AMERICAN BANKRUPTCY INSTITUTE

Winter Leadership Conference

Judicial Debate: Tough Issues in Subchapter V Cases

Hon. Michelle M. Harner, Moderator
U.S. Bankruptcy Court (D. Md.); Baltimore

Hon. Hannah L. Blumenstiel
U.S. Bankruptcy Court (N.D. Cal.); San Francisco

Hon. Daniel P. Collins
U.S. Bankruptcy Court (D. Ariz.); Phoenix

Hon. Bruce A. Harwood
U.S. Bankruptcy Court (D. N.H.); Concord

Hon. Sage M. Sigler
U.S. Bankruptcy Court (N.D. Ga.); Atlanta

2023

How to use poll.abi.org

Complimentary Wi-Fi Available

Wi-Fi: ABIWLC

Password: kccwifi

1. Take out your preferred device (phone, iPad, laptop, e-reader)
2. Open up your web browser and type in poll.abi.org
3. Click on the 'Great Debates' Session
4. When prompted by the moderator, open up each poll question and vote

Judicial Debate: Tough Issues in Subchapter V Cases

Do you think Congress should make the current debt cap in Subchapter V permanent?

Judicial Debate: Tough Issues in Subchapter V Cases

Do you think a non-voting class of creditors should be deemed to accept a Subchapter V plan?

How to use poll.abi.org

Complimentary Wi-Fi Available
Wi-Fi: ABIWLC
Password: kccwifi

1. Take out your preferred device (phone, iPad, laptop, e-reader)
2. Open up your web browser and type in poll.abi.org
3. Click on the 'Great Debates' Session
4. When prompted by the moderator, open up each poll question and vote

Judicial Debate: Tough Issues in Subchapter V Cases

Do you think the US Supreme Court will rule that non-consensual third-party releases are permitted by the Bankruptcy Code?


WINTER
Leadership
CONFERENCE
AMERICAN
BANKRUPTCY
INSTITUTE
FAIRMONT SCOTTSDALE PRINCESS
SCOTTSDALE, ARIZONA
NOV. 30-DEC. 2, 2023

Later Developments Don't Undo Subchapter V Eligibility, Houston Judge Says

Writing in a high-profile case, Bankruptcy Judge Christopher Lopez of Houston wrote an opinion of nationwide significance regarding eligibility to be a debtor under Subchapter V of chapter 11. Recently enacted, Subchapter V was designed by Congress to simplify reorganization for small companies with less than $7.5 million in debt.

In his March 31 opinion, Judge Lopez said that a debtor's eligibility for Subchapter V is determined as of the filing date. He ruled that the debtor can't be kicked out of Subchapter V if an affiliate with too much debt for Subchapter V later files a petition under "ordinary" chapter 11.

If adopted broadly, the opinion means that a family of companies with too much collective debt for Subchapter V may first put one member with less than $7.5 million into Subchapter V and later put other companies into ordinary chapter 11 if there's too much debt. The first-filing company could thereby enjoy a simplified route to plan confirmation, while the other members of the group would face the rigors of "ordinary" chapter 11.

The Alex Jones Filings

Radio host Alex Jones gained notoriety for stating on his show that the Sandy Hook school massacre was a hoax. Families of murdered students filed defamation suits in state courts in Connecticut and Texas against Jones and his companies. The defendants defaulted, and default judgments were entered.

Jones owned one of the defendants, Free Speech Systems LLC. It filed a Subchapter V petition in July 2022, before the trial on damages concluded in Connecticut and before the damages trial began in Texas, Judge Lopez said.

Early in the Subchapter V case, Judge Lopez modified the automatic stay to allow the suits to proceed. In October 2022, a Connecticut jury awarded about $1.4 billion. The Texas suit resulted in a judgment of about $50 million.

In December 2022, Jones himself filed a petition under "ordinary" chapter 11 because the judgment gave him more than the $7.5 million cap for Subchapter V.

The Plaintiffs' Motion to Dedesignate

In February 2023, the plaintiffs filed a motion to revoke the corporate debtor's Subchapter V status. Rather than dismiss or convert to chapter 7, the plaintiffs wanted the corporate case to continue in "ordinary" chapter 11.

The plaintiffs conceded that the corporate debtor had less than $7.5 million in debt and was eligible for Subchapter V when it filed the original petition, but they contended that the corporate debtor lost eligibility for Subchapter V when Jones filed his own chapter 11 petition. They relied on the eligibility requirements for Subchapter V contained in Section 1182(1)(A) and (1)(B)(i).

On "the date of the order for relief," Subsection (1)(A) provides that the debtor may have "not more than $7,500,000" in "aggregate noncontingent liquidated secured and unsecured debts."

Subsection (1)(B)(i) deals with filings by affiliates. It bars a debtor from Subchapter V if it is a "member of a group of affiliated debtors under this title that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $7,500,000."

Judge Lopez said that "a debtor must satisfy both prongs *on the petition date*" and that "[s]ubparagraphs A and B must be construed together *at the same time, all the time*." [Emphasis added.

Judge Lopez found support for his conclusion in Bankruptcy Rule 1020(a), which says that a case proceeds in accordance with the debtor's election "unless and until" the court rules that the debtor's election was "incorrect."

Rule 1020(b) has a challenge period. It provides that an objection to the election must be made "no later than 30 days after the conclusion of the meeting of creditors held under § 341(a) of the Code, or within 30 days after any amendment to the statement, whichever is later."

The plaintiff's motion was therefore untimely. Even if it had been filed on time, Judge Lopez said he would have denied "the relief requested . . . for the reasons stated above."

Judge Lopez found "practical" reasons for a more static view of Subchapter V eligibility. If eligibility were governed by events after filing, "debtors could float in and out of Subchapter V at any time," he said.

"A roaming eligibility trap," Judge Lopez said, "could also punish an innocent Subchapter V debtor." One member of a corporate group, with its own board, could file a petition under Subchapter V, to be undone by a subsequent filing by another member of the group with a different board, "perhaps with unrelated debts."

Judge Lopez denied the motion to revoke the corporate debtor's Subchapter V election. However, he ended the opinion by noting that the debtor is not out of the woods. He said there are "several" nondischargeability adversary proceedings.

With regard to nondischargeability as to corporate debtors, courts disagree. The Fourth Circuit ruled that corporate debtors in Subchapter V may not discharge debts "of the kind" specified in Section 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.

Bankruptcy Judge Craig A. Gargotta of San Antonio disagreed with Cleary and held that "corporate debtors proceeding under Subchapter V cannot be made defendants in § 523 dischargeability actions." *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337, 344 (Bankr. W.D. Tex. Nov. 10, 2022). To read ABI's report, click here.

A direct appeal in *GFS* is pending in the Fifth Circuit.

The outcome of the Fifth Circuit appeal in *GFS* may determine whether Free Speech Systems can discharge debts to the Connecticut and Texas debtors. If the Fifth Circuit agrees with the Fourth Circuit, the judgments may not be dischargeable.

Judge Name: Christopher Lopez

Case Citation:
In re Free Speech Systems LLC, 22-60043 (Bankr. S.D. Tex. March 31, 2023).

Case Name:
In re Free Speech Systems LLC

Selling Assets of a Defunct Business Is a Legitimate Activity in 'Sub V,' Florida Judge Says

Bankruptcy Judge Lori V. Vaughan of Orlando, Fla., squarely held that a corporate debtor is eligible to sell the assets and liquidate in Subchapter V of chapter 11, even if the company had terminated normal operations before filing.

Just to distribute assets that already had been liquidated, the decision allows the estate to avoid the (probably unnecessary) expenses that would result from conversion to chapter 7 and appointment of a trustee.

Judge Vaughan's July 23 opinion means that the sale and liquidation of assets is a legitimate activity in Subchapter V not requiring oversight from a trustee in chapters 7 or 11.

The corporate debtor had been a contractor. Claims of shoddy construction led to lawsuits that the insurer defended. Unable to renew insurance, the debtor shut down the business and filed a petition under Subchapter V of chapter 11.

