AMERICAN BANKRUPTCY INSTITUTE

2023 Annual Spring Meeting

# Subchapter V Sale Cases


**Richardo I. Kilpatrick, Moderator**
Kilpatrick & Associates, P.C.; Auburn Hills, Mich.

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

**Soneet R. Kapila**
KapilaMukamal, LLP; Fort Lauderdale, Fla.

**Morgan L. Patterson**
Womble Bond Dickinson; Wilmington, Del.

**Brett S. Theisen**
Gibbons P.C.; New York


CONCURRENT SESSION

2023

# ABI Spring Meeting

# Recent Developments in Subchapter V

# Written Materials

# April 21, 2023

**I. Panelists**

a. The Honorable Michelle Harner

b. Brett S. Theisen, Moderator

c. Soneet Kapila

d. Morgan Patterson

**II. Introduction**

a. The Panel will discuss several recent developments which have occurred since the Small Business Reorganization Act of 2019 (SBRA) became effective. Offering a streamlined reorganization process with shortened timeframes, fewer administrative burdens, and lower costs compared to a traditional chapter 11 bankruptcy case, SBRA has become a cost-effective and popular solution for distressed small businesses. The Panelists will explore the growing body of case law and other recent updates on the SBRA.

# III. Topics

## a. *Designation As a Subchapter V Debtor*

i. 11 U.S. Code § 1182: A subchapter V "debtor" is as follows —

1. (A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning single asset real estate) 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 (excluding debts owed to 1 or more affiliates or insiders) not less than 50 percent of which arose from the commercial or business activities of the debtor; and

2. (B) does not include—

a. (i) any 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 (excluding debt owed to 1 or more affiliates or insiders);

b. (ii) any debtor that is a corporation subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)); or

c. (iii) any debtor that is an affiliate of a corporation described in clause (ii).

ii. De-Designation and Revocation of Designation:

1. 11 U.S. Code § 1185: On request of a party in interest, and after notice and a hearing, the court shall order that the debtor shall not be a debtor in possession for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor, either before or after the date of commencement of the case, or for failure to perform the obligations of the debtor under a plan confirmed under this subchapter.

2. Bankruptcy Rule 1009(a): A voluntary petition, list, schedule, or statement may be amended by the debtor as a matter of course at any time before the case is closed.

3. Bankruptcy Rule 1020(b): The United States trustee or a party in interest may file an objection to the debtor's [designation as a small business debtor] 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

4. Recent Developments

a. District of Columbia Bankruptcy Court revoked the designation of the small business debtor after it failed to be able to confirm a plan. *See National Small Business Alliance Inc.*, 642 B.R. 345 (Bankr. D.D.C. 2022).

b. District of Delaware Bankruptcy Court discusses the potential to de-designate a small business debtor. *See In re ComedyMX, LLC*, 647 B.R. 457, 459 (Bankr. D. Del. 2022).

c. The District Court in the Eastern District of New York overruled the Bankruptcy Court's finding that a debtor could "re-designate" itself as a small business debtor 16 months after filing its bankruptcy case due to the extreme prejudice on its creditors due to their prejudicial reliance on the debtor's initial designations. *See Gregory Funding v. Ventura*, 638 B.R. 499 (E.D.N.Y. 2022).

d. Houston Bankruptcy Court finds that later developments do not serve to de-designate a subchapter V debtor. *See In re Free Speech Systems LLC*, 22-60043 (Bankr. S.D. Tex. March 31, 2023).

e. The Ninth Circuit Bankruptcy Appellate Panel recently held that a business need not operate for profit in order to be designated as a subchapter V debtor. *See NetJets Aviation Inc. v. RS Air LLC (In re RS Air LLC)*, 21-1227 (B.A.P. 9th Cir. April 26, 2022).

iii. Removal of Debtor

1. 11 U.S. Code 1182(2): The term "debtor in possession" means the debtor, unless removed as debtor in possession under section 1185(a) of this title.

2. 11 U.S. Code 1183(b):

a. (b) Duties. — The trustee shall— (5) if the debtor ceases to be a debtor in possession—
   i. (A) perform the duties specified in section 704(a)(8) and paragraphs (1), (2), and (6) of section 1106(a) of this title; and
   ii. (B) be authorized to operate the business of the debtor….

