-thirds of the cases assigned to it.

10 Your author has learned that the witty Hon. **Leif M. Clark** (a retired bankruptcy judge with the Western District of Texas who authored more than 300 opinions and an ABI member since 1986) "provides mediation and consulting services for a broad spectrum of commercial matters both domestically and internationally." *See* "Executive Summary," *available at* leifmclark.com/assets/lmclark-cv.pdf.

Read Civil Rule 26

Follow Rule 26 of the Federal Rules of Civil Procedure regarding disclosures. There is a "discovery hold" in Civil Rule 26(d)(1) ("A party may not seek discovery from any source before the parties have conferred as required by Rule 26(f)....").

Consider Expert Testimony

If expert testimony would be helpful to the judge, hire that expert early and share the report with the other side. A good report might help with settlement.

If the Judge Issues an Order Regarding Procedures, Follow That Order

Many judges issue orders regarding discovery and pretrial procedures. Read, calendar and comply with these orders.

Status Reports

In the U.S. Bankruptcy Court for the Central District of California, the mandatory form of the summons in an adversary proceeding includes this text:

> You must comply with LBR 7016-1, which requires you to file a joint status report and to appear at a status conference. All parties must read and comply with the rule, even if you are representing yourself. You must cooperate with the other parties in the case and file a joint status report with the court and serve it on the appropriate parties at least 14 days before a status conference. A court-approved joint status report form is available on the court's website.... The court may fine you or impose other sanctions if you do not file a status report. The court may also fine you or impose other sanctions if you fail to appear at a status conference.

Judge Russell requires timely joint status reports. If a lawyer fails to file a joint status report, Judge Russell will usually fine the lawyers at least $400.

Discovery Disputes

You do not like discovery disputes. Judge Russell does not like discovery disputes. Solve your discovery problems outside of the courthouse. If you cannot solve a discovery dispute, refer to the Local Bankruptcy Rules. In the Central District of California, Local Bankruptcy Rule 7026-1(c)(3) sets up a meet-and-confer procedure, with a joint stipulation. Judge Russell is surprised that "many good lawyers miss this requirement":

> If the parties are unable to resolve the dispute, the party seeking discovery must file and serve a notice of motion together with a written stipulation by the parties. The stipulation must not simply refer the court to the document containing the discovery request forming the basis of the dispute. For example, if the sufficiency of an answer to an interrogatory is in issue, the

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stipulation must contain, verbatim, both the interrogatory and the allegedly insufficient answer, followed by each party's contentions, separately stated.

Pretrial Stipulations

Avoid dueling *unilateral* pretrial statements. If there are difficulties with language, try "Plaintiff Smith contends" or "Defendant Jones contends" to break the logjam. Alternatively, use neutral language. "Did Defendant Jones make any misrepresentations to Plaintiff Smith regarding the purchase of XYZ Inc.? If so, what were such misrepresentations?"

Perhaps you can follow the elements of a claim for relief. "On Plaintiff Smith's claim for relief under 11 U.S.C. § 523(a)(2)(A) regarding material misrepresentations, has [Plaintiff Smith] established: (1) misrepresentation, fraudulent omission or deceptive conduct by [Defendant Jones]; (2) knowledge of the falsity or deceptiveness of [Defendant Jones'] statement or conduct; (3) [Defendant Jones'] intent to deceive; (4) justifiable reliance by [Plaintiff Smith] on [Defendant Jones'] statement or conduct; and (5) damage to [Plaintiff Smith] proximately caused by its reliance on [Defendant Jones'] statement or conduct? *In re Harmon*, 250 F.3d 1240, 1246 (9th Cir. 2001); *In re Jacks*, 266 B.R. 728, 733 (9th Cir. BAP (Cal.) 2001). *See* Trial Testimony of actor Jason Statham; Exhibits 1, 24, 37."

In the pretrial stipulation, stipulate to the authenticity and admissibility of most exhibits. The pretrial stipulation/order will govern the rest of the adversary proceeding, so extra care is required at this stage.[11]

Evidence and Elements

What are the elements of each claim for relief? For each element, write down the evidence you have (or hope to discover). Do you need authentication for an exhibit? Do you anticipate evidentiary issues at trial? You will not impress Judge Russell with unimportant evidentiary objections — because he wrote the book. Literally.[12]

But ask whether Judge Russell will strike the other side's expert's testimony under Rule 702 of the Federal Rules of Evidence (because only the witness who is not qualified as an expert by knowledge, skill, experience, training or education).

Also, ask yourself if the opponent's declaration refers to a purported "admission" of your party/client. Was the statement "made by the party's agent or employee on a matter within the scope of that relationship and while it existed" as provided by Rule 801(d)(2)(D) of the Federal Rules of Evidence?

Finally, consider whether certain evidentiary issues should be addressed before or at the start of trial through a motion *in limine*. Renew your evidentiary objections during trial.[13]

Direct Testimony by Way of Declaration

In almost every adversary proceeding, Judge Russell issues an order providing for the use of declarations in lieu of live testimony from most witnesses. Judge Russell's order states:

> [Trial] procedure is similar to a motion for summary judgment, except that the admissibility of a declaration is dependent upon the presence of the declarant at trial subject to cross examination....
>
> [E]ach party shall present the testimony of all its witnesses through declarations....
>
> [O]ral testimony will be strictly limited to rebuttal testimony....
>
> [I]f a portion of the witness' declaration concerns an exhibit ... the exhibit must be attached.
>
> If a party is unable to obtain a declaration of a witness, counsel for that party shall file a declaration stating the name of the witness and a detailed summary of the expected testimony and why the counsel was unable to obtain the witness' declaration.