The petition listed assets of some $300,000, including a $13,000 bank account and accounts receivable with a face value of $200,000. The schedules listed $800,000 in unsecured claims and another 200 unliquidated, disputed construction claims.

Soon after filing, the debtor filed a motion to sell the assets under Section 363. Before the court approved the sale, the U.S. Trustee objected to the debtor's right to proceed under Subchapter V.

The U.S. Trustee claimed that the debtor was ineligible for Subchapter V because there were no business operations on the filing date. In essence, the U.S. Trustee was contending that Subchapter V may only be used to reorganize and may not be employed to liquidate assets.

The Small Business Reorganization Act, or SBRA, became effective in February 2020 and is codified primarily in Subchapter V of chapter 11, 11 U.S.C. §§ 1181 – 1195. To be eligible for Subchapter V, the debtor must have less than $7.5 million in debt and must be "a person engaged in commercial or business activities . . . ." See Sections 1182(1) and 101(D)(A).

Judge Vaughan ruled in favor of the debtor. In her view, the statutory words "commercial or business activities" are not ambiguous. She focused on the debtor's activities on the filing date.

Consulting dictionaries, Judge Vaughan said that the "term 'commercial' is commonly understood to involve commerce." The term "business," she said, "has a similar meaning."

Citing cases such as *Offer Space* and *Ikalowych*, Judge Vaughan concluded that "the plain meaning of engaged in 'commercial or business activities' is broad with a very inclusive range of commercial or business activity." To read ABI's reports on those two cases, click here and here.

On the filing date, the debtor was not operating. However, the debtor had bank accounts, was working with insurance adjusters to resolve claims, and was engaged in selling the assets. "These acts were commercial or business in nature" and were being conducted "with a view toward profit, or at least minimizing loss," Judge Vaughan said.

By "maintaining bank accounts, working with insurance adjusters and insurance defense counsel to resolve the Construction Claims and preparing for the sale of its assets," Judge Vaughan held that the debtor was engaged in commercial or business activities on the petition date and was thus eligible for Subchapter V.

Judge Name: Lori V. Vaughan

Case Citation:
In re Vertical Mac Construction LLC, 21-1520 (Bankr. M.D. Fla. July 23, 2021).

Case Name:
In re Vertical Mac Construction LLC

Arguments Both Ways, Power to De-Designate from Subchapter V Left Undecided

For a free trial subscription to RDW, please visit http://connect.abi.org/rdwsignup.

For more information about ABI, please visit www.abi.org.

Bankruptcy Judge Craig T. Goldblatt of Delaware laid out the arguments for and against the court's power to de-designate a Subchapter V case to proceed under "regular" chapter 11.

In his December 16 opinion, Judge Goldblatt decided it was unnecessary to rule on the "close" question, because the evidence led him to conclude that it was "abundantly clear" that he instead should remove the Subchapter V debtor as debtor in possession.

Before filing under Subchapter V, the debtor was in litigation with its primary creditor. The district court had imposed a preliminary injunction which the debtor had violated. The injunction was not of a type that would be vacated by the automatic stay in bankruptcy.

In bankruptcy court, the creditor filed a motion asking the court (1) to de-designate the case from proceeding under Subchapter V and to appoint a trustee under "regular" chapter 11 or (2) remove the debtor as debtor in possession, thus allowing the Subchapter V trustee to manage the business.

The U.S. Trustee wanted Judge Goldblatt to remove the debtor as debtor in possession under Section 1185 or dismiss the case for cause.

At the ensuing hearing, evidence included "dozens" of emails sent by the debtor's principal which were "repugnant and undoubtedly violate the district court's injunction," Judge Goldblatt said. He characterized the messages as including "vulgarity, racism, misogyny, and homophobia."

More troublesome, the debtor's principal had said in messages that he would take actions to cut off the debtor's income. The principal also said he was willing to defy court orders.

De-Designation

Judge Goldblatt first addressed his power to de-designate the case from proceeding under Subchapter V.

As background, he said that Section 1185 "permits a court to remove the debtor from possession on a showing of cause, in which case (under § 1183(b)(5)) the subchapter V trustee is empowered to operate the debtor's business." If removed, the debtor in Subchapter V would nonetheless retain sole authority to file a plan.

So long as the plan devotes disposable income to the payment of creditors' claims, the absolute priority rule would not apply even though the debtor in possession had been deposed. However, the creditor wanted Judge Goldblatt to de-designate the case under Subchapter V and require the case to proceed under "regular" chapter 11 with a "regular" chapter 11 trustee.

The power to de-designate may (or may not) be found in Bankruptcy Rule 1009(a), which provides that the court, on motion of a party in interest and after notice and a hearing, "may order any voluntary petition, list, schedule, or statement to be amended and the clerk shall give notice of the amendment to entities designated by the court."

However, Rule 1009(b) says that the "statement of intention may be amended by the debtor at any time before the expiration of the period provided in §521(a) of the Code."

Judge Goldblatt observed that neither the Rules nor the Code contains standards for ruling on a motion to amend a petition. He found "sound reasons" for believing that a case could be de-designated on motion by someone other than the debtor.

Judge Goldblatt also saw a "serious argument" against de-designation by anyone other than the debtor. Most persuasively, he said:

> [D]e-designating a subchapter V case so that another party in interest may propose a plan or so that a trustee may be appointed under § 1104 would be an improper end run around the contrary provisions contained in subchapter V itself.

Removal of the DIP

Even if he had power to de-designate, Judge Goldblatt said that his authority should be exercised "only as a last resort" and not before giving the debtor an opportunity to file and confirm a plan.

Section 1185(a) gives the court power to remove a Subchapter V debtor in possession "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor. . . ." Given the facts, Judge Goldblatt found the debtor was "poorly suited" to fulfill its statutory obligations in the operation of the business.

By removing the debtor as debtor in possession, Judge Goldblatt invoked Section 1183(b)(5), which says that the Subchapter V trustee shall, "if the debtor ceases to be a debtor in possession … be authorized to operate the business of the debtor."

Recognizing that the deposed Subchapter V debtor alone retains the right to file a plan, Judge Goldblatt said that the debtor's "efforts [toward confirmation of a plan] should be exhausted before the Court considers more drastic measures."

Having no need to decide if he could de-designate, Judge Goldblatt removed the Subchapter V debtor as debtor in possession, denied the motion to de-designate and denied the motion to dismiss as moot.

Judge Name: Craig T. Goldblatt

Case Citation:
In re Comedymx LLC, 22-11181 (Bankr. D. Del. Dec. 16, 2022).

Case Name:
In re Comedymx LLC

May a Judge Revoke a Small Business Designation Under Subchapter V of Chapter 11?

For a free trial subscription to RDW, please visit http://connect.abi.org/rdwsignup.

For more information about ABI, please visit www.abi.org.

In the first opinion anywhere on the subject, Bankruptcy Judge Elizabeth L. Gunn of Washington, D.C. revoked the small business designation and appointed an "ordinary" chapter 11 trustee when the debtor was unable to confirm plan.

The debtor had 700 "members" who paid dues for the debtor's referrals and marketing assistance for the members' small businesses. Embroiled in litigation with two parties, the debtor filed a petition and designated itself as a small business debtor under Subchapter V of chapter 11.

The debtor plowed through four amendments of its plan before Judge Gunn denied confirmation of the fifth amended plan. At trial, the parties had not addressed the topic, but Judge Gunn analyzed whether conversion, dismissal or something else would be in the best interests of the debtor and creditors.

In her June 29 opinion, Judge Gunn evidently believed that the debtor's business had promise and that members were receiving valuable services. Dismissal or conversion would have meant the demise of the business and would not have been in the best interests of creditors, the judge believed.

Did Judge Gunn have any alternatives beyond dismissal or conversion to chapter 7? She said that the question was a matter of first impression. The issue, she said, was the "converse" of the often-raised question of whether a debtor in an "ordinary" chapter 11 case could "convert" to Subchapter V.

Judge Gunn said that "conversion" from ordinary chapter 11 to Subchapter V was incorrect. Rather, the debtor should amend a petition by electing to proceed under Subchapter V.

