2022 Consumer Practice Extravaganza

Subchapter V Lightning Rounds and Rods

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Hon. Mary P. Gorman
U.S. Bankruptcy Court (C.D. Ill.); Springfield

Hon. Kesha L. Tanabe
U.S. Bankruptcy Court (D. Minn.); St. Paul

CONCURRENT SESSION

2022

SUBCHAPTER V LIGHTNING ROUNDS AND RODS

Randy Nussbaum

SACKS TIERNEY

Meet Randy Nussbaum

For more than 41 years, Randy Nussbaum has assisted individuals and businesses with complex bankruptcy protection (debtor and creditor), transaction, and litigation matters.

Randy is a Certified Bankruptcy Specialist (Arizona Board of Legal Specialization) and a Certified Business Bankruptcy Specialist (American Board of Certification). Randy has presented at American Bankruptcy Institute programs annually since 2011

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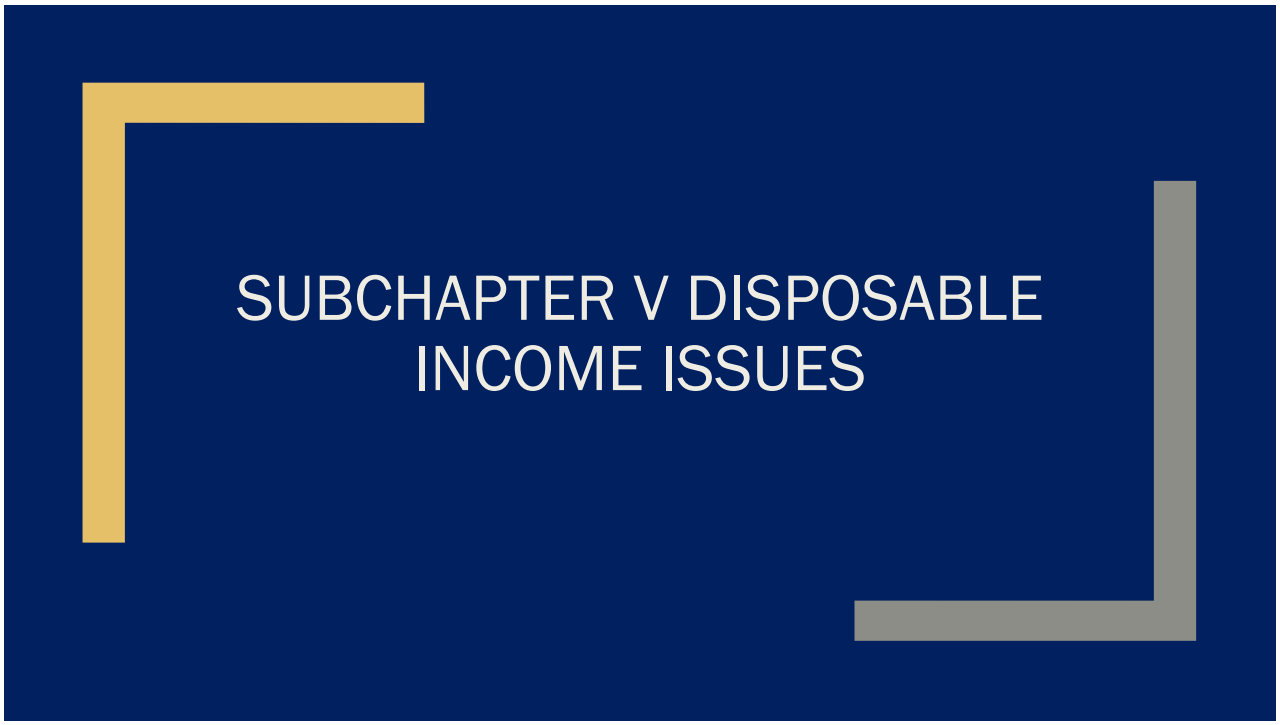

- A Subchapter V debtor must pay all of its disposable income into its plan for at least three (3) or up to five (5) years as the court may fix. The length of the obligatory period depends upon a number of factors, including the need to meet the "best interests" test and to pay priority and administrative expenses.