This provides an opportunity to present the testimony of each witness in a chronological, factual manner — without interruption from that pesky lawyer on the other side. The opponent will still get the chance to conduct live cross-examination of the witness (declarant) at trial. Judge Russell's trials are speedy. His trial-by-declaration process complies with due process:[14]

> The Adairs have challenged the bankruptcy court's standard procedure requiring that direct testimony be presented by written declaration. Under this procedure the parties submit written narrative testimony of each witness they expect to call for purposes of direct evidence. The witness then testifies orally on cross-examination and on redirect....
>
> The use of written testimony "is an accepted and encouraged technique for shortening bench trials." *Phonetele, Inc. v. American Tel. & Tel. Co.*, 889 F.2d 224, 232 (9th Cir. 1989) (citing *Malone v. United States Postal Serv.*, 833 F.2d 128, 133 (9th Cir. 1987)), *cert. denied*, 488 U.S. 819, 109 S. Ct. 59, 102 L. Ed. 2d 37 (1992). Accordingly, we have held that a district court did not abuse its discretion in accepting only declarations and exhibits on a particular issue where the parties were afforded "ample opportunity to submit their evidence." *See Vieux v. East Bay Regional Park Dist.*, 906 F.2d 1330, 1342 (9th Cir.), *cert. denied*, 498 U.S. 967, 111 S. Ct. 430, 112 L. Ed. 2d 414 (1990).
>
> The bankruptcy court's procedure permits oral cross-examination and redirect examination in open court and thereby preserves an opportunity for the judge

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11 *Neilson v. United States (In re Olshan)*, 356 F.3d 1078, 1085 (9th Cir. Cal. 2004) ("The trustee was bound by the pretrial order. *See* Fed. R. Civ. P. 16(e) (stating that the pretrial order 'shall control the subsequent course of the action unless modified by a subsequent order' and 'shall be modified only to prevent manifest injustice'")); *N.Y. Skyline Inc. v. Empire State Bldg. Co. LLC (In re N.Y. Skyline Inc.)*, 497 B.R. 700, 704, fn.5 (Bankr. S.D.N.Y. 2013) ("The pre-trial order supersedes the pleadings and becomes the governing pattern of the lawsuit." [quotes and citation omitted]).

12 Barry Russell, *Bankruptcy Evidence Manual, 2019-2020 ed.*

13 Johnine Barnes, "So How Should I Deal with My Opponent's Expert Witness Report," Am. Bar Ass'n, *available at* americanbar.org/content/dam/aba/administrative/labor_law/meetings/2009/ac2009/135.pdf ("As a result, any *in limine* ruling is essentially an advisory opinion by the court, subject to change during the course of trial. *U.S. v. Allison*, 120 F.3d 71, 75 (7th Cir.)....").

14 *See In re Adair*, 965 F.2d 777, 779 (9th Cir. 1992).

to evaluate the declarant's demeanor and credibility. The procedure is essential to the efficient functioning of the crowded bankruptcy courts. *See In re Heckenkamp*, 110 B.R. 1, 4 (Bankr. C.D. Cal.).

Judge Russell's trial-declaration procedure allows a lawyer to prepare a clean cross-examination of an opposing witness, using questions suggested by the language of each declaration itself. For example:

On page ten, you said, "I conclude that the value of my house is $550,000.00, based on my review of Zillow's web site." Mr. Witness, is Zillow all that you relied upon in reaching your conclusion of value? On page 54, you said, "I conclude that the defendant is liable under the doctrine of *res ipsa loquitor*." Did you study Latin in school?

Should You Ever Object to the Judge's Question to Your Witness at Trial?

Of course not. The judge is your finder of fact. abi

Cyber-U

By Kathryn C. Nadro

Generative AI: Legal Ethics and Best Practices

Kathryn C. Nadro
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Katie Nadro, CIPP/US is a partner in Levenfeld Pearlstein, LLC's Corporate Group in Chicago. She helps clients navigate various data-security and privacy issues, and assists clients with policy drafting, program management and data collection. She also advises clients on best practices for compliance with evolving state, federal and international data-protection laws.

While attorneys are not generally known to be tech-savvy, it stands to reason that attorneys have likely heard about — if not dabbled with — such generative artificial intelligence (GenAI) tools as ChatGPT. While the use of certain types of AI tools such as predictive coding in e-discovery is already well established, the advent of GenAI tools has the potential to dramatically change how attorneys practice in an short amount of time.

New GenAI tools are seemingly launched every day, including an array of such tools specifically crafted for professionals and attorneys. Attorneys cannot avoid GenAI altogether, nor should they, as these tools might offer value to their clients and will most likely soon be integrated into commonly used technology. However, many attorneys are also rightly wary of these new tools, as tales abound of GenAI's misuse and misunderstandings in the legal field. GenAI tools can raise issues related to client confidentiality and attorney/client privilege, as well as potential problems related to data security and supervision of legal staff and junior attorneys.