Consequently, Judge Gunn said she could not "convert" to ordinary chapter 11. She therefore examined whether she had the statutory power to revoke the designation to proceed under Subchapter V.

In terms of statutory power, Judge Gunn observed:

> Section 1185 specifically provides for the dispossession of a debtor in possession while remaining in Subchapter V, but nothing in Subchapter V discusses the revocation of election to proceed thereunder by the Court or any other party.

Judge Gunn therefore "look[ed] to chapter 11 and the Bankruptcy Code as a whole to determine [whether] the election by a debtor to proceed under Subchapter V may be revoked post-petition."

"[I]f a petition may be amended to elect to proceed under Subchapter V post-petition, logically it follows that the opposite must also be an option for debtors and courts," Judge Gunn said. She found "[v]arious sections of the Bankruptcy Code [that] allow for a debtor to seek conversion from one chapter to another if the debtor is an eligible debtor under such chapter."

Judge Gunn reasoned:

> [T]he ability to revoke a Subchapter V election is consistent with the Bankruptcy Code but also the Congressional goals of ensuring that Subchapter V cases provide a quicker reorganization process. If a debtor discovers post-petition that it is unable to meet the deadlines of Subchapter V, the option to revoke such designation provides the ability to continue to attempt to reorganize under the rigors and requirements of standard chapter 11.

When a debtor cannot comply with the truncated deadlines inherent in Subchapter V, Judge Gunn said that "allowing for the revocation of the Subchapter V designation so that the debtor may proceed under standard chapter 11 is consistent with the right conferred to a debtor in the Bankruptcy Code to convert a case to another chapter therein."

Judge Gunn found "benefits to both debtors and creditors to allow a case to remain under chapter 11 with a revocation of the Subchapter V election in lieu of requiring a debtor to have its case dismissed and immediately refiled." She held that, "in the appropriate situations and based upon a totality of the circumstances, the Court is able order the revocation of the Debtor's Subchapter V election, even where the revocation is not specifically provided for in the Bankruptcy Code."

Judge Gunn went on to find that the debtor should not retain operational control. She called for appointment of a traditional chapter 11 trustee on revocation of Subchapter V status.

Observations

Robert J. Keach told ABI why he found the opinion "troubling." "The concern," he said, is "that only the debtor can file a plan in a Sub V, and that is a key provision driving the election to file under Sub V. If that election can be involuntarily rescinded, a key element of the statute is undermined and a basis for choosing to file is at risk. Subchapter V was passed in response to debtors avoiding chapter 11 altogether."

However, Subchapter V does not have a get-out-of-jail free card like chapter 13, where the debtor has a right to dismiss "at any time" under Section 1307(b). The absence of a provision like Section 1307(b) could be understood as leaving a debtor stuck in bankruptcy, whether the debtor likes it or not.

Mr. Keach saw alternatives. He noted that the "court could have just appointed a section 1104 chapter 11 trustee without changing the election." Although the "trustee could still not have filed a plan, it could have done a lot of things (operate the business, sell the assets, etc.) short of that to move the case forward. If not, the options are to dismiss or convert, not fundamentally alter the statute."

If the case were converted or dismissed, the business presumably would fail, extinguishing the debtor's interest in the enterprise. With revocation of Subchapter V status, the debtor would retain the right to file a plan. If the debtor were ultimately able to craft a confirmable plan continuing the business, the debtor at that juncture might seek redesignation under Subchapter V to retain ownership and avoid the absolute priority rule, a major feature Subchapter V.

The chair of the business restructuring and insolvency practice group at Bernstein Shur Sawyer & Nelson P.A. in Portland, Maine, Mr. Keach was the co-chair of the ABI commission that recommended the legislation Congress adopted in the Small Business Reorganization Act.

Judge Name: Elizabeth L. Gunn

Case Citation:
National Small Business Alliance Inc., 21-00031 (Bankr. D.D.C. June 29, 2022).

Case Name:
National Small Business Alliance Inc.

Ninth Circuit BAP Holds that Debts of Corporate Sub V Debtors Can't Be Nondischargeable

All six bankruptcy courts to confront the question have held that debts of corporate debtors in Subchapter V of chapter 11 cannot be nondischargeable under Section 523(a) in nonconsensual plans.

The Ninth Circuit Bankruptcy Appellate Panel has joined the horde by affirming Bankruptcy Judge Noah G. Hillen of Boise, Idaho, in holding that debts can be nondischargeable in Subchapter V only when the debtor is an individual.

The bankruptcy judges and the BAP are aligned against the Fourth Circuit, which held that corporate debtors in Subchapter V may not discharge debts "of the kind" specified in Section 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.

Bankruptcy Judge Craig A. Gargotta of San Antonio disagreed with Cleary and held that "corporate debtors proceeding under Subchapter V cannot be made defendants in § 523 dischargeability actions." *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337, 344 (Bankr. W.D. Tex. Nov. 10, 2022). To read ABI's report on GFS, click here. The Fifth Circuit accepted a direct appeal in GFS in April. Briefing should be completed before September.

The Facts in the BAP

The July 6 BAP opinion by Bankruptcy Judge Scott H. Gan reads like an amicus brief submitted in the Fifth Circuit in support of the debtor. Judge Gan refutes the Fourth Circuit's arguments, line by line, and concludes that dischargeability should be the same whether a corporate debtor is in "regular" chapter 11 or in Subchapter V.

The facts in the BAP case pull on the heartstrings in favor of nondischargeability, but the BAP resisted the urge to make bad law in a hard case.

The debtor allegedly suffered sexual harassment and discrimination at the hands of her corporate employer. She filed a complaint with the state employment commission and was awarded the right to sue after her former employer filed a chapter 11 petition and elected to proceed under Subchapter V.

The employee filed a claim accompanied by an adversary proceeding to declare the debt nondischargeable under Section 523(a)(6) as a willful and malicious injury. Judge Hillen dismissed the complaint for failure to state a claim.

Judge Hillen relied on his own previous decision in *Catt v. Rtech Fabrications, LLC (In re Rtech Fabrications, LLC)*, 635 B.R. 559 (Bankr. D. Idaho 2021), and on Judge Gargotta's GFS opinion. He was not persuaded by Cleary, nor was Judge Gan when the creditor appealed to the BAP.

The statutes are less than clear. Section 523(a) says, "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 for money obtained by false pretenses or fraud." [Emphasis added.]

Governing discharge for Subchapter V debtors, Section 1192 states that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A)." Subsection (2) of Section 1192 goes on to say that a discharge in Subchapter V does not cover "any debt . . . of the kind specified in section 523(a) of this title."

Finally, Section 1141(d)(1)(A) says that a "discharge under this chapter [11] does not discharge a debtor who is an individual from any debt excepted from discharge under section 523 of this title." [Emphasis added.]

Judge Gan said that Sections 523(a) and 1192 are "[f]acially" in "conflict." The "better interpretation," he said, "is that § 1192 reiterates § 523(a)'s application to debtors under subchapter V, and § 523(a) limits its applicability to individuals." Among other things, he said that "nothing in § 1192 obviates the express limitation in the preamble of § 523(a) or otherwise expands its scope to corporate debtors."

Noting that Congress amended Section 523(a) to add Section 1192 to the list of provisions to which it applies, Judge Gan said that accepting the Fourth Circuit's reasoning would render the amendment surplusage.

Judge Gan differed with the Fourth Circuit's idea that Section 1192, the more specific section, should control. He said that the canon of interpretation only governs when the statutes are irreconcilable, which they were not, in his view. And if they were irreconcilable, he saw Section 523(a) as being more specific, given that it applies in chapter 11 cases.

From a broader perspective, Judge Gan said that Subchapter V is part of chapter 11, "and its discharge provisions should be interpreted consistent with the overall statutory scheme in chapter 11." He noted that Congress had narrowed the corporate discharge only once, in the amendment adding Section 1141(d), and only after eight years of deliberation.

Judge Gan said it was "improbable" that Congress would have enacted such a major change in dischargeability in a bill that was introduced and adopted within one month in 2019.