3. 11 U.S. Code 1189(a): Who May File a Plan. —

   i. Only the debtor may file a plan under this subchapter.

4. Bankruptcy Court for the District of Mexico removed a debtor when debtor's plan was uncomfirable after several years and consecutive bankruptcy filings. *See In re Young*, No. 20-11844-T11, 2021 WL 1191621, at *6 (Bankr. D.N.M. Mar. 26, 2021).

## b. *Plan Related Issues*

i. Disposable Income:

1. 11 U.S. Code § 1191(c)(2): A subchapter V plan is considered fair and equitable if:

    a. (A) the plan provides that all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date that the first payment is due under the plan will be applied to make payments under the plan; or

    b. (B) the value of the property to be distributed under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date on which the first distribution is due under the plan is not less than the projected disposable income of the debtor.

2. 11 U.S. Code § 1191(d): Disposable income means:

    a. income that is received by the debtor and that is not reasonably necessary to be expended—

        i. (1) for—

            1. (A) the maintenance or support of the debtor or a dependent of the debtor; or

            2. (B) a domestic support obligation that first becomes payable after the date of the filing of the petition; or

        ii. (2) for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor.

3. Recent Developments

    a. Middle District of Florida Judge affirmed the Bankruptcy Court finding that post-confirmation payments could

fluctuate over the course of 5 years if the Debtor's disposable income fluctuated. *See Staples v. Wood-Staples (In re Staples)*, Case No. 22-157 (M.D. Fla. Jan. 6, 2023)

ii. Priority of Payments

1. 11 U.S. Code 1181(a): (a) In General. —
    a. Sections 105(d), 1101(1), 1104, 1105, 1106, 1107, 1108, 1115, 1116, 1121, 1123(a)(8), 1123(c), 1127, 1129(a)(15), 1129(b), 1129(c), 1129(e), and 1141(d)(5) of this title do not apply in a case under this subchapter.

    b. 11 U.S. Code 1129(B): With respect to a class of unsecured claims—
        i. (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
        ii. (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.

iii. Cramdown

1. 11 U.S. Code § 1191(d): (b) Exception.—

    a. . . . the court, on request of the debtor, shall confirm the plan notwithstanding the requirements of such paragraphs if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

2. 11 U.S. Code § 1191(c) (2): (c) Rule of Construction.—

    a. For purposes of this section, the condition that a plan be fair and equitable with respect to each class of claims or interests includes the following requirements:

i. (2) As of the effective date of the plan—

1. (A) the plan provides that all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date that the first payment is due under the plan will be applied to make payments under the plan; or

2. (B) the value of the property to be distributed under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, beginning on the date on which the first distribution is due under the plan is not less than the projected disposable income of the debtor.

3. Recent Developments

a. The Ninth Circuit BAP interpreted subchapter V to provide the bankruptcy courts discretion to determine the appropriate commitment payment for a subchapter V debtor. *See Legal Services Bureau Inc. v. Orange County Bail Bonds Inc. (In re Orange County Bail Bonds Inc.)*, Case No. 212-1086 (B.A.P. April 27, 2022)

iv. Dischargeability

1. 11 U.S. Code § 1141(d)(1)(A)(2): A discharge under this chapter does not discharge a debtor who is an individual from any debt excepted from discharge under section 523 of this title.

2. Recent Developments

a. Fourth Circuit held that small business debtors are subject to dischargeability complaints pursuant to bankruptcy code section 523(a) because their path to confirmation was easier than that of a regular chapter 11 debtor. *See In re Cleary Packaging, LLC,* 36 F. 4th 509, 512 (4th Cir. 2022).

b. Judge Gargotta held that a corporate debtor under subchapter V was not subject to dischargeability complaint pursuant to bankruptcy code 523(a). *See Avion Funding*

*LLC v. GFS Industries LLC (In re GFS Industries LLC)*, Case No. 22-05052 (Bankr. W.D. Tex. Nov. 10, 2022)

v. Timing for Filing

1. 11 U.S. Code § 1189(b): Deadline.—

a. The debtor shall file a plan not later than 90 days after the order for relief under this chapter, except that the court may extend the period if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable.