In response to the rapid rise of this technology, on July 29, 2024, the American Bar Association (ABA) released Formal Opinion 512, which outlines the ethical principles related to the use of GenAI tools in the legal profession. Formal Opinion 512 grounds the ethical use of GenAI tools in the existing framework of rules related to other technologies, including rules related to competence, confidentiality, client communication and responsible supervision of both attorneys and nonattorney staff. The Formal Opinion 512 was drafted to allow attorneys to harness the benefits of GenAI and minimize the risks. This article discusses the urgent need of addressing the ethical issues created by GenAI and taking necessary steps for the attorneys to comply with the guidelines.

What Is GenAI?

A little background on GenAI can be helpful to understand and mitigate its potential risks. While attorneys have been using certain types of "artificial intelligence" (*e.g.*, predictive coding) in e-discovery for years, GenAI presents new challenges because it arguably *creates* new content. GenAI tools are trained on vast amounts of text, images, video and even software code to both analyze and ingest those data sources, then generate new text, images, video or software code in response to a user's query. As the ABA pointed out, some of these tools are described as "self-learning," as they "will learn from themselves as they cull more data."[1] However, GenAI tools are not foolproof and require validation of any outputs, especially prior to filing any document using that output with a court.

GenAI offers tantalizing benefits to attorneys who know how to properly harness this technology. For example, GenAI can assist attorneys with drafting complex legal documents, conducting legal research, sifting through gigabytes of e-discovery or due-diligence materials, and automating standard documents. Of particular interest to bankruptcy attorneys might be GenAI's potential to drastically cut down on the time needed for certain tasks, which in turn may reduce legal fees for distressed businesses and individuals. However, both the use of the underlying data sources and the potential reliability concerns with the output of GenAI may raise ethical issues.

Ethical Implications of GenAI

Formal Opinion 512 outlines the ethical framework underpinning the responsible use of GenAI tools, building on previous principles related to other technologies.

Rule 1.1: Competence

An attorney's duty to provide competent representation is paramount; it is literally the first rule in the book. ABA Model Rule of Professional Conduct 1.1 states that a lawyer "shall provide competent representation to a client," which requires the "legal knowledge, skill, thoroughness, and preparation necessary for the representation."[2] Comment 8 to Rule 1.1 adds that "to maintain the requisite knowledge and skill, lawyers should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology."[3]

The ABA went on to state that, practically speaking, this provision "require[s] lawyers to better understand any advances in technology that genuinely relate to competent performance of the lawyer's

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1 ABA Formal Op. 512.
2 ABA Model Rule 1.1, Cmt. 8.
3 *Id.*

duties to a client." However, it does not require an attorney to become an expert in any technology, including GenAI; attorneys can instead rely on trusted vendors (if properly vetted).[4]

Therefore, attorneys must not only understand how GenAI trains on data sets and generates new data (and the implications arising from that training or any biases or inaccuracies in the underlying data), but attorneys must also independently verify the information obtained via the tools. In Formal Opinion 512, the ABA states that although GenAI "may be used as a springboard or foundation for legal work — for example, by generating an analysis on which a lawyer bases legal advice, or by generating a draft from which a lawyer produces a legal document — attorneys may not abdicate their responsibilities by relying solely on a [GenAI] tool to perform tasks that call for the exercise of professional judgment."[5] As such, attorneys must independently validate any output received from GenAI tools, or risk running afoul of both rules of professional conduct, clients and the court.

Rule 1.6: Client Confidentiality

Maintaining client confidentiality is also crucial and requires the protection of a broader range of information than the attorney/client privilege. Pursuant to Model Rule 1.6, a lawyer "owes a duty of care in protecting the confidences of a client ... [and a] lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information related to the representation of a client."[6] This rule may require enacting specific security measures as requested by the client to maintain confidentiality. Using GenAI might require entering information related to the representation into a GenAI tool, which leads to sharing it with third parties and "raises the risk that information related to one client's representation may be disclosed improperly" even when used only internally within a firm.[7]

Of course, if the GenAI tool trains its model on any chat histories or inputs, that information could then be used in any output provided by the model. The ABA points out that the very nature of self-learning GenAI requires informed client consent:

> [B]ecause many of today's self-learning [GenAI] tools are designed so that their output could lead directly or indirectly to the disclosure of information relating to the representation of a client, a client's informed consent is required prior to inputting information relating to the representation into such a [GenAI] tool.[8]

Formal Opinion 512 further states:

> When consent is required, it must be informed. For the consent to be informed, the client must have the lawyer's best judgment about why the [GenAI] tool is being used, the extent of and specific information about the risk, including particulars about the kinds of client information that will be disclosed, the ways in which others might use the information against the client's interests, and a clear explanation of the [GenAI] tool's benefits to the representation.

Boilerplate provisions to engagement letters are insufficient.[9] Attorneys must both take precautions to protect the confidentiality of any client information and obtain informed consent to the use of GenAI tools when warranted.

Rules 5.1 and 5.3: Supervisory Responsibilities

Model Rules 5.1 and 5.3, Comment 3 states that attorneys with managerial authority in a law firm must take reasonable steps to ensure that the law firm or government agency has measures in effect that give reasonable assurance that the person's conduct is compatible with the professional obligations of the lawyer.[10] This obligation also applies to attorneys with direct supervisory authority over nonattorneys. In addition, attorneys must appropriately instruct and supervise assistants (including secretaries, investigators, law student interns and paraprofessionals), regardless of whether they are employees or independent contractors, on the ethical aspects of their employment, especially the obligation not to disclose information relating to client representation. However, ABA rules specifically state that a lawyer's obligation to take reasonable steps to protect confidential client information do not require them to "become an expert in information technology."[11]

Rather, attorneys can comply with this responsibility through both responsible information technology vendor vetting practices and internal policies on the acceptable use of any GenAI tool. These measures should include a review of any provider's information security policies and safeguards, the provider's retention schedule for any information submitted, and any policies related to acceptable use of GenAI.