Judge Gan differed with the Fourth Circuit's reliance on notions of fairness and equity to justify making debts nondischargeable in Subchapter V. Although the fairness idea was "plausible," he said it did not "comport with the purpose of facilitating reorganization of small businesses." Moreover, he said that making debts nondischargeable "is more likely to harm most general unsecured creditors by steering small businesses with nondischargeable debts toward liquidation."

In sum, Judge Gan saw the policy considerations in Cleary as "unavailing." He held "that § 1192 does not make debts specified in § 523(a) applicable to corporate debtors in subchapter V."

Judge Name: Scott H. Gan

Case Citation:
Lafferty v. Off-Spec Solutions LLC (In re Off-Spec Solutions LLC), 23-1020 (B.A.P. 9th Cir. July 6, 2023).

Case Name:
In re Off-Spec Solutions LLC

All Future Liability on a Lease Counted for Subchapter V Eligibility

For a free trial subscription to RDW, please visit http://connect.abi.org/rdwsignup.

For more information about ABI, please visit www.abi.org.

If followed by other courts, a decision by Bankruptcy Judge Klinette H. Kindred of Alexandria, Va., could knock some debtors out of Subchapter V solely as result of liability on long-term leases.

In her June 14 decision, Judge Kindred distinguished a decision by Bankruptcy Judge Thomas J. Catliota of Greenbelt, Md., who held that the contingent liability on a lease is not counted in deciding whether the debtor has more than $7.5 million in debt. *See In re Parking Mgmt.*, 620 B.R. 544 (Bankr. D. Md. 2020).

The debtor was a software developer who ran into bad times during the pandemic. With employees working from home, the debtor needed less office space. On filing in chapter 11 and electing treatment under Subchapter V, the debtor filed a motion to reject the office lease.

The rent owing throughout the remainder of the term of the lease was $14.4 million. The landlord moved to dismiss the case as a bad faith filing. Short of dismissal, the landlord wanted Judge Kindred to declare that the debtor was ineligible for Subchapter V, counting the remaining rent under the lease.

The debtor countered by saying that future rent was contingent on the filing date and that the lease claim shouldn't be more than the capped rejection claim under Section 502(b)(6).

For Subchapter V eligibility, the outcome was controlled by Section 1182(1). It requires the debtor to have:

> noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition. . . in an amount not more than $7,500,000 . . . not less than 50 percent of which arose from the commercial or business activities of the debtor.

Judge Kindred said that the parties found no cases "directly on point." *Parking Management* was the closest. There, the debtor moved to reject leases alongside the filing of the petition. Evidently, lease-rejection damages would make the debtor ineligible for Subchapter V.

Because rejection was dependent on action by the court after filing, Judge Catliota held that the rejection claims were contingent and thus not included in the eligibility calculation.

Judge Kindred distinguished *Parking Management* for having only focused on rejection damages that were contingent. She said, "that does not mean this Court will ignore the Debtor's existing pre-petition liability under the Leases in favor of post-petition events when determining eligibility." Absent rejection, she said that the debtor would owe $14.4 million under the lease.

"In this case," Judge Kindred said, liability on the lease arose before filing when the lease was executed. Therefore, she held that liability on the lease "must be considered noncontingent and liquidated," making the debtor ineligible for Subchapter V. She also rejected the idea of counting only the capped lease claim.

Believing that other creditors would not benefit from dismissal, Judge Kindred revoked Subchapter V eligibility but allowed the debtor to continue under "regular" chapter 11.

Together with granting the debtor's motion to reject the lease, Judge Kindred also denied the landlord's motion to dismiss for a bad faith filing. She held that the landlord had not shown both subjective bad faith and objective futility, as required by the Fourth Circuit in *Carolin Corp. v. Miller*, 886 F.2d 693 (4th Cir. 1989).

On subjective bad faith, Judge Kindred found nothing wrong with a debtor who files bankruptcy to reject a lease and cap damages. On objective futility, she said that the debtor's 100% plan may require "some tweaks" but "cannot find that the restructuring in this case is objectively futile."

Questions

On signing a lease, is the lessee immediately liable under state law for all of the rent during the term of the lease? Or, is the lessee only liable each month for that month's rent when the rent comes due?

If a debtor is current on a lease on filing a Subchapter V petition, is there any debt to count with regard to the $7.5 million cap for eligibility?

Is the debtor liable under state law for all remaining rent if the debtor was in default on filing? Or, is the debtor liable only for the amount in arrears?

If the debtor moves to assume and cure lease defaults, how much is there in lease liability? If the debtor moves to reject a lease, is Subchapter V liability based on the capped rent claim?

Judge Name: Klinette H. Kindred

Case Citation:
In re Macedon Consulting Inc., 23-10300 (Bankr. E.D. Va. June 14, 2023).

Case Name:
In re Macedon Consulting Inc.

Eligibility for Subchapter V Is Liberal, but Not Wide Open

An opinion by Bankruptcy Judge Robert E. Littlefield, Jr. of Albany, N.Y., is a mixed bag for individuals aiming to qualify for reorganization under Subchapter V of chapter 11.

Fending off a lawsuit arising from a defunct business supplies one element of eligibility for Subchapter V, but Judge Littlefield's June 2 opinion also requires the debtor to show that half of total debt must have arisen from the particular business relied upon for eligibility.

The individual debtor filed a chapter 11 petition and elected treatment under Subchapter V. She owned or had owned two businesses. The debtor had no debt arising from one of the businesses that was evidently still in existence, but she had almost $700,000 in debt arising from a business that was no longer operating.

Specifically, the debtor had been the owner of a business that defaulted on a lease. The debtor was being sued on her personal guarantee of the lease. The landlord filed a claim for about $700,000 on the guarantee.

Total debt was almost $1 million, so everyone agreed that 50% or more of her debt had arisen from one of the businesses, satisfying one of the criteria for Subchapter V.

The landlord objected to the debtor's eligibility for Subchapter V, contending that the debtor was not engaged in business at the time of filing. The Subchapter V trustee supported the debtor's eligibility.

The outcome turned on the definition of a Subchapter V debtor. Pertinent to the case before Judge Littlefield, Section 1182 requires the debtor to have:

noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date . . . in an amount not more than $7,500,000 . . . not less than 50 percent of which arose from the commercial or business activities of the debtor.

Currently Engaged in Business or Not?

Judge Littlefield first confronted the question of whether the debtor must have been engaged in "commercial or business activities" as of the filing date. He said that a majority of bankruptcy courts found "a temporal restraint and require the eligibility analysis to review the debtor's activity as of the petition date." He cited, among others, *Nat'l Loan Invs., L.P. v. Rickerson (In re Rickerson)*, 636 B.R. 416, 424-25 (Bankr. W.D. Pa. 2021); and *In re Offer Space LLC*, 629 B.R. 299, 305-06 (Bankr. D. Utah 2021). To read ABI's reports, click here and here.

Judge Littlefield therefore held "that the Debtor must demonstrate she was presently engaged in commercial or business activities as of the Petition Date."

Next, Judge Littlefield examined the "totality of the circumstances" to understand whether the debtor was engaged in business on the filing date. He said that "most courts" interpret the statute broadly "to provide wide availability for debtors to elect to file under subchapter V," citing *In re Ikalowych*, 629 B.R. 267, 276-77 (Bankr. D. Colo. 2021). To read ABI's report, click here.

Citing *In re Port Arthur Steam Energy, L.P.*, 629 B.R. 233, 237 (Bankr. S.D. Tex. 2021), Judge Littlefield held that a "debtor can qualify for subchapter V absent the company's traditional business operations where the company is winding down." To read ABI's report, click here.

Applying the law to the facts, Judge Littlefield said that the debtor was defending a lawsuit on her personal guarantee of the commercial lease. He held that defense of the suit on the "personal guaranty . . . is sufficient winding down activity for the Debtor to satisfy the 'engaged in commercial or business activities' requirement of § 1182(1)(A)."