2. Recent Developments

a. Southern District of New York Bankruptcy Court found that litigation with creditor was justification for additional time to file plan. *See In re HBL SNF, LLC*, 635 B.R. 725, 730 (Bankr. S.D.N.Y. 2022)

## c. *Post-Confirmation*

i. Amendments to Plan

1. 11 U.S. Code § 1193(b): Modification of Plan Following Confirmation.—

a. If a plan has been confirmed under section 1191(a) of this title, the debtor may modify the plan at any time after confirmation of the plan and before substantial consummation of the plan, but may not modify the plan so that the plan as modified fails to meet the requirements of sections 1122 and 1123 of this title, with the exception of subsection (a)(8) of such section 1123. The plan, as modified under this subsection, becomes the plan only if circumstances warrant the modification and the court, after notice and a hearing, confirms the plan as modified under section 1191(a) of this title.

2. 11 U.S. Code § 1101(2): "substantial consummation" means—

a. (A) transfer of all or substantially all of the property proposed by the plan to be transferred; (B) assumption by

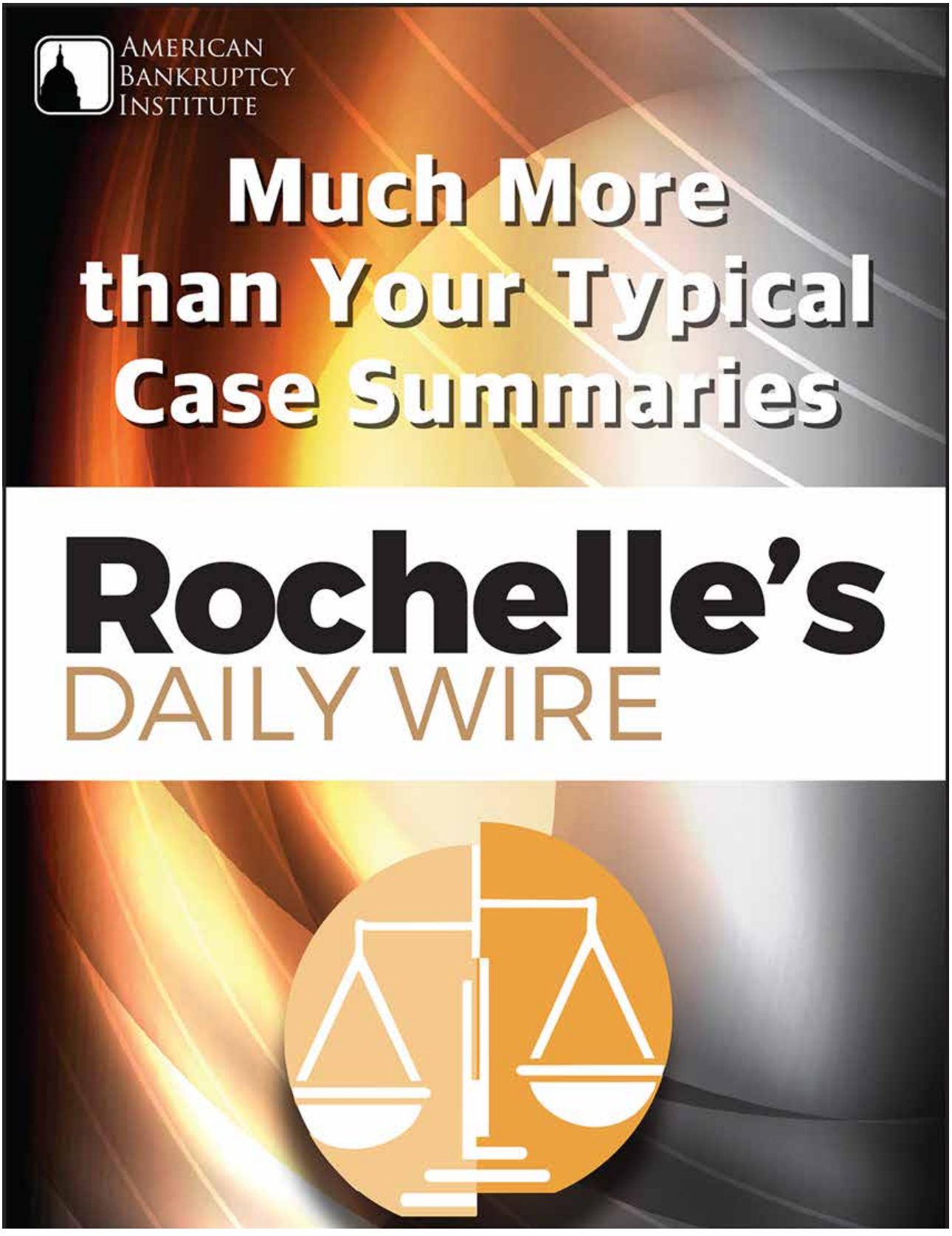
the debtor or by the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and (C) commencement of distribution under the plan.