- Under Subchapter V a three (3) year obligation is both the minimum, and the most common plan term. Under the best interests test, the debtor must pay enough into the plan to ensure that general unsecured creditors would receive at least what they would receive in a Chapter 7 liquidation.

- In certain instances, simply paying disposable income for three (3) years may not be adequate to properly fund the plan, which could prevent confirmation of a plan that is when a five (5) year plan can be used.

- Occasionally, a debtor's disposable income over the term of the plan is not enough for the "best interests" test to be met, and therefore the plan is unconfirmable. Fortunately for debtors, in the majority of cases, the disposable income will cover any obligation under the best interests test.

SUBCHAPTER V DISPOSABLE INCOME IN A BUSINESS CASE

- To determine disposable income, you first have to recognize what expenses are proper in a Subchapter V case. As a general rule, they are expenses needed for the continuance, preservation, and operation of the debtor's business.

- In most instances, pre-bankruptcy expenses can provide an excellent barometer of appropriate and necessary expenses, although in other situations, a Subchapter V debtor needs to reduce its expenses to successfully organize. In those situations, prefiling expenses may be of little benefit in formulating post-filing expenditures.

- However, it's rare that a Subchapter V debtor will meet resistance when the expenses being claimed are less than ones that were being incurred pre-filing. Resistance is more often met when the Subchapter V debtor wants to increase its monthly expenses.

- Inflationary costs, strategical steps undertaken to increase revenues by taking on additional expenses, and/or financial considerations beyond the debtor's control, such as the increase in loan costs triggered by fluctuating interest rates, will determine whether the Subchapter V debtor will be able to increase expenses.

- A Subchapter V debtor will also be allowed to set aside part of its income for capital expenditures, etc. How much the debtor can put aside will depend upon a number of factors, including the debtor's prefiling conduct, how much needs to be devoted to capital expenditures relative to other expenses, and whether the need to set aside that money is really necessary based upon the debtor's financial affairs and condition.

- Obviously, creditors will be very skeptical of a Subchapter V debtor earmarking an inordinate amount of money for capital improvement purposes, but reasonable amounts should not be challenged.

DISPOSABLE INCOME IN INDIVIDUAL CASES

- When individuals are specifically operating a business as proprietors, the same basic factors will be present as in a business case. However, determining what individuals need to set aside to pay their monthly obligations is not as clear.

- The case law primarily revolves around what is reasonable, but some general propositions need to be considered:

    - Fixed expenses, which by their very nature are reasonable, such as rent or a mortgage payment are authorized.
    - Similarly, expenditures for vehicle expenses, medical expenses, food, utilities, and provisions will all be permitted unless the amounts by their very nature appear to be unreasonable.

- Unlike in a Chapter 13 case in which trustees rely upon objective third-party guidelines as general parameters for what is allowed, no such guidelines are present in Subchapter V cases. Presumably, this could lead to litigation, but such litigation has not become commonplace in these cases.

- In many cases, if individual Subchapter V debtors want to continue a pre-petition expenditure that may not be absolutely necessary, but is one that is not necessarily unusual or luxurious, they appear to have been able to do so. For example, gym memberships don't appear to have triggered substantial litigation, nor similar personal expenditures which overall don't amount to that much over the course of three years.

- Especially since Subchapter V by its very nature is designed to be debtor friendly, creditors have apparently recognized that quarreling over $100 or $200 a month is simply not worth the aggravation nor the potential expense even if the expenditure is eliminated.

PREPAYING THE OBLIGATORY DISPOSABLE INCOME

- Just like in a traditional Chapter 11, once disposable income is calculated at confirmation, a debtor can simply pay that amount over the course of the plan or prepay that amount post-confirmation. Because a debtor will be facing certain limitations on financial options while in Chapter 11, pre-paying the plan can be extremely advantageous. This is in marked contrast to a Chapter 13, which specifically will not allow a prepayment of the plan payments unless creditors are paid in full.