Nexus Between the Business and the Debt

Judge Littlefield turned to a question on which courts are split: Is it sufficient if 50% of the debt arose from all of the debtor's businesses, or must more than 50% have arisen from the specific business making the debtor eligible for Subchapter V?

Once again citing *Ikalowych* and calling it the "seminal case," Judge Littlefield held that 50% or more of the debt must have arisen from the business that qualifies the debtor for Subchapter V.

In the case before him, the debtor had $700,000 in debt from her guarantee of the personal debt from the business that made her eligible for Subchapter V. He allowed the debtor to proceed in Subchapter V.

Judge Name: Robert E. Littlefield, Jr.

Case Citation:
In re Hillman, 22-10175 (Bankr. N.D.N.Y. June 2, 2023).

Case Name:
In re Hillman

Bankruptcy Judges Agree: Later Developments Don't Undo Subchapter V Eligibility

Bankruptcy judges in Virginia and Texas agree: Subsequent events do not unravel eligibility for Subchapter V.

Specifically, Bankruptcy Judge Rebecca B. Connelly of Harrisonburg, Va., held that a debtor's eligibility for Subchapter V is determined as of the filing date. Even if an affiliate files bankruptcy the next day with more debt than Subchapter V permits, the first debtor to file remains eligible to reorganize under Subchapter V.

A husband and wife filed a chapter 11 petition and elected to proceed under Subchapter V. The husband was the sole owner and manager of a corporation. The next day, the corporation filed a chapter 7 petition.

The U.S. Trustee agreed that the husband and wife, standing alone, were eligible for Subchapter V because their combined debt did not exceed $7.5 million. However, the couple and the corporation were affiliates under Section 101(2). If the corporate debt were added to the individuals' debt, the combined debt would exceed $7.5 million, making the couple ineligible for Subchapter V.

If it matters, the couple first consulted an attorney regarding a bankruptcy filing by the corporation. Evidently, counsel advised the couple that they should file first under Subchapter V, because a prior filing by the corporation would relegate them to "ordinary" chapter 11.

The U.S. Trustee filed a motion aimed at forcing the individual debtors to proceed under "ordinary" chapter 11 because their debt, when combined with the corporation's, exceeded $7.5 million. Judge Connelly denied the motion in her May 17 opinion.

The U.S. Trustee admitted that the couple by themselves were eligible for Subchapter V under Section 1182(1)(A) because they were engaged in commercial activity and had not more than $7.5 million in debt "as of the date of the filing of the petition," of which not less than 50% arose from commercial activity.

The sticking point, according to the U.S. Trustee, was Section 1182(1)(B)(i). It bars a debtor from Subchapter V if it is a "member of a group of affiliated debtors under this title that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $7,500,000."

The U.S. Trustee argued that the court must consider eligibility based on events that occur postpetition, because the words "as of the date of the filing of the petition" appear in subsection (1)(A) but not in subsection (1)(B).

Judge Connelly disagreed. She said that the "language of section 1182 does not direct a court to determine petition eligibility based on postpetition events." More specifically, she said:

> Section 1182 does not say the conditions are ongoing, include postpetition events, or persist "throughout the case," nor does section 1182 contain any other language

> to provide that the debtor's eligibility is not determined as of the initiation of the case under subchapter V.

The U.S. Trustee contended that a recent amendment adding the words "under this title" to Section 1182(1)(B)(i) means that eligibility is a continuing qualification. Again, Judge Connelly disagreed. She said it was added to make the statute

> abundantly clear that the term "debtors" in section 1182(1)(B)(i) is not limited to a group of affiliated debtors which are all proceeding under subchapter V — it was made clear that the debt of any affiliate debtor under any chapter be counted in the calculation.

Judge Connelly rejected the idea that the debtors filed in bad faith because they put themselves into bankruptcy just one day before the affiliated corporation. She said that "the U.S. Trustee has failed to show how professional advice and deliberate planning of the timing of a bankruptcy petition is unlawful or abusive."

On the merits, Judge Connelly said she agreed with Bankruptcy Judge Christopher Lopez of Houston and his decision in *In re Free Speech Sys., LLC*, 649 B.R. 729, 733 (Bankr. S.D. Tex. 2023). To read ABI's report, click here. Like Judge Lopez, she held:

> A later event does not make a statement made as of the petition date incorrect. It does not change the eligibility as of the petition date. The debtor is either eligible or not. He does not change his existence during the case.

To bolster her holding, Judge Connelly pointed out the problems that would arise if eligibility were a continuing question. For example, obtaining post-petition financing could push the debtor's debt above $7.5 million. Or, dismissal of an affiliate's case might make a sister debtor once again eligible for Subchapter V.

Judge Connelly ended her opinion by pointing out the advantages that Subchapter V bestows on creditors. In Subchapter V as opposed to "ordinary" chapter 11, creditors will have a larger recovery because the debtor pays no fees to the U.S. Trustee. Confirming a plan takes "appreciably" less time, and creditors benefit from the guidance of the Subchapter V trustee.

Judge Connelly denied the motion of the U.S. Trustee, finding that the debtors had established eligibility for Subchapter V.

Judge Name: Rebecca B. Connelly

Case Citation:
In re Dobson, 23-60148 (Bankr. W.D. Va. May 17, 2023).

Case Name:
In re Dobson

To Count in Subchapter V, Loans Need Not Benefit Only the Small Business Debtor

Loans made to finance a leveraged buyout may be included in calculating eligibility for reorganization under Subchapter V of chapter 11, even if the loan also conferred benefits on the buyers, according to Bankruptcy Judge Thomas J. Catliota of Greenbelt, Md.

In his October 26 opinion, Judge Catliota said that Section 1182(1)(A) does not require "excluding debt that directly benefitted others," such as the buyers in a leveraged buyout, or LBO.

The LBO Loans

Two individuals arranged to buy a corporation. To effect the purchase, the buyers formed a holding company of which they were the exclusive owners.

For the holding company to acquire the equity interests in the target corporation, a lender made three loans totaling $5.75 million. The target corporation (soon to be the chapter 11 debtor) was the borrower and pledged all of its assets.

The corporate borrower filed a chapter 11 petition and elected treatment as a small business debtor under Subsection V of chapter 11. The debtor listed debts of about $6.4 million.

The former owner (that is, the seller in the LBO) purchased a $500 claim to have status as a creditor. As a creditor, the former owner objected to the debtor's eligibility to proceed as a small business debtor.

Must a Debt Benefit Only the Debtor?

The outcome of the objection was controlled by Section 1182(1)(A), which says that a small business debtor must be

> 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 $7,500,000 . . . not less than 50 percent of which arose from the commercial or business activities of the debtor.

The creditor conceded that the debtor was a "person" with no more debt that the statute allows. The creditor also admitted that the loans were "commercial or business activities."

However, the creditor argued that the $5.75 million in LBO loans could not be counted because they did not arise "from the commercial or business activities *of the debtor*." [Emphasis added.] According to the creditor, the LBO loans primarily benefitted the two buyers in acquiring the corporate debtor.

Interpreting "the commercial or business activities of the debtor," Judge Catliota said that "virtually" all courts "have applied a liberal construction of the phrase in keeping with the [Small Business Reorganization Act's] purpose and the language of § 1182(1)(A)." He cited Bankruptcy

Judge Thomas B. McNamara of Denver, who said in *In re Ikalowych*, 629 B.R. 261, 276 (Bankr. D. Colo. 2021), that the phrase is "exceptionally broad." To read ABI's report on *Ikalowych*, click here.

The creditor relied on *In re Ventura*, 615 B.R. 1 (Bankr. E.D.N.Y. 2020). To read ABI's report on *Ventura*, click here.

To Judge Catliota's way of thinking, *Ventura* was inapposite. Ventura decided whether a debt was primarily a commercial or consumer debt under Section 101(8).

Judge Catliota said:

> The primary purpose test is applied to resolve the binary question of whether a debt is commercial or consumer. A transaction can have both commercial and consumer attributes, and a court must determine whether it is one or the other by assessing why the debt was "primarily" incurred. § 101(8). The language of § 1182(1)(A) does not require, or even invite, this inquiry where the debt so clearly arose from the commercial or business activities of the debtor.