Rule 1.4: Client Communication

Model Rule 1.4(a) requires attorneys to "reasonably consult with the client" and "keep the client reasonably informed about the status of the matter; [and] promptly comply with reasonable requests for information."[12] Accordingly, attorneys might be required to tell clients what kinds of technology may impact their representation and keep the client abreast of any impact on their matter from that technology (such as potential exposure of confidential information or waiver of privilege). However, it is likely the specific facts of each case and GenAI use under the circumstances determine whether Model Rule 1.4 requires disclosure of the use of GenAI, depending on both the sensitivity of the information involved and the GenAI tool used.

Rule 1.5: Reasonable Fees

Model Rule 1.5(a) requires a lawyer's fees and expenses to be "reasonable."[13] GenAI might drastically speed up the time needed to complete a legal task. For example, if a task

4 *Id.* at 7.
5 ABA Formal Op. 512; *see also Mata v. Avianca Inc.*, 2023 WL 4114965 at *3 (S.D.N.Y. June 22, 2023) (imposing sanctions on attorney who used ChatGPT to perform legal research and failed to verify accuracy of citations in filing).
6 *See* ABA Comm. on Ethics and Professional Responsibility, Formal Op. No. 90-358, Sept. 13, 1990.
7 ABA Formal Op. 512 at 6.
8 *Id.*
9 *Id.*
10 ABA Model Rules 5.1 and 5.3.
11 New Hampshire Bar Ass'n Ethics Comm. Advisory Opinion No. 2012-13/04, "The Use of Cloud Computing in the Practice of Law."
12 ABA Model Rule 1.4(a).
13 ABA Model Rule 1.5(a).

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normally takes six hours but can be done within 30 minutes using GenAI, the attorney can likely only charge for 30 minutes of time. Attorneys who must file fee applications might be the first wave of the legal profession to confront this change, but all attorneys should prepare to consider adapting how to charge their clients.

Rules 3.1, 3.3 and 8.4(c): Meritorious Claims and Candor Toward the Tribunal

Attorneys who use GenAI in litigation must be candid with the tribunal regarding the use of those tools. These rules are fairly self-evident in that an attorney must make only meritorious claims and defenses based on validated research (whether assisted by GenAI tools or not), and must be candid with the tribunal related to the attorney's legal filings.[14] Attorneys must independently check any citations they rely on in any GenAI generated content and must be truthful in their representations to the court.

Five Best Practices for Complying with Ethical Obligations When Using GenAI

How can attorneys harness the benefits while mitigating the risks, including those related to ethics obligations? There are five best practices to consider.

Vet Service Providers and GenAI Tools

Model Rule 1.1 requires attorneys to learn about new technologies and use them competently to benefit their clients, while Rule 5.3 requires the supervision of nonlawyer staff, including such vendors as software providers. Attorneys considering using any GenAI tools in their practice should make sure to understand how GenAI tools use and store the data that is entered into the tool. Accordingly, attorneys should review all vendor or other third-party policies protecting client confidentiality, data privacy and data security.

Attorneys should consider vetting multiple vendors and choose those who have the most protective policies and terms of use for client confidentiality (*i.e.*, no training on customer data by default). In Formal Opinion 512, the ABA states, "As a baseline, all lawyers should read and understand the Terms of Use, privacy policy, and related contractual terms and policies of any [GenAI] tool they use to learn who has access to the information that the lawyer inputs into the tool or consult with a colleague or external expert who has read and analyzed those terms and policies."[15] A thorough review of these documents, coupled with appropriate diligence, will help select the most secure vendors.

Create an Acceptable-Use Policy and Update It Frequently

Attorneys should create internal policies and procedures to take advantage of GenAI's benefits while protecting client confidentiality, data privacy and data security. These policies and procedures should ensure that attorneys and staff exercise reasonable care with GenAI tools to safeguard client confidentiality, privilege and other ethical obligations. Attorneys who input client-confidential information into a GenAI tool should only do so in compliance with an established policy to show the requisite "reasonable care" to maintain confidentiality.

This can include ensuring that the relevant third-party provider has an enforceable obligation to preserve confidentiality and security; investigating the provider's security measures, policies and recovery methods to ensure that they are adequate under the circumstances; employing technology to guard against reasonably foreseeable attempts to access the client's data without authorization; and investigating the storage provider's ability to purge and wipe the client's data.

Revise Engagement Letters and Client Intake

Attorneys should consider revisions to any engagement letters and the client-intake process overall to account for any informed-consent requirements. Clients will need to be given additional information related to the use of any GenAI tools, and client consent forms will need to be drafted and stored for the appropriate retention period.

Use Enterprise Software over "Open" Software

"Open" GenAI tools such as ChatGPT might use any information that users input to train the large language model, and individual users might have little leverage to change any default settings related to data. Enterprise software also allows for uniformity of settings and security across the enterprise, rather than each user individually choosing their own settings or even applications. When using enterprise GenAI tools, attorneys may stipulate in their service contracts that the provider may not use their information to train the large language model, which offers more confidentiality and data-privacy protections.