- In cases in which a debtor may have accessibility to exempt assets for that purpose, or a third party is willing to assist that person in prepaying a plan, this option makes Subchapter V extremely attractive to individuals obligated on a relatively minimal payment who want to exit Chapter 11 as quickly as possible.

CALCULATING INCOME

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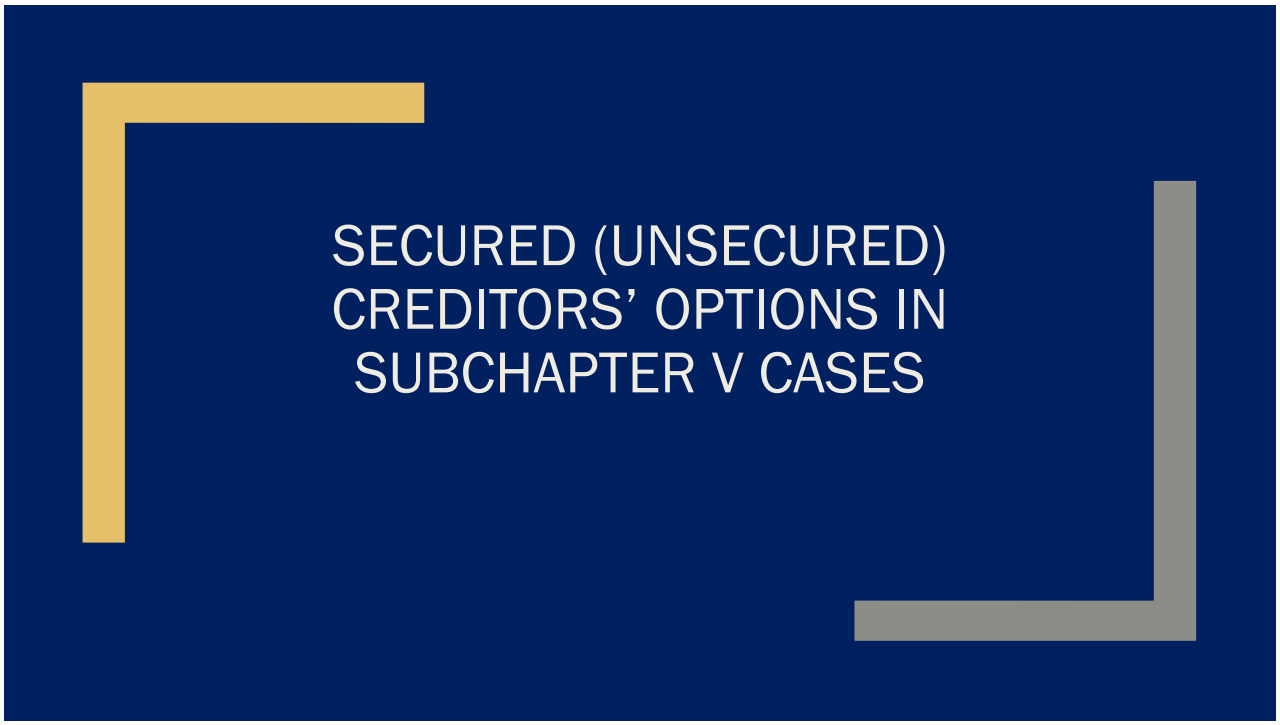
- This topic is not as straightforward as it may first appear to be. Many debtors may have historically worked overtime or two jobs to cover their monthly expenses. This raises the issue of whether it's bad faith or inappropriate for that debtor to cease doing so once in Chapter 11 to minimize the disposable income obligation.
- This issue is not litigated for the obvious reason that unless the debtor is acting in bad faith, a high likelihood exists that the individual sought Subchapter V relief specifically because that person was tired of having to work an extra job or put in so many overtime hours.
- It's hard to imagine a scenario in which such a debtor will be punished for seeking Subchapter V relief so that that individual can simply work a normal job and not kill himself in perpetuity.