"Primacy," Judge Catliota said, "is not included in the assessment once the debt is determined to be incurred through the debtor's commercial or business activities." The statute, he said, "does not require the court to dissect the various benefits obtained by all the parties and, for purposes of § 1182(1)(A), include only debt that is linked to a direct benefit obtained by a debtor, while excluding debt that directly benefitted others."

Judge Catliota noted several benefits received by the debtor from the LBO loans. Among other things, he pointed to a $250,000 working capital loan and a covenant requiring $600,000 in working capital.

"It simply cannot be disputed," Judge Catliota said, "that, under the ordinary, contemporary, common meaning of the phrase, the debt 'arose from the commercial or business activities . . . of the debtor.'" He denied the objection to treatment under Subchapter V because the objection was "not consistent with the statutory language and ignores the substance of the transaction, including an assessment of the direct and indirect benefits the Debtor obtained."

Judge Name: Thomas J. Catliota

Case Citation:
Lyons v. Family Friendly Contracting LLC (In re Family Friendly Contracting LLC), 21-14213 (Bankr. D. Md. Oct. 26, 2021).

Case Name:
In re Family Friendly Contracting LLC

Judge Gargotta Splits with the Fourth Circuit on Nondischargeability in Subchapter V

To justify holding that "corporate debtors electing to proceed under Subchapter V of Chapter 11 are not subject to complaints to determine dischargeability pursuant to § 523(a)," Bankruptcy Judge Craig A. Gargotta of San Antonio issued a 25-page, line-by-line refutation of the recent, contrary holding by the Fourth Circuit in *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022).

Resolving what it called a "close" question, the Fourth Circuit held in June that "fairness and equity" required making the debts nondischargeable for a corporation, since a small business debtor in Subchapter V has an easier road to confirmation given the absence of the absolute priority rule. To read ABI's report on *Cleary*, click here.

Judge Gargotta's Facts

Judge Gargotta's 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.

The lender's complaint alleged that the debtor made a misrepresentation by not disclosing that bankruptcy was imminent. The complaint also asserted that the debtor failed to disclose that the debtor had other, more senior lenders.

The debtor responded with a motion to dismiss for failure to state a claim under Rule 12(b)(6), based on the idea that corporations in Subchapter V of chapter 11 are allowed to discharge debts that would be nondischargeable by individual debtors in Subchapter V. The debtor won dismissal of the complaint in Judge Gargotta's November 10 opinion.

The Statutory Language

The question before Judge Gargotta came down to this: Is Section 523(a) applicable to corporate debtors in Subchapter V?

Of pertinence to the case at hand, Section 523(a) says, "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" for money obtained by false pretenses or fraud." [Emphasis added.]

Governing discharge for Subchapter V debtors, Section 1192 states that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A)." Subsection (2) of Section 1192 goes on to say that a discharge in Subchapter V does not cover "any debt . . . of the kind specified in section 523(a) of this title."

Finally, Section 1141(d)(1)(A) says that a "discharge under this chapter [11] does not discharge a debtor who is an *individual* from any debt excepted from discharge under section 523 of this title." [Emphasis added.]

Judge Gargotta summarized the interplay among the sections as follows:

> [T]he language of § 1192(2) does not intend to except from discharge any debts that § 523(a) does not already except. Because § 523(a) unequivocally applies only to individuals, the language of § 1192(2) does not empower § 523(a) to cast a wider net than the text of § 523(a) permits. Had Congress included a phrase in § 1192(2) explicitly stating that the list found in § 523(a) applies to all debtors proceeding in Subchapter V, then the interpretation would be straightforward. Congress's choice not to insert this language is instructive.

In drafting Section 1192, Judge Gargotta said that Congress knew how to distinguish dischargeability based on the nature of the debtor but "did not make this distinction in § 1192(2)."

Judge Gargotta said that "interpreting § 523 as excepting from discharge debts of corporate debtors in Subchapter V would be to ignore the import of § 1192 into § 523(a)." He went on to say that "corporate debtors proceeding under Chapter 11 historically have been immune to dischargeability actions under § 523(a)." He added, "For Congress to suddenly depart from this well-established principle when it enacted Subchapter V defies reason."

Adding "§ 1192 into § 523 demonstrates that Congress intended § 1192(2) to limit the § 523 exceptions in Subchapter V to individuals only," Judge Gargotta said. "This conclusion is mandated by the canon of statutory construction against surplusage."

"In sum," Judge Gargotta said, "the statutory language along with the broader Chapter 11 statutory scheme mandate this Court's holding that corporate debtors proceeding under Subchapter V cannot be made defendants in § 523 dischargeability actions."

JRB Distinguished

The lender threw *New Venture Partnership v. JRB Consolidated, Inc. (In re JRB Consolidated, Inc.)*, 188 B.R. 373, 374 (Bankr. W.D. Tex. 1995), into Judge Gargotta's face.

In *JRB*, a different bankruptcy judge in the same district had held in 1995 that similar language in Chapter 12 made debts nondischargeable as to corporate debtors, not only individual debtors. *JRB* had been cited approvingly by the Fourth Circuit in *Cleary*.

Judge Gargotta said that Chapter 12's incorporation of Section 523 is "broader." He also noted that unlike chapter 12 cases, "Subchapter V is not its own chapter of bankruptcy, but rather is a subchapter of Chapter 11."

Cleary and Other Cases

The case before him was an issue of first impression in the Fifth Circuit, Judge Gargotta said. He cited four bankruptcy courts that confronted the same question, and all held that corporate debtors in Subchapter V cannot be saddled with nondischargeable debts.

However, one of the four cases was reversed by the Fourth Circuit in *Cleary*. So, Judge Gargotta set about rebutting the six arguments on which the Fourth Circuit primarily relied. He saw *Cleary* as "frustrat[ing] the entire Chapter 11 statutory scheme."

Dismissing the lender's nondischargeability complaint, Judge Gargotta said that he "disagrees" with *Cleary* "and joins [his] sister bankruptcy courts in holding that corporate Subchapter V debtors should not be subject to § 523 dischargeability actions."

For debtor's counsel facing the same issue, Judge Gargotta has written the brief for you.

Judge Name: Craig A. Gargotta

Case Citation:
Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC), 22-05052 (Bankr. W.D. Tex. Nov. 10, 2022).

Case Name:
In re GFS Industries LLC

The Standard for Enlarging the Time to File a Subchapter V Plan

In the form of an opinion, Bankruptcy Judge Robert H. Jacobvitz of Albuquerque, N.M., wrote a treatise identifying the best definition of Section 1189(b), which requires a debtor in Subchapter V of chapter 11 to file a plan within 90 days of filing, but allows the court to "extend the period if the need for the extension is *attributable to circumstances for which the debtor should not justly be held accountable*." [Emphasis added.]

The debtor was a homebuilder with most of its debt in the hands of a few unsecured creditors. Judge Jacobvitz had already extended the 90-day plan-filing deadline four times, but the debtor was seeking a fifth extension for one month.

Notably, unsecured creditors likely would recover nothing on conversion to chapter 7 because the assets were subject to lien. In a plan, Judge Jacobvitz said that the "major creditors might be substantially better off."

Beforehand, Judge Jacobvitz had authorized mediation with four of the primary creditors. Two had agreed on settlements, and negotiations were to continue with the other two. Two different creditors objected to an extension of the plan-filing deadline.

The objectors argued, among other things, that Subchapter V was designed to be "speedy" and that negotiating with creditors was not a circumstance "for which the debtor should not justly be held accountable."

Addressing the objections, Judge Jacobvitz noted how courts "agree that § 1189(b) imposes a stricter standard than the 'for cause' standard set forth in § 1121(d)(1) that governs extensions of time to file a plan in chapter 11 cases not governed by subchapter V." However, he said that courts are split on what constitutes "circumstances for which the debtor should not justly be held accountable."