Consider Fee Arrangements

GenAI tools will likely increase the speed at which attorneys practice law, which may also require changes to the billable-hour model. While it is too early to make definitive statements on this topic, attorneys should consider implementing alternative-fee or flat-fee arrangements as warranted, in addition to the billable hour options.

Conclusion

Many attorneys already use GenAI, and this use will only expand in the next several years. As scary as this technological change might be, they cannot afford to avoid GenAI in their practice for long. Instead, attorneys should feel empowered to learn about this new technology to use it responsibly, which will improve efficiency tremendously and help both attorneys and clients in the end. abi

14 ABA Formal Op. 512 at 9-10.
15 *Id.* at 7.

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Practical Overview of Lawyers' Use of AI and Billing

Committee: Ethics and Professional Compensation

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Increasingly, consumer bankruptcy lawyers will be using AI in the future. It therefore is incumbent upon them to develop procedures and policies for its use and in billing for such services. Doing so will be a combination of art and science controlled by both ethical and practical considerations. Because its use is in an embryotic phase, standards are still being developed, and the area is plagued by a dearth of both case law and statutory guidelines. Practitioners also have to be cognizant that AI is a rapidly and ever-changing tool characterized by advances made on a constant basis.

This article is designed to highlight the issues that need to be addressed and to provide an impetus for discussion and additional analysis.

Why Use AI?

The benefits of AI are numerous, but many of them are not as evident as others. The expertise of the user can play a significant role in the efficacy of its use. In the hands of a skilled user, those benefits include:

1. reduced cost;
2. consistency in work product;
3. accuracy of work product;
4. speed of production;
5. freeing up time; and
6. widespread access to sources of material.

Prerequisites of AI Use

In the hands of skilled professionals, AI's usefulness may be unlimited. However, it is fraught with risks and dangers when used irresponsibly. It therefore is crucial that the following be considered when promulgating an AI policy:

1. proper training for the user;
2. firm policies for how it will be used;
3. billing policies;
4. ethical considerations;
5. staying updated on products available;
6. promulgating policies for oversight of the AI work product;
7. being aware of your court's rules and procedures regarding AI use;
8. recognition of AI options; and
9. reviewing insurance coverage for its use.

Risks of Its Use

Everyone is aware of the sanctions assessed against the New York lawyer who irresponsibly relied upon AI in an unwitting manner. Because his misuse occurred in the relative infancy of AI's use, the court exhibited some sympathy for the respected lawyer. One can assume that the court's attitude will become far less forgiving as attorneys become more aware of AI's shortcomings.

The following is a summary of the risks of using AI:

1. improper charging;
2. inaccurate information;
3. actual cost of its use exceeds traditional legal work not using AI;
4. lawyer complacency;
5. unskilled user triggering an erroneous response;
6. misplaced client expectation by its use; and
7. you could violate your court's rules and procedures regarding AI use.

Considerations in Billing for It

Without question, lawyers appreciate that AI should expedite the production of legal work product at a reduced cost. Otherwise, its usefulness would be limited. This, of course, leaves the law firm facing a quandary as to how to bill for AI work.

The firm needs to assume it cannot pass on the cost of designing and implementing AI procedures and use, nor can it charge for training costs. Those expenses are the cost of doing business. Consequently, law firms have to consider how to maximize the benefits of AI while not chipping away at the bottom line, since AI could very well decrease the time needed to provide a variety of legal services.

Consequently, firms should consider alternative forms of billing, starting with the necessity that whatever is offered is clearly spelled out in the firm's fee agreement with all clients. Those options include:

1. *Normal hourly billing*: The firm will probably need to confirm that certain services can be provided for less cost. Obviously, the AI product needs to be reviewed and edited to ensure accuracy, but if the final work product was more expensive than work produced by traditional means, little reason exists to utilize AI.
2. *Set fee-billing*: This option focuses on the overall cost of the final product and shifts part of the economic risk of the representation to the law firm.
3. *Contingency billing*: In certain cases, representation can be handled on the basis of the law firm accepting a percentage of the recovery. As in the case of set fee-billing, any efficiency and economic savings may justify the law firm reducing its charges.
4. *Hybrid fee arrangement*: The law firm can combine different options that would divide the risk and cost savings between the client and law firm. Depending on the outcome of the case, the client could save money and the law firm may be able to recoup some of the lost revenue triggered by the use of AI.
5. *Set monthly charging*: This is similar to set fee-billing but is a negotiated amount for agreed-upon services to be provided for a set monthly fee. Once again, both the client and the law firm would be absorbing a certain amount of risk and cost savings by the use of AI.

From a consumer debtor lawyer's perspective, some of the above options might not be practical or feasible, but a consumer creditor's lawyer could quickly realize that AI might be the impetus for that lawyer to consider alternative billing strategies.

No one knows how prevalent AI might be in the near future. Since it is constantly evolving, it would be impossible to now anticipate its application in the coming years, but a practitioner would be foolish not to understand and utilize AI now.

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AI: The New Leverage for Forensic Accountants in Bankruptcy Proceedings

Committee: Financial Advisors and Investment Banking

Tod McDonald

Valid8 Financial; Seattle

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The financial analysis required in bankruptcy proceedings has always been time-consuming and demanding.[1] Over a decade ago, I led the forensic investigation of a complex Ponzi scheme bankruptcy. Audits had failed, and the books were thoroughly cooked. My team spent years manually reconstructing financial records, while the DOJ and FBI ran parallel investigations under looming statute of limitations deadlines.