DEALING WITH REAL ESTATE ISSUES IN SUBCHAPTER V

- A Subchapter V debtor is in an extremely advantageous position in addressing secured debt. A Subchapter V debtor still has to address evaluation issues when the debtor is attempting a cram down the loan and also has to deal with fluctuating interest rates but otherwise is normally negotiating from a position of strength.
- However, unlike in a normal Chapter 11 in which cramming down a secured creditor can result in that secured creditor controlling the unsecured creditors' voting class, which can complicate plan confirmation because of the absolute priority rule and the need to contribute new value, Subchapter V eliminated the absolute priority rule.
- Consequently, a Subchapter V debtor only needs to be concerned with the lender taking the 1111(b) election, but otherwise has little to fear by an aggressive cram down. Subchapter V also allows individuals to modify a loan on their residence if that loan is a non-purchase one and was used for business purposes.
- Although residential loans could always be crammed down in both Chapter 11 and Chapter 13 if the loan was secured by other assets besides the debtor's principal residence, Subchapter V now allows such a modification even if the loan is only secured by the debtor's house.



Creditors in Subchapter V have limited recourse because by its very nature, Subchapter V was enacted to expedite, streamline, and simplify the Chapter 11 process. Nevertheless, creditors, and especially secured creditors, have to be aware of the following options available to them.

- Unlike Chapter 13, a debtor has to include all debt in calculating the 7.5-million-dollar cap, including contingent, unliquidated, and disputed. Debtors may try to circumvent this cap by not including debt. Not only would this strategy probably be considered to be in bad faith, but it could bias the judge or the U.S. Trustee going forward. There is an interesting emerging issue of how claims that haven't been defined, such as a pending lawsuit, should be valued.

- A debtor must be primarily a business debtor. Individuals facing a large mortgage debt on their residence may not be eligible for Subchapter V. It is important to carefully review the composition of the debtor's obligations.

- Finally, if the debtor is a single asset real estate debtor, that debtor will not be eligible for Subchapter V. In other words, if the debtor's income is primarily derived from real estate itself, that debtor may not be eligible for Subchapter V.

- What constitutes a debtor's income being primarily derived from the real estate in certain instances may be determined on a case-by-case basis and may depend in part upon the predilection of the judge towards encouraging Subchapter V cases.

TAKE ADVANTAGE OF THE STRICT TIMELINES

- Most Chapter 11 lawyers are still not familiar with the rather strict timelines for performance in Subchapter V. The strict timelines were enacted specifically to try to balance some of the inequities to creditors in Subchapter V. Said another way, if debtors are granted such generous terms, they should have to proceed expeditiously.
- Debtors only have 90 days to file a plan and efforts to extend that deadline should be summarily rejected except in extreme circumstances.
- A material creditor in a Subchapter V case should not consent to the extension of that deadline unless that creditor has strategic benefits in doing so.

1111(B) ELECTION

- As long as a creditor has a significant secured position in an asset, even if primarily unsecured, that creditor can take the 1111(b) election, which requires the debtor to pay back to the creditor the principal amount of its loan, albeit over time.
- In return for being provided this treatment, a creditor would have to forgive its rights to participate as an unsecured creditor, which in many instances would have otherwise allowed it to control the unsecured creditor class.
- Even though case law has provided that a debtor will have more than the three to five-year period of a plan to pay back this obligation, in most cases, creditors should seriously consider taking the 1111(b) election.
- Since the absolute priority rule does not apply in Subchapter V, a secured creditor is not giving up any voting power and in most instances, will recover far more by taking the election versus allowing a substantial cram down.

FEASIBILITY?

- A Subchapter V debtor has to demonstrate it can not only make its plan payments, but cover its legal fees and Subchapter V trustee's fees as well. In many cases, Subchapter V proceedings are "thinly" funded and if enough money is not available to pay administrative claims and to meet the best interests test, the plan will fail.