As a guideline for statutory interpretation, Judge Jacobvitz examined *Pioneer Inv. Servs. Co. v. Brunswick Assocs. Ltd. P'ship*, 507 U.S. 380 (1993), where the Supreme Court gave definition to the excusable neglect standard in Bankruptcy Rule 9006(b)(1). He said that the Supreme Court "construed the 'excusable neglect' standard as an equitable inquiry after taking into account that 'the bankruptcy courts are necessarily entrusted with broad equitable powers to balance the interests of the affected parties, guided by the overriding goal of ensuring the success of the reorganization.'" *Id.* at 389.

Next, Judge Jacobvitz analyzed "three approaches taken by different courts" in defining the standard in Section 1189(b).

"Several courts," Judge Jacobvitz said, "have equated 'circumstances for which the debtor should not justly be held accountable' with 'circumstances beyond the debtor's control.'" Those courts, he said, do not weigh "equitable considerations."

The second standard is known as the four-factor *Baker* test, and the third is called the "equitable inquiry."

Judge Jacobvitz said that Bankruptcy Judge Michelle M. Harner of Maryland wrote "the most comprehensive analysis" of the "equitable inquiry" test in *In re Trepetin*, 617 B.R. 841, 848-50 (Bankr. D. Md. 2020). To read ABI's report on *Trepetin*, click here.

For guidance regarding the best interpretation of "circumstances for which the debtor should not justly be held accountable," Judge Jacobvitz acknowledged the meanings ascribed to the same language in Section 1221 (governing extensions of time to file a chapter 12 plan), Sections 1228(b)(1) and 1328(b)(1) (for granting hardship discharges), and Section 1188(b) (for extensions of time to hold a Subchapter V status conference).

On hardship discharges, Judge Jacobvitz said that the courts are split on whether the debtor must show "catastrophic circumstances" or whether the court may "conduct an equitable inquiry." For extensions of time to file chapter 12 plans, he said that courts "do not extensively analyze why 'circumstances for which the debtor should not justly be held accountable' means 'circumstances beyond the debtor's control.'"

Overall, though, Judge Jacobvitz said that he did "not find the caselaw interpreting the other Code provisions with the language 'circumstances for which the debtor should not justly be held accountable' to be conclusive in the context of § 1189(b)."

Judge Jacobvitz therefore employed "the reasoning of *Pioneer* to conclude that § 1189(b) requires the Court to conduct an equitable inquiry" and found "*Trepetin* persuasive in its conclusion that courts may balance subchapter V goals in considering whether to grant an extension of time to file a subchapter V plan."

Furthermore, Judge Jacobvitz said that "the term 'justly,' as used in § 1189(b), allows the Court to take into account all relevant circumstances surrounding the debtor's need for an extension of time to file a plan and to balance the interests of the affected parties," including the "overarching goals of subchapter V." Specifically, he said that circumstances to be taken into consideration include:

whether the need for the extension is within the debtor's reasonable control and may include such things as the danger of prejudice by granting or refusing to grant the extension, the length of the extension, the debtor's good faith, the debtor's progress in formulating a meaningful plan, and the views of creditors as a whole and the subchapter V trustee.

Finally, Judge Jacobvitz noted that Subchapter V's lack of a deadline for confirming a plan "is consistent with the court having discretion elsewhere over the confirmation process."

Taking into account "all relevant circumstances" and "balancing the best interests of affected parties," Judge Jacobvitz granted a one-month extension for filing a plan. However, he said the court would be "disinclined to grant any further extensions."

Judge Name: Robert H. Jacobvitz

Case Citation:

In re Trinity Legacy Consortium LLC, 22-10973 (Bankr. D.N.M. Sept. 25, 2023)

Case Name:
In re Trinity Legacy Consortium LLC

In Sub V, a Class with No Votes Isn't Considered in Confirming a Chapter 11 Plan

When no one in a class of creditors has voted for or against a Subchapter V plan, former Bankruptcy Judge David R. Jones of Houston holds that the class "will not be considered for purposes of 11 U.S.C. § 1129(a)(8)," which requires that every class of creditors under a plan must be unimpaired or must have accepted the plan, otherwise the so-called cramdown requirements are invoked.

The Subchapter V debtor's plan had six classes. Three classes voted to accept the plan, but there were no votes for or against the plan by creditors in the other three classes.

The classes with no votes covered a secured creditor, a creditor with a priority claim, and unsecured creditors.

As Judge Jones explained in his October 4 opinion, the U.S. Trustee argued that the "plan could not be confirmed under 11 U.S.C. § 1191(a) due to the failure of all classes to affirmatively accept the plan under 11 U.S.C. § 1129(a)(8) as required by 11 U.S.C. § 1191(a)."

As authority for the objection, the U.S. Trustee cited *In re Bressler*, No. 20-31024, 2021 WL 126184 (Bankr. S.D. Tex. Jan. 13, 2021), a decision by Bankruptcy Judge Eduardo V. Rodriguez, also of the Southern District of Texas.

Judge Jones marched through the requisites for confirmation of a Subchapter V plan contained in Section 1191(a), which requires the satisfaction of the requirements in Section 1129(a) other than subsection (15). Evidently, all of the confirmation requirements were met aside from subsection (8), which requires that every class must accept the plan or be unimpaired.

Because no one voted in the three classes, Judge Jones said that the mathematical "calculation required by § 1126(c) cannot be performed." He found that

> attempting to do what the laws of mathematics prohibit is an absurd proposition and could not have been intended when Congress enacted the current version of § 1126. By implementing a denominator that includes only votes actually cast in § 1126, it logically follows that Congress presumed that at least one vote was cast.

To buttress the idea that a vote must be cast, Judge Jones quoted the legislative history accompanying Section 1126, which said that the "amount and number are computed on the basis of claims actually voted for or against the plan, not as under Chapter X [of the former Bankruptcy Act] on the basis of the allowed claims in the class."

In an "unusual case" not contemplated by the statute, Judge Jones cited a Fifth Circuit decision from 1980 saying that the court should interpret the statute in line with "congressional intent" and "the statute's design." *Truvillion v. King's Daughters Hosp.*, 614 F.2d 520, 527 (5th Cir. 1980).

Judge Jones cited the Tenth Circuit for being the only circuit to address the question. *In re Ruti-Sweetwater, Inc.*, 836 F.2d 1263 (10th Cir. 1988). He paraphrased the Denver-based appeals

court for holding "that by failing to cast a ballot, the non-voting creditors had consented to the debtor's plan and that their inaction amounted to a deemed acceptance. *Id.* at 1267–68."

Judge Jones cited one bankruptcy court in Texas for having followed *Ruti-Sweetwater* in 2009 and another Texas court for having rejected *Ruti-Sweetwater*, also in 2009.

For his part, Judge Jones found the "policy underlying *Ruti-Sweetwater*" to be "compelling." He referred to Subchapter V as being designed "to encourage consensual plans." From a "practical perspective," he said that "a creditor that agrees to a debtor's plan may express its consent by affirmatively voting for a plan or by simply choosing not to file an objection."

Judge Jones overruled the U.S. Trustee's objection and confirmed the plan. He held that a class with no votes "should not be counted for purposes of § 1129(a)(8)." In his view, "Congress presumed the existence of at least one vote in each class [in] making the change to § 1126 when enacting the Bankruptcy Code."

Judge Name: David R. Jones

Case Citation:
In re Franco's Paving LLC, 23-20069 (Bankr. S.D. Tex. Oct. 4, 2023).

Case Name:
In re Franco's Paving LLC

Bankruptcy Judge Stong Penned a Compendium About Eligibility for Subchapter V

For a free trial subscription to RDW, please visit http://connect.abi.org/rdwsignup.

For more information about ABI, please visit www.abi.org.

Synthesizing the leading cases about eligibility for Subchapter V, Bankruptcy Judge Elizabeth S. Stong of Brooklyn, N.Y., held that an individual debtor was entitled to reorganize in Subchapter V because she owned a small, income-producing real property and was dealing with a $3.3 million judgment arising from a defunct business in which she was a 25% owner.