This laborious effort served multiple critical purposes: claims verification, identification of undisclosed accounts, tracing fraudulent transfers, locating hidden assets, and building evidence for litigation against banks and auditors. Any missed transaction could have impacted creditor recovery. Today, artificial intelligence (AI) is transforming how bankruptcy professionals approach financial analysis — not by replacing expert judgment, but by dramatically enhancing what's possible within practical time and budget constraints.

The High-Stakes Reality of Bankruptcy Financial Analysis

When a company files for bankruptcy, investigators face mountains of data: years of transactions from multiple accounts, credit cards, loans and more. Key evidence — whether for routine matters like claims verification or complex fraud investigations — is typically buried in thousands of financial records and tangled account relationships.

Traditionally, forensic teams spent most of their time on tedious data-gathering — copying figures from PDFs into spreadsheets, sorting documents, reconciling balances — before actual analysis could begin. In fact, studies indicate that investigators may spend up to 90% of investigation time just on data prep, leaving minimal time for substantive analysis.

The stakes couldn't be higher. Overlooking undisclosed accounts could mean that substantial funds are never recovered for the estate. In cases where records were deliberately falsified, reconstructing the actual financial reality becomes critical. The resulting financial analysis serves as the foundation for multiple legal proceedings, from claims objections to fraudulent transfer litigation to professional liability suits against auditors. Until recently, months of manual labor was simply the cost of certainty in complex cases.

AI Tools Boosting Investigative Speed and Quality

Modern AI is changing this equation, materially improving both the speed and quality of bankruptcy financial analyses. Key capabilities already making a difference include:

- *Document Classification and OCR*: AI can rapidly classify and organize documents by type, automatically identifying bank statements, canceled checks, wire confirmations and more. In cases where accounting records have been falsified, this allows forensic teams to bypass potentially fraudulent books and build financial reconstructions directly from primary banking records.
- *Statement Parsing and Data Extraction*: Machine-learning models can extract transactions from virtually any financial statement without requiring custom templates. AI concurrently verifies data quality, flagging missing pages, potential duplicates or balance inconsistencies. What previously took weeks of manual entry can now be done in hours, on larger datasets, with fewer errors.
- *Transaction Matching and Fund-Tracing*: AI significantly accelerates fund flow analysis, performing automated transfer matching across entire account networks. This builds a comprehensive map of fund flow through various accounts and entities, quickly surfacing patterns like offshore transfers or fundings to previously unknown entities that a manual review might miss.
- *Anomaly Detection and Pattern Recognition*: AI algorithms can analyze the full ledger to flag anomalies warranting closer scrutiny, such as unusual payment patterns, round-dollar transfers to unknown entities, or unexpected recipient relationships. This gives investigators a powerful tool for identifying undisclosed accounts, hidden assets or signs of when insolvency truly began.

AI is compressing weeks of forensic work into hours while improving analysis thoroughness. Investigators can now feasibly examine 100% of the financial data in a case rather than a sampling. When faced with cooked books or failed audits, AI can help identify all previously undisclosed accounts, detect assets hidden through entity structures, and uncover the true flow of funds that accounting records might have deliberately obscured.

Maintaining Evidentiary Integrity

While speed and automation are game-changers, evidentiary integrity remains paramount. The best AI tools preserve a source-linked trail for every data point, allowing investigators to confidently defend their work in court. If an attorney or judge questions a specific transaction in an AI-generated report, they can immediately see the actual source document from which that data was derived.

This capability delivers Verified Financial Intelligence — a fully traceable dataset where nothing is taken on faith. The technology establishes a clear chain of custody for all information, resulting in auditable, courtroom-ready evidence. Many platforms generate courtroom exhibits directly from the verified dataset, simplifying complex information into digestible visuals for judges and creditors' committees.

Emerging Frontiers

What we're seeing today is likely just the beginning. Future systems will learn what hidden asset patterns typically look like across hundreds of past cases, then instantly flag similar patterns in new matters. Large Language Models will digest unstructured data — such as emails, memos and legal filings — extracting relevant insights that would take humans days to find.

More futuristic but rapidly developing are AI "agents": autonomous assistants that can perform multi-step investigative tasks. Imagine instructing an AI agent to "trace all funds from the CFO's discretionary account through any shell companies and identify where they ultimately landed overseas." The AI agent would autonomously discover related entities through public records, map intricate transaction networks, identify suspicious timing patterns, and even correlate fund movements with the CFO's travel schedule — all while you focus on strategy.

Better Outcomes for All Stakeholders

The benefits of adopting AI in bankruptcy proceedings extend to all stakeholders:

- *Accelerated Case Resolution*: By vastly accelerating financial analysis, AI helps shorten overall case timelines. What required a six-month investigation might be completed in six weeks. Creditors receive distributions more quickly, and courts operate more efficiently.
- *Greater Recoveries*: Case studies demonstrate impressive results: In one case, AI-driven analysis identified $8.5 million in previously undisclosed assets held through nominee entities that conventional methods had missed. In another case, AI tools revealed a network of offshore accounts containing over $12 million — nearly 30% of the total estate value. These discoveries represent funds that would likely have remained hidden without AI-enhanced investigation techniques.
- *Lower Administrative Costs*: Studies of AI implementation show time savings of 60-80% for data extraction and initial analysis tasks. A mid-sized bankruptcy that would have incurred $500,000 in forensic accounting fees might now require only $200,000 — a $300,000 direct benefit to the estate.
- *Improved System Integrity*: When investigators have tools to unravel even convoluted financial schemes, it raises stakes for would-be bad actors while giving honest parties confidence that the process yields fair outcomes.