SUBCHAPTER V LIGHTNING ROUNDS AND RODS

ABI Consumer Practice Extravaganza

November 16, 2022

Randy Nussbaum
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SUBCHAPTER V LIGHTNING ROUNDS AND RODS

I. SUBCHAPTER V DISPOSABLE INCOME ISSUES

A Subchapter V debtor has to pay all of its disposable income into its plan for at least three (3) or up to five (5) years as the court may fix. The length of the obligatory period depends upon a number of factors, including the need to meet the "best interests" test and to pay priority and administrative expenses. Under Subchapter V a 3 year obligation is both the minimum, and the most common plan term. Under the best interests test, the debtor must pay enough into the plan to ensure that general unsecured creditors would receive at least what they would receive in a Chapter 7 liquidation. Obviously, in certain instances, simply paying disposable income for three (3) years may not be adequate to properly fund the plan, which could prevent confirmation of a plan, which is where a five (5) year plan can be used. Occasionally, a debtor's disposable income over the term of the plan is not enough for the "best interests" test to be met, and therefore the plan is unconfirmable. Fortunately for debtors, in the majority of cases, the disposable income will cover any obligation under the best interests test.

Since the calculation of disposable income is a vehicle in determining the debtor's financial commitment, it's a crucial determination in Subchapter V cases. This leaves the following discrete issues that need to be addressed because of the importance of this concern.

A. Disposable Income in a Business Case

To determine disposable income, you first have to recognize what expenses are proper in a Subchapter V case. As a general rule, they are expenses needed for the continuance, preservation, and operation of the debtor's business.

In most instances, pre-bankruptcy expenses can provide an excellent barometer of appropriate and necessary expenses, although in other situations, a Subchapter V debtor needs to reduce its expenses to successfully organize. In those situations, prefiling expenses may be of little benefit in formulating post-filing expenditures. However, it's rare that a Subchapter V debtor will meet resistance when the expenses being claimed are less than ones that were being incurred pre-filing. Resistance is more often met when the Subchapter V debtor wants to increase its monthly expenses. Whether it can do so depends upon a variety of circumstances and factors, including inflationary costs, strategical steps undertaken to increase revenues but require taking on additional expenses, and/or financial considerations beyond the debtor's control, such as the increase in loan costs triggered by fluctuating interest rates.

A Subchapter V debtor will also be allowed to set aside part of its income for capital expenditures, etc. Presumably, how much the debtor can put aside will depend upon a number of factors, including the debtor's prefiling conduct, how much needs to be devoted to capital expenditures relative to other expenses, and whether the need to set aside that money is really

necessary based upon the debtor's financial affairs and condition. Obviously, creditors will be very skeptical of a Subchapter V debtor earmarking an inordinate amount of money for capital improvement purposes, but reasonable amounts should not be challenged.

B. Disposable Income in Individual Cases

When individuals are specifically operating a business as proprietors, the same basic factors will be present as in a business case. However, determining what individuals need to set aside to pay their monthly obligations is not as clear.

The case law primarily revolves around what is reasonable, but some general propositions need to be considered:

Fixed expenses, which by their very nature are reasonable, such as rent or a mortgage payment are authorized. Similarly, expenditures for vehicle expenses, medical expenses, food, utilities, and provisions will all be permitted unless the amounts by their very nature appear to be unreasonable.

Unlike in a Chapter 13 case in which the trustees all rely upon objective third-party guidelines as general parameters for what is allowed, no such guidelines are present in Subchapter V cases. Presumably, this could lead to litigation, but such litigation doesn't appear to have become commonplace in these cases. In many cases, if individual Subchapter V debtors want to continue a pre-petition expenditure which may not be absolutely necessary but is one that is not necessarily unusual or luxurious, they appear to have been able to do so. For example, gym memberships don't appear to have triggered substantial litigation, nor similar personal expenditures which overall don't amount to that much over the course of three years. Especially since Subchapter V by its very nature is designed to be debtor friendly, creditors have apparently recognized that quarreling over $100 or $200 a month is simply not worth the aggravation nor the potential expense even if the expenditure is eliminated.