The debtor and her brother were each 25% owners of a hardware business. Ten months before bankruptcy, the business, the debtor and her brother were saddled with joint and several liability for a $3.3 million judgment owing to a supplier. The business had halted operations several years before the debtor filed her individual chapter 11 petition and elected treatment under Subchapter V.

The debtor also owned a two-family home and had been renting one of the units for about three years before filing.

The judgment creditor filed a motion objecting to the debtor's election to proceed under Subchapter V. Given that the business had long since ceased operations, the creditor contended that the debtor was not currently engaged in business. Judge Stong denied the motion in her 41-page opinion on September 15.

The outcome turned on Section 1182(1)(A), which demands that a debtor in Subchapter V must be "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 $7,500,000 . . . not less than 50 percent of which arose from the commercial or business activities of the debtor."

The debtor was a "person" with a smattering of debt aside from the judgment. Consequently, her eligibility for Subchapter V turned on whether she could carry the debtor's burden of showing that she was "a person engaged in commercial or business activities."

The creditor in large measure objected to eligibility because the business was no longer operating, and the debtor had ceased her participation in the business about six years before filing.

Citing a plethora of leading cases on the topic, Judge Stong held that the "debtor's eligibility to reorganize under Subchapter V turns on whether the debtor is 'engaged in' commercial or business activities as of the . . . Petition Date." But what does "commercial or business activities" mean?

Judge Stong noted that the statute refers to "activities," not the "operation" of a business, and that the two words are not "interchangeable." She said that "activities" is "more encompassing" and is intended to provide "wide availability" for electing treatment under Subchapter V, citing authorities.

Following courts that look to the "totality of the circumstances," Judge Stong held that

> the court may look to the facts and circumstances of the debtor's particular situation, including what led to the debtor's bankruptcy filing, the activities in which the debtor is engaged as of the petition date, and how the debtor plans to proceed in the bankruptcy case to marshal its assets and address its debts.

While the act of filing a petition is not sufficient in itself to confer eligibility, Judge Stong noted that the debtor remained a 25% owner of the defunct business and that she was renting one unit in a two-family home. In addition, the debtor was a plaintiff in an ongoing lawsuit with former associates in the business.

Judge Stong agreed "with the substantial majority of courts that have found that a debtor may be eligible to reorganize under Subchapter V when it seeks to address residual business debt, and to marshal residual business assets." In particular, she said that "evaluating, asserting, pursuing, and defending litigation claims . . . can still . . . satisfy Section 1182(1)(A)'s requirement of 'commercial or business activities.'"

Furthermore, Judge Stong noted that the debtor was renting a unit in the two-family home and that no "nexus" is required between the debt and an active business.

Judge Stong ruled that the debtor was eligible for Subchapter V because "the purpose of this Subchapter V case is to address residual business debt, and to marshal residual business assets."

Judge Name: Elizabeth S. Stong

Case Citation:
Fama-Chiarizia, 21-42341 (Bankr. E.D.N.Y. Sept. 15, 2023).

Case Name:
Fama-Chiarizia

Faculty

Hon. Hannah L. Blumenstiel is a U.S. Bankruptcy Judge for the Northern District of California in San Francisco. Prior to her appointment on Feb. 11, 2013, Judge Blumenstiel was an associate (2003-08) and then a partner (2008-12) with Winston & Strawn LLP, where she focused her practice on creditors' rights litigation in state and federal court, including bankruptcy court. From 2001 to 2003, Judge Blumenstiel was an associate with Murphy Sheneman Julian & Rogers LLP, where she represented debtors, creditors and trustees in bankruptcy cases and adversary proceedings. She served as a law clerk to Hon. Charles M. Caldwell of the U.S. Bankruptcy Court for the Southern District of Ohio (Eastern Division) from 1998 to 2001, and from 1997-98, she represented the State of Ohio's interests in bankruptcy cases as an assistant attorney general with the Revenue Recovery Section of the Ohio Attorney General's Office. Judge Blumenstiel is ABI's Vice President-Research Grants and serves as an Executive Editor of the *ABI Journal*. She received her J.D. from Capital University Law School in 1997 while working full-time for the Columbus Bar Association as director of its *pro bono* initiative, "Lawyers for Justice," and her B.A. from Ohio State University in 1992.

Hon. Daniel P. Collins is a U.S. Bankruptcy Judge for the District of Arizona in Phoenix, appointed on Jan. 18, 2013. He served as chief judge from 2014-18 and is presently a conflicts judge in the Districts of Guam, Hawaii and Southern California. Previously, Judge Collins was a shareholder with the Collins, May, Potenza, Baran & Gillespie, P.C. in Phoenix, practicing primarily in the areas of bankruptcy, commercial litigation and commercial transactions. He is president of the National Conference of Bankruptcy Judges, is a Fellow in the American College of Bankruptcy, served on ABI's Board of Directors, is on the board of the Phoenix Chapter of the Federal Bar Association and is a member of the University of Arizona Law School's Board of Visitors. He also is a founding member of the Arizona Bankruptcy American Inn of Court. Judge Collins received both his B.S. in finance and accounting in 1980 and his J.D. in 1983 from the University of Arizona.

Hon. Michelle M. Harner is a U.S. Bankruptcy Judge for the District of Maryland in Baltimore, appointed in 2017. Prior to her appointment to the bench, she was the Francis King Carey Professor of Law and the Director of the Business Law Program at the University of Maryland Francis King Carey School of Law, where she taught courses in bankruptcy and creditors' rights, business associations, business planning, corporate finance and the legal profession. Judge Harner lectured frequently during her academic career on various topics involving corporate governance, financially distressed entities, risk management and related legal issues. Her academic scholarship is widely published, with her publications appearing in, among others, the *Vanderbilt Law Review*, *Notre Dame Law Review*, *Washington University Law Review*, *Minnesota Law Review*, *Indiana Law Journal*, *Fordham Law Review* (reprinted in *Corporate Practice Commentator*), *Washington & Lee Law Review*, *William & Mary Law Review*, *University of Illinois Law Review*, *Arizona Law Review* (reprinted in *Corporate Practice Commentator*) and *Florida Law Review*. Judge Harner has served as the Associate Reporter to the Advisory Committee on the Federal Rules of Bankruptcy Procedure, the Reporter to the ABI Commission to Study the Reform of Chapter 11, and most recently chaired the Dodd-Frank Study Working Group for the Administrative Office of the U.S. Courts. She also served as the Robert M. Zinman ABI Resident Scholar for the fall of 2015. She most recently served as the chair of the Dodd-Frank Study Working Group for the Administrative Office of the U.S. Courts. Judge Harner is an

elected conferee of the National Bankruptcy Conference, an elected Fellow of the American College of Bankruptcy, and an elected member of the American Law Institute. She previously was in private practice in the business restructuring, insolvency, bankruptcy and related transactional fields, most recently as a partner at the Chicago office of the international law firm Jones Day. Judge Harner received her B.A. *cum laude* from Boston College in 1992 and her J.D. *summa cum laude* from The Ohio State University College of Law in 1995.

Hon. Bruce A. Harwood is Chief U.S. Bankruptcy Judge for the District of New Hampshire in Concord, appointed to the bench in March 2013. He also serves 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 Vice President-Communication, Information & Technology, and serves on its Executive Committee. He previously served as ABI's Secretary, 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. Sage M. Sigler is a U.S. Bankruptcy Judge for the Northern District of Georgia in Atlanta, appointed in March 2018. She succeeded Hon. Mary Grace Diehl, for whom she clerked after graduating from law school. Prior to her appointment to the bench, Judge Sigler was a partner in Alston & Bird LLP's Bankruptcy Group. She is an active member of ABI's Board of Directors, NCBJ, IWIRC, TMA and the Bankruptcy Section of the Atlanta Bar Association, and she has been a volunteer presenter for the Credit Abuse Resistance Education (CARE) program. Judge Sigler was an honoree in ABI's inaugural class of "40 Under 40" in 2017. She received her B.A. in political science from the University of Florida in 2001 and her J.D. in 2006 from Emory University School of Law, where she was the executive symposium editor of the *Emory Bankruptcy Developments Journal*.