3. Recent Developments

   a. Northern District of Illinois Bankruptcy Court held Plan could not be amended because distributions had been made and therefore, the process contemplated in the confirmed plan was underway. *See In re National Tractor Parts, Inc.*, 640 B.R. 916 (N.D. Ill. 2022).

# IV. Attachments

a. Attached please find articles with detailed discussion of the above issues.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# Rochelle's **Daily Wire**

**Bill Rochelle**
***Editor-at-Large***

**Bill Rochelle** joined the staff in mid-November 2015 as ABI's Editor-at-Large, and he continues to be a valuable resource and ambassador for ABI. Bill's daily case commentary site launched in January 2016, and he has since analyzed nearly 1,300 opinions by more than 600 judges. Rochelle's Daily Wire is now available to members only, and in 2019 the webpage was given a facelift.

Dovetailing with his daily analyses, Bill caps off each week with a short video highlighting the week's key cases, and he has recorded special video segments on Supreme Court matters. The videos are available on ABI's social media sites. In addition, he has been active in public speaking at both ABI and industry events, such as at the NCBJ and Westbrook UT Seminar. His work is uniformly respected, including by many judges, and was also cited in a petition for *writ of certiorari* in *Lorenzen v. Taggart.*

## Testimonials from the Bench

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**—U.S. Bankruptcy Judge Guy Humphrey (S.D. Ohio)**

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Selections from ABI's "Rochelle's Daily Wire"

# Sub V Plan Can Require Automatic Increases Based on Actual Disposable Income

**A district judge in Florida upheld a Subchapter V plan that required automatic increases in payments to unsecured creditors based on actual disposable income.**

A cramdown plan in Subchapter V can require an individual debtor to calculate disposable income every quarter and to increase payments automatically to unsecured creditors if *actual* disposable income turns out to be more than *projected* disposable income, according to District Judge John E. Steele, who affirmed Bankruptcy Judge Caryl E. Delano of Tampa, Fla.

*Pro se*, the debtor confirmed a plan under Subchapter V of chapter 11 requiring $150 monthly payments to unsecured creditors for five years. The plan provided that the payments to unsecured creditors "shall fluctuate based upon the Debtor's actual disposable income remaining" after payments to senior creditors.

The plan went on to require the debtor to file quarterly operating reports showing actual disposable income. If actual disposable income were more than projected disposable income, the plan required automatically increased payments to unsecured creditors. If actual disposable income were less than $150 per month, the plan still required the debtor to distribute $150 *pro rata* to unsecured creditors.

To no avail, the debtor appealed the confirmation order entered by Bankruptcy Judge Delano, contending that the bankruptcy court had no statutory authority to base plan payments on actual disposable income rather than projected disposable income.

Evidently, the debtor confirmed a so-called cramdown plan because the debtor was required to comply with the "fair and equitable" standard in Section 1191(b). The term "fair and equitable" is defined in Section 1191(c).

"As of the effective date of the plan," Section 1191(c)(2)(A) requires "that all of the projected disposable income of the debtor to be received [within five years of the first plan payment] will be applied to make payments under the plan."

Although "projected disposable income" is not defined, "disposable income" is defined in Section 1191(d) to mean "income that is received by the debtor and that is not reasonably necessary to be expended" for domestic support obligations, for maintenance or support of the debtors and dependents, and "for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor."

"Requiring all the actual disposable income to be reported and distributed does not [violate] these statutory rules of construction," District Judge Steele said in his January 6 opinion. He saw no conflict between the plan and Section 1191(d), because it is "simply" a definition of disposable income.