C. Prepaying the Obligatory Disposable Income?

Just like in a traditional Chapter 11, once disposable income is calculated at confirmation, a debtor can simply pay that amount over the course of the plan or prepay that amount post-confirmation. Especially because a debtor will be facing certain limitations on financial options while in Chapter 11, pre-paying the plan can be extremely advantageous. This is in marked contrast to a Chapter 13 which specifically will not allow a prepayment of the plan payments unless creditors are paid in full.

Especially in cases in which a debtor may have accessibility to exempt assets for that purpose, or a third party is willing to assist that person in prepaying a plan, this option makes Subchapter V extremely attractive to individuals obligated on a relatively minimal payment who want to exit Chapter 11 as quickly as possible.

D. Calculating Income

This topic is not as straightforward as it may first appear to be. Many debtors may have historically worked overtime or two jobs to cover their monthly expenses. This raises the issue of whether it's bad faith or inappropriate for that debtor to cease doing so once in Chapter 11 to minimize the disposable income obligation.

This issue is not litigated for the obvious reason that unless the debtor is acting in bad faith, a high likelihood exists that the individual sought Subchapter V relief specifically because that person was tired of having to work an extra job or put in so many overtime hours. It's hard to imagine a scenario in which such a debtor will be punished for seeking Subchapter V relief so that that individual can simply work a normal job and not kill himself in perpetuity.

II. DEALING WITH REAL ESTATE ISSUES IN SUBCHAPTER V

A Subchapter V debtor is in an extremely advantageous position in addressing secured debt. A Subchapter V debtor still has to address evaluation issues when the debtor is attempting a cram down the loan and also has to deal with fluctuating interest rates but otherwise is normally negotiating from a position of strength. However, unlike in a normal Chapter 11 in which cramming down a secured creditor can result in that secured creditor controlling the unsecured creditors' voting class, which can complicate plan confirmation because of the absolute priority rule and the need to contribute new value, Subchapter V eliminated the absolute priority rule. Consequently, a Subchapter V debtor only needs to be concerned with the lender taking the 1111(b) election, but otherwise has little to fear by an aggressive cram down. Subchapter V also allows individuals to modify a loan on their residence if that loan is a non-purchase one and was used for business purposes. Although residential loans could always be crammed down in both Chapter 11 and Chapter 13 if the loan was secured by other assets besides the debtor's principal residence, Subchapter V now allows such a modification even if the loan is only secured by the debtor's house. .

III. SECURED (UNSECURED) CREDITORS' OPTIONS IN SUBCHAPTER V CASES

Creditors in Subchapter V have limited recourse because by its very nature, Subchapter V was enacted to expedite, streamline, and simplify the Chapter 11 process. Nevertheless, creditors, and especially secured creditors, have to be aware of the following options available to them.

A. Is the Debtor Eligible for Subchapter V?

Unlike Chapter 13, a debtor has to include all debt in calculating the 7.5-million-dollar cap, including contingent, unliquidated, and disputed. Occasionally debtors may try to circumvent this cap by not including debt, but not only would this strategy probably be considered to be in bad faith, but it could bias the judge or the U.S. Trustee going forward. There is an interesting emerging issue of how claims that haven't been defined, such as a pending lawsuit, should be valued.

A debtor has to be primarily a business debtor and with individuals facing a large mortgage debt on their house, they may not be eligible, but review carefully the composition of the debtor's obligations.

Finally, if the debtor is a single asset real estate debtor, that debtor will not be eligible for Subchapter V. In other words, if the debtor's income is primarily derived from real estate itself, that debtor may not be eligible for Subchapter V.

What constitutes a debtor's income being primarily derived from the real estate in certain instances may be determined on a case-by-case basis and may depend in part upon the predilection of the judge towards encouraging Subchapter V cases.