Practical Adoption

For bankruptcy professionals, here are practical steps toward adoption:

1. *Start with specific-use cases*: Identify high-impact areas like asset-tracing, undisclosed account identification and reconstructing incomplete records.
2. *Evaluate AI platforms with bankruptcy expertise*: Look for solutions developed specifically for financial investigation and bankruptcy work that understand preference periods, claim hierarchies and evidentiary requirements.
3. *Consider a pilot project*: Select an upcoming case of moderate complexity for a controlled trial, measuring time saved and additional insights generated.
4. *Invest in training*: The learning curve for bankruptcy-focused AI tools is typically modest, with most professionals becoming proficient within days.
5. *Start building your digital financial library*: Begin digitizing and organizing financial records systematically to create the foundation for future AI analysis.

The transition need not be abrupt. Most firms find that gradual implementation, starting with areas of highest return, creates a sustainable path to adoption.

Empowering Professionals, Not Replacing Them

AI isn't replacing bankruptcy professionals; it's empowering them. Despite AI's strengths in data processing, it "cannot — and should not — draw conclusions" independently. Context is key, and humans excel at context. With routine tasks automated, bankruptcy attorneys and forensic accountants can devote their expertise to developing case strategies, interpreting patterns, and making nuanced judgment calls that no algorithm can replicate.

The complexity and volume of financial data in modern cases are growing exponentially. The average corporate bankruptcy now involves four to five times more transaction data than it did just a decade ago. By leveraging AI, practitioners can take on more complex matters without adding staff, or handle mega-cases that would otherwise strain resources.

From my perspective as a veteran of forensic accounting, this shift feels like a long-awaited breakthrough. We're still the builders — we design the investigation, interpret the financial events and ensure our conclusions are legally sound — but now we have machines to handle the heavy lifting. The result is not fewer bankruptcy professionals; it's better-equipped professionals.

As financial oversight becomes more sophisticated thanks to AI, the demand for sharp legal and forensic minds will only increase. By embracing these innovations, we can ensure that bankruptcy professionals remain one step ahead of complexity, delivering better outcomes for all stakeholders. The question is no longer whether AI will transform bankruptcy financial analysis, but rather who will lead this transformation — and who will be left behind.

[1] Tod McDonald, CPA, CIRA is the founder of Valid8 Financial and a recognized thought leader in AI-enhanced forensic accounting. Drawing from his extensive experience investigating complex financial fraud and bankruptcy cases — including multi-year reconstructions of sophisticated Ponzi schemes — he led his team to develop Valid8's proprietary Verified Financial Intelligence platform to address the industry's most pressing challenges. His work bridges the gap between traditional forensic expertise and modern AI capabilities, enabling professionals to conduct more thorough investigations in a fraction of the time. His insights on the intersection of technology and financial investigation have been featured in leading industry publications, and his platform has become the go-to solution for forensic professionals seeking to maximize recovery while maintaining the highest evidentiary standards.

Faculty

Hon. Kevin R. Anderson is a U.S. Bankruptcy Judge for the District of Utah in Salt Lake City, appointed on Sept. 4, 2015. Previously, he served for 17 years as the standing chapter 13 trustee for the District of Utah, administering more than 70,000 chapter 13 cases. Judge Anderson served as president of the National Association of Chapter 13 Trustees (NACTT), and he served on several national committees regarding chapter 13 legislation, rules, forms and policy. He has frequently written and presented on chapter 13 issues, including for the *Norton Bankruptcy Law Advisor*, the *ABI Journal*, the *NACTT Quarterly* and the *NACTT Academy for Consumer Bankruptcy Education*. He also is a Fellow in the American College of Bankruptcy. Prior to his appointment as chapter 13 trustee, Judge Anderson practiced for 13 years as a commercial litigator with an emphasis on civil fraud, real property, and representing chapter 11 and 7 trustees. He also clerked for Hon. David N. Naugle, U.S. Bankruptcy Judge for the Central District of California. Prior to law school, Judge Anderson worked for two years as a data systems specialist testing military and commercial jet engines for General Electric. He received his J.D. *cum laude* from the J. Ruben Clark Law School at Brigham Young University.

Hon. Bruce A. Harwood is a retired U.S. Bankruptcy Judge for the District of New Hampshire in Concord, appointed to the bench in March 2013, and currently resides in San Francisco. He also served as Chief Bankruptcy Judge prior to his retirement from the bench, and he served on the First Circuit's Bankruptcy Appellate Panel. Prior to his appointment to the bench, Judge Harwood chaired the Bankruptcy, Insolvency and Creditors' Rights Group at Sheehan Phinney Bass + Green in Manchester, N.H., representing business debtors, asset-purchasers, secured and unsecured creditors, creditors' committees, trustees in bankruptcy, and insurance and banking regulators in connection with the rehabilitation and liquidation of insolvent insurers and trust companies. He was a chapter 7 panel trustee in the District of New Hampshire and mediated insolvency-related disputes. Judge Harwood is ABI's President. He previously served as ABI's Secretary and Vice President-Communication, Information & Technology, as co-chair of ABI's Commercial Fraud Committee, as program co-chair and judicial chair of ABI's Northeast Bankruptcy Conference, and as Northeast Regional Chair of the ABI Endowment Fund's Development Committee. He also served on ABI's Civility Task Force. Judge Harwood is a Fellow in the American College of Bankruptcy and was consistently recognized in the bankruptcy law section of *The Best Lawyers in America*, in *New England SuperLawyers* and by *Chambers USA*. He received his B.A. from Northwestern University and his J.D. from Washington University School of Law.