Judge Steele found authority for the floating payments in the Bankruptcy Code's iteration of the All Writs Act found in Section 105(a). He affirmed the confirmation order because the floating payments "were clearly necessary and appropriate under the facts of this case."

Case citation: Staples v. Wood-Staples (In re Staples), 22-157 (M.D. Fla. Jan. 6, 2023)

*Published February 17, 2023*

Selections from ABI's "Rochelle's Daily Wire"

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

**Although deposed as debtor in possession, the Subchapter V debtor retains the sole power to file a chapter 11 plan.**

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.

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

*Published December 20, 2022*

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

**The Fourth Circuit had recently held that both individuals and corporations in subchapter V of chapter 11 are barred from discharging debts that are nondischargeable under Section 523(a).**

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.

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

*Published November 16, 2022*

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

## Bankruptcy Judge Gunn found the power to revoke a small business designation and proceed under 'traditional' chapter11 in lieu of dismissing or converting to chapter 7.

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.

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

*Published July 7, 2022*

Selections from ABI's "Rochelle's Daily Wire"

# Plan Amendment Barred When Just a Few Claims Had Been Paid After Confirmation

**Substantial consummation under Section 1193(b) was defined by the bankruptcy court to mean commencement of distributions to some but not all creditor classes.**

Even if the distributions made to creditors after confirmation were *de minimis*, and even if all creditor classes have not even begun to receive distributions, a plan under Subchapter V of chapter 11 has been substantially consummated, and the debtor may not amend the plan, according to Bankruptcy Judge David C. Cleary of Chicago.

The corporate debtor filed a petition under Subchapter V of chapter 11 in November 2020 and confirmed a plan in December 2021. The plan had six classes of creditors and equity holders. All voting classes accepted the plan.

The plan put the claim of the Small Business Administration in the class for general unsecured creditors.

After confirmation, the debtor learned that it would be eligible for a new SBA loan if it were to pay the "old" loan in full. So, the debtor proposed an amended plan that would put the SBA in a new class by itself and pay the SBA's "old" claim in full. The amendment would be conditioned on the SBA's agreement to grant the new, favorable loan.

No creditors objected to confirmation of the amended plan, but Judge Cleary refused to approve the amendment in his June 6 opinion.

The case turned on the question of whether the plan had been substantially consummated under Sections 1193(b) and 1101(2). Here was the status in terms of consummation:

Two creditor classes had received no payments at all. The debtor had paid about $850 to one class and $585 to another. The debtor had not made a $50,000 payment to a different class.

If other conditions are met, Section 1193(b) provides that a debtor "may modify the plan at any time after confirmation of the plan and before substantial consummation of the plan."

In turn, "substantial consummation" is defined in Section 1101(2) to mean:

> (A) transfer of all or substantially all of the property proposed by the plan to be transferred;
>
> (B) assumption by the debtor or by the successor to the debtor under the plan of the business or of the management of all or substantially all of the property dealt with by the plan; and

(C) commencement of distribution under the plan.

The debtor conceded that it had assumed management of the business. Perhaps fatally, the debtor also admitted that substantially all of the property had been transferred. The debtor argued that distributions had not commenced, because the payments so far were *de minimis*.

The debtor relied on a North Carolina case that had defined "commencement of distribution" as the beginning of distributions to all or substantially all creditors. *In re Dean Hardwoods, Inc.*, 431 B.R. 387, 392 (Bankr. E.D.N.C. 2010).

Having "no binding authority" from the Seventh Circuit, Judge Cleary said that the "plain language of this Code section does not require commencement of distribution to every creditor, or every class, or even substantially all creditors or classes. It means, simply, that the process contemplated in the confirmed plan is underway. *See In re MF Global Holdings Ltd.*, No. 13 CIV. 3532(AT), 2014 WL 231130, at *3 (S.D.N.Y. Jan. 22, 2014)."

[Note: *MF Global* was a decision defining the requisites for invoking substantial consummation as an element required to dismiss an appeal as equitably moot.)

Judge Cleary went on to say that Congress said "all or substantially all" in other sections of the Bankruptcy Code, but not in Section 1101(2).

Judge Cleary declined to follow *Dean Hardwoods*, saying that its "analysis violates the plain meaning canon; it reads into § 1101(2)(C) a condition that does not exist." He said that the "*Dean Hardwoods* decision is in the minority."