B. Take Advantage of the Strict Timelines

Most Chapter 11 lawyers are still not used to the rather strict timelines for performance in Subchapter V. The strict timelines were enacted specifically to try to balance some of the inequities to creditors in Subchapter V. Said another way, if debtors are granted such generous terms, they should have to proceed expeditiously. Debtors only have 90 days to file a plan and efforts to extend that deadline should be summarily rejected except in extreme circumstances. A material creditor in a Subchapter V case should not consent to the extension of that deadline unless that creditor has strategic benefits in doing so.

C. 1111(b) Election?

As long as a creditor has a significant secured position in an asset, even if primarily unsecured, that creditor can take the 1111(b) election, which requires the debtor to pay back to the creditor the principal amount of its loan, albeit over time. In return for being provided this treatment, a creditor would have to forgive its rights to participate as an unsecured creditor, which in many instances would have otherwise allowed it to control the unsecured creditor class. Even though case law has provided that a debtor will have more than the three to five-year period of a plan to pay back this obligation, in most cases, creditors should seriously consider taking the 1111(b) election. Since the absolute priority rule does not apply in Subchapter V, a secured creditor is not giving up any voting power and in most instances, will recover far more by taking the election versus allowing a substantial cram down.

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A Subchapter V debtor has to demonstrate it can not only make its plan payments, but cover its legal fees and Subchapter V trustee's fees as well. In many cases, Subchapter V proceedings are "thinly" funded and if enough money is not available to pay administrative claims and to meet the best interests test, the plan will fail.

Faculty

James E. Cross is a sole practitioner with Cross Law Firm, P.L.C. in Phoenix. He settled in the Phoenix area in 1980 after honorably serving as a Staff Sergeant in the U.S. Air Force and Ohio Air National Guard. In January 2012, he left his position as chair of the Bankruptcy Department at the Phoenix law firm of Osborn Maledon, PA, and later established Cross Law Firm, PLC. Simultaneously, he founded a business restructuring firm that focuses on troubled loans, receiverships and related non-legal matters. Mr. Cross is admitted to practice in Arizona and Texas, and before the U.S. District Court for the District of Arizona, the Ninth Circuit Court of Appeals and the U.S. Supreme Court. He has been certified as a Specialist in Bankruptcy Law by the Arizona Board of Legal Specialization since 1989. In February 2020, Mr. Cross was appointed by the Office of the U.S. Trustee as a Subchapter V Pool Trustee, the first subchapter V trustee to be appointed in the state of Arizona, and among the first in the nation. He also is in the pool serving the state of New Mexico. Mr. Cross has practiced bankruptcy law at several successful law firms in Phoenix. He has represented debtors, creditors, committees (equity and unsecured), trustees, asset-purchasers and virtually every other party appearing in bankruptcy proceedings. He also has served as a court-appointed examiner, trustee and mediator. Mr. Cross is AV-rated by Martindale Hubbell in the areas of bankruptcy and insolvency practice. His firm has been repeatedly recognized among the "Best Law Firms in America" by *U.S. News and World Report*, and he has been nominated by his peers in *Super Lawyers* magazine for the past several years. For the past 30 years, he has appeared in nearly all of the region's high-profile bankruptcies, including America West Airlines, Circle K Corp., the Phoenix Coyotes Hockey Club, Mortgages, Ltd., Danny's Family Car Wash, Inc. and Bashas', Inc. Mr. Cross received his B.A. *cum laude* in international business from The Ohio State University in 1980 and his J.D. from the Sandra Day O' Connor College of Law at Arizona State University in May 1983.