Hon. Peggy M. Hunt is a U.S. Bankruptcy Judge for the District of Utah in Salt Lake City, appointed on March 10, 2023. Previously, she spent approximately 25 years practicing bankruptcy and receivership law, and at the time of her appointment was the co-managing shareholder of the Salt Lake City office of Greenberg Traurig, LLP. Judge Hunt started her career as a law clerk to Justice Robert J. Callahan of the Connecticut Supreme Court. She served two other clerkships, one for Hon. Glen E. Clark, Chief Bankruptcy Judge for the District of Utah, and the other as one of the first law clerks for several judges on the Bankruptcy Appellate Panel for the Tenth Circuit. Judge Hunt is a Fellow in the American College of Bankruptcy and in the American Bar Association. She was appointed to serve on the Utah Securities Commission. Judge Hunt also served as president of numerous professional and community organizations, including the Utah Bar Foundation, Women Lawyers of Utah, the Utah Chapter of the Federal Bar Association, Utah Women's Forum, and the Board of Advisors for the Utah Museum of Natural History. She received her B.A. in economics and political science from Washington and Jefferson College and her J.D. from the University of Pittsburgh School of Law, where she was also head notes and comments editor of the *University of Pittsburgh Law Review*.

Sarah Laybourne is a judicial law clerk for Hon. Kevin R. Anderson of the U.S. Bankruptcy Court for the District of Utah in Salt Lake City.

Hon. Joel T. Marker is a U.S. Bankruptcy Judge for the District of Utah in Salt Lake City, sworn in on July 1, 2010. Prior to his appointment, he practiced with the Salt Lake City law firm McKay Burton and Thurman for more than 25 years. Judge Marker has served as chair of the Bankruptcy Section of the Utah State Bar and as president of the Utah Bankruptcy Lawyers Forum. He also served as a member of the panel of chapter 7 trustees in the District of Utah from 1997-2010 and represented individuals and businesses in a variety of proceedings before the state and federal courts. Judge Marker received his undergraduate degree from the University of Wisconsin in 1979 and his J.D. in 1984 from the University of Utah College of Law.

Hon. Cathleen D. Parker is Chief U.S. Bankruptcy Judge for the District of Wyoming in Cheyenne, appointed on June 2, 2015. She also serves as a bankruptcy judge on the U.S. Bankruptcy Court for the District of Colorado. Prior to her appointment, she was an attorney with the Wyoming Attorney General's Office for 16 years, where she primarily represented the Wyoming Departments of Revenue and Audit in front of administrative tribunals, the Wyoming State Courts and the Wyoming Supreme Court. At the time of her appointment, she was the supervisor of the Revenue Section of the Civil Division and was the head of the Attorney General's Bankruptcy Unit. Prior to joining the Office of the Attorney General, Judge Parker worked as an attorney in private practice in Colorado, handling both civil and criminal matters. She also sits on the Tenth Circuit Bankruptcy Appellate Panel. Judge Parker received her J.D. with honors from the University of Wyoming College of Law in 1998.

Hon. Michael E. Romero is a U.S. Bankruptcy Judge in the District of Colorado in Denver, initially appointed in 2003 and appointed Chief Judge from July 2014-June 2021. He is also Chief Judge of the Tenth Circuit Bankruptcy Appellate Panel. Since becoming a judge, Judge Romero has served on numerous committees and advisory groups for the Administrative Office of the U.S. Courts, is the past chair of the Bankruptcy Judges Advisory Group and has served as the sole bankruptcy court representative/observer to the Judicial Conference of the United States, the governing body for the federal judiciary. He is a past president of the National Conference of Bankruptcy Judges and actively participates in several of its committees. He also serves on the Executive Board of Our Courts, a joint activity between the Colorado Judicial Institute and the Colorado Bar Association that provides programs to further public understanding of the federal and state court systems. Judge Romero is a member of the Colorado Bar Association, ABI, the Historical Society of the Tenth Circuit and the Colorado Hispanic Bar Association. He received his undergraduate degree in economics and political science from Denver University in 1977 and his J.D. from the University of Michigan in 1980.

Hon. William T. Thurman is a U.S. Bankruptcy Judge for the District of Utah in Salt Lake City, appointed in 2001 and now on recall status, and served as its chief judge. He also is a member and former chief judge of the Tenth Circuit Bankruptcy Appellate Panel. Judge Thurman served as a member of the U.S. Judicial Conference's Code of Conduct Committee and as a member of Conference's Financial Disclosure Committee. He has been active in the National Conference of Bankruptcy Judges, having served on its board and chaired several of its committees. He also has been a frequent speaker for and member of other national and local organizations focusing on lawyer and judicial education and ethical conduct, and he is a Fellow with the American College of Bankruptcy. Prior to his appointment, Judge Thurman was in private practice in Salt Lake City with McKay, Burton & Thurman for 27 years, where he focused on bankruptcy law and served as a panel chapter 7 trustee. He received both his B.A. and J.D. from the University of Utah.