Judge Cleary denied the motion to modify, saying that "*Dean Hardwoods* is not binding on this court and its reasoning cannot be reconciled with the plain and unambiguous language of section 1101(2) of the Bankruptcy Code."

## Observations

Distributions under confirmed plans often continue for years. If "substantial consummation" meant the completion of all or substantially all distributions, then substantial consummation often would not occur until years after confirmation in many chapter 11 cases.

For substantial consummation to occur closer to confirmation, perhaps "commencement of distribution" should mean the commencement of distributions to all or most classes, but not distributions to just a handful of the creditor body.

Case citation: In re National Tractor Parts Inc., 20-20833 (Bankr. N.D. Ill. June 6, 2022)

*Published June 16, 2022*

Selections from ABI's "Rochelle's Daily Wire"

# Sub V Has a Flexible Commitment Period in Cramdown, Ninth Circuit BAP Says

**Unlike chapters 12 and 13, the bankruptcy court in Subchapter V has discretion in selecting the commitment period for confirmation of a cramdown plan.**

The statutory standards for confirming a cramdown plan under Subchapter V of chapter 11 are imprecise, if not downright vague. The Bankruptcy Appellate Panel for the Ninth Circuit has written an opinion "to explain the unique role" played by the bankruptcy court "to set the commitment period in which the debtor must pay its projected disposable income or its value."

The debtor was a bail bond company that had been foundering in chapter 11 before the advent of Subchapter V in March 2020. To gain a new lease on life and avert dismissal, the debtor amended the petition to elect treatment under Subchapter V.

### The Sub V Plan

Continuing to operate and hoping to remain in business indefinitely, the debtor sold a parcel of real property that the debtor had foreclosed after a criminal defendant skipped bail. The sale generated net proceeds of some $433,000.

In the three years after confirmation, the debtor estimated its net disposable income would be about $287,000. If it were a five-year period, the estimated net disposable income would be almost $500,000, the debtor said.

Most of the debt was held by one creditor, who had been persistently imploring Bankruptcy Judge Erithe A. Smith to dismiss the case.

With guidance from the Subchapter V trustee, the debtor proposed a plan that would pay the principal creditor $433,000 on confirmation. In addition, the plan committed the debtor to pay all of its disposable income to the principal creditor, whatever it might turn out to be.

The plan did not promise to pay a specific amount of net disposable income. For the debtor to obtain a discharge, the plan did oblige the debtor to pay the principal creditor at least an additional $181,000 above the payment on confirmation.

Creditors did not approve the plan, so the debtor was obliged to invoke cramdown. Naturally, the principal creditor opposed confirmation. Using cramdown, Judge Smith confirmed the plan nonetheless.

In his April 27 opinion for the BAP, Bankruptcy Judge Scott H. Gan upheld confirmation.

## Flexible Rules on the Commitment Period

The appeal from the confirmation order called on the BAP to determine whether the cramdown plan satisfied the so-called fair and equitable test under Section 1191(b). The subsection requires the court to confirm the plan "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."

Section 1191(c)(2) contains a unique definition of "fair and equitable" for the purposes of Subchapter V. Subsection (c)(2)(A) requires the plan to provide that:

> all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, . . . will be applied to make payments under the plan.

The plan did not comply with subsection (c)(2)(A), Judge Gan said, because it only promised a "possible payment of an unknown amount from Debtor's actual disposable income."

The plan was not doomed, however, because Section 1191(c)(2) permits a debtor to satisfy either subsection (c)(2)(A) or (c)(2)(B). Subsection (c)(2)(B) permits confirmation if:

> the value of the property to be distributed under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, . . . is not less than the projected disposable income of the debtor.

For Judge Gan, "the record is clear" that the plan satisfied subsection (c)(2)(B) "because the effective date payment [of $433,000] is greater than Debtor's projected disposable income for the minimum three-year period required by § 1191(c)(2)."

Judge Gan said that Subchapter V "sets a baseline requirement that a debtor commit three years of projected disposable income, while it also affords the bankruptcy court discretion to require more as a condition of finding a plan fair and equitable."

The ability of the court to set a longer commitment period "is unique to subchapter V," Judge Gan said. The commitment periods are fixed in chapters 13 and 12, he said.