Justin P. Fasano is a principal at McNamee Hosea in Alexandria, Va., and his primary areas of practice are bankruptcy, business reorganizations, creditor rights and litigation. He represents debtors, trustees, creditors, lessors, secured lenders and vendors in chapter 7 and 13 voluntary and involuntary cases. Mr. Fasano is experienced in various bankruptcy-related litigation, including confirmation of proposed plans, automatic stay actions, preferential and fraudulent conveyance lawsuits and transfer actions, and dischargeability and discharge actions. He also has experience handling lawsuits related to the fiduciary duties of corporate insiders. Mr. Fasano is admitted to practice in Maryland and Virginia. He is a member of the Maryland Bankruptcy Bar Association and Northern Virginia Bankruptcy Bar Association, for which he chairs its Young Lawyers Division. He also is a member of the Walter Chandler Inn of Court and the Bankruptcy Bar Liaison Committee. Mr. Fasano received his B.A. from the College of William and Mary and his J.D. from George Mason University School of Law.

Hon. Mary P. Gorman is a U.S. Bankruptcy Judge for the Central District of Illinois in Springfield, appointed in September 2005 by the Seventh Circuit Court of Appeals. She served as Chief Judge from January 2013 until August 2019. Prior to her appointment to the bench, she was in private practice, concentrating in bankruptcy and commercial transactions and litigation, and she was admitted to practice in the Illinois Supreme Court, the Northern and Central Districts of Illinois, the Seventh Circuit Court of Appeals, the U.S. Tax Court and the U.S. Supreme Court. Judge Gorman is a past

president of the Winnebago County Bar Association and has been active on the Illinois State Bar Association's Task Force on the Unauthorized Practice of Law and the Commercial, Banking, and Bankruptcy Section Council. From 1999-2003, she was an adjunct professor of bankruptcy law at the Northern Illinois University College of Law. Judge Gorman is a member of the National Conference of Bankruptcy Judges, ABI, and the Illinois State, Winnebago County and Sangamon County Bar Associations. She has served on the Administrative Office of the U.S. Courts' Bankruptcy Judges Advisory Group and on the Administrative Office's Budget and Finance Advisory Council. Judge Gorman recently completed seven years of service as one of the five bankruptcy judge representatives on the Judicial Conference Committee on the Administration of the Bankruptcy System. During her service on the Bankruptcy Committee, she served as a liaison to the Judicial Conference Advisory Committee on Bankruptcy Rules and the Judicial Conference Budget Committee's Economic Subcommittee. She also was a member of the task force created by the Bankruptcy Committee to review current policies, rules and regulations regarding unclaimed funds, and she currently serves as a member of the Administrative Office's Judiciary Data Working Group. Judge Gorman received her undergraduate degree with honors from Rosary College (now Dominican University) and also attended the University of Fribourg, Switzerland. She received her J.D. with high honors from the University of Illinois College of Law, where she served as a member of its law review and the Order of the Coif.

Hon. Kesha L. Tanabe is a U.S. Bankruptcy Judge for the District of Minnesota in St. Paul, appointed on Jan. 7, 2022, and the first Asian-American woman on the federal bench in Minnesota. She previously was a bankruptcy attorney with Tanabe Law in Minneapolis and is licensed in North Dakota, Minnesota and New York. Judge Tanabe started her career as an assistant attorney general in New York. Prior to starting her own firm, she was a partner at ASK LLP, Maslon LLP and Faegre Baker Daniels. Additionally, she was a subchapter V trustee in Region 12 and taught bankruptcy law at the University of St. Thomas School of Law. Judge Tanabe is a board-certified business bankruptcy specialist, a former member of the Bankruptcy Practice Committee for the District of Minnesota and a former co-editor in chief of the *MSBA Bankruptcy Bulletin*. She is a frequent lecturer on bankruptcy topics nationwide, and she is a member of several legal and community organizations, including the Japanese American Citizens League, International Women's Insolvency & Restructuring Confederation, Minnesota Asian Pacific American Bar Association and Minnesota Lavender Bar Association. She also served as a Special Projects Leader for ABI's Bankruptcy Litigation Committee. Judge Tanabe is a graduate of the University of St. Thomas and the London School of Economics, and she received her J.D. in 2005 from Cardozo School of Law.