"By giving the bankruptcy court the sole authority to require a longer commitment period in appropriate cases, subchapter V ensures an efficient confirmation process for small business debtors," Judge Gan said.

To satisfy the minimum requirement of subsection (c)(2)(B), Judge Gan said that the plan must provide for payments in three years after confirmation "having a present value of not less than [the debtor's estimate of some $287,000]."

Judge Gan held that the bankruptcy court did not err in finding the plan to be fair and equitable and in satisfaction of Section 1191(c)(2)(B) because "the Plan provides for distribution of the [sale proceeds] on the effective date in the amount of [about $433,000]."

Although the plan satisfied cramdown confirmation requirements with the initial payment of $433,000, Judge Gan noted that the debtor will not receive a discharge unless the later payments of disposable income end up totaling at least $181,000.

If the debtors' "projections are as fanciful" as the objecting creditor argued, Judge Gan said that the debtor "may not receive a discharge," even though it complied with confirmation requirements.

The BAP upheld the bankruptcy court's other findings on issues such as good faith and affirmed the bankruptcy court's confirmation of the plan.

Case citation: Legal Services Bureau Inc. v. Orange County Bail Bonds Inc. (In re Orange County Bail Bonds Inc.), 212-1086 (B.A.P. April 27, 2022)

*Published May 13, 2022*

# A Business Not Designed to Turn a Profit Is Eligible for Subchapter V, BAP Says

**The Ninth Circuit BAP holds that litigating with the largest creditor and maintaining the corporation in good standing is sufficient to show that the debtor 'is engaged' in business on the filing date.**

Having a "profit motive" is not a requisite for eligibility to reorganize under Subchapter V of chapter 11, according to the Ninth Circuit Bankruptcy Appellate Panel. Likewise, eligibility does not depend on conducting historical operations on the filing date.

The April 26 opinion for the BAP by Bankruptcy Judge Julia W. Brand also held that the debtor bears the burden of proof in establishing eligibility for Subchapter V.

## The Non-Profitable Business

The debtor leased fractional interests in private jet aircraft from a company in the business of leasing fractional interests. The relationship had been successful for more than 15 years when disputes arose.

As a consequence of the disputes, the lessor did not allow the debtor to use any jets beginning sometime in 2017. Eventually, the lessor filed suit in a state court for breach of contract. The debtor counterclaimed for breach of contract and fraud.

On the eve of trial, the debtor filed a chapter 11 petition and elected treatment as a small business debtor under Subchapter V. The lessor held 98% of the debtor's non-insider debt.

The lessor objected to the debtor's eligibility to proceed under Subchapter V because it was not engaged in business, had not been since 2017, and never had any intention of generating a profit. The debtor countered by saying that the business was designed to throw off tax deductions for the owner.

The bankruptcy judge overruled the objection and later confirmed the debtor's plan, after overruling the same eligibility objection a second time.

The lessor appealed to the BAP from both the confirmation order and the order overruling the eligibility objection.

## Profit Motive

The outcome of the appeal was governed by the BAP's interpretation of the eligibility rules contained in Section 1182(1)(A). As long as the debtor does not own single asset real estate, has not more debt than the statute allows, and is not a reporting company, the section says that a debtor may 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 . . . [of] not more than [$7,500,000] . . . not less than 50 percent of which arose from the commercial or business activities of the debtor.

Judge Brand said that the "only question here is whether [the debtor] was 'engaged in commercial or business activities' within the meaning of § 1182(1)(A)."

Although "the case law is sparse," Judge Brand said that a "majority of courts have held that a debtor need not be 'actively operating' on the petition date, but must be 'presently' engaged in commercial or business activities on the petition date to satisfy § 1182(1)(A)."

Although the term "engage in" is not "retrospective," Judge Brand said that "a debtor need not be maintaining its core or historical operations on the petition date, but it must be 'presently' engaged in some type of commercial or business activities to satisfy § 1182(1)(A)."

When the debtor "is no longer operational," Judge Brand turned to the question of what activities satisfy the statutory requirement. She said that courts generally hold "that the scope of commercial or business activities is very broad."

The lessor argued that the debtor never turned a profit and never intended to turn a profit. The debtor responded by saying that the debtor's business plan was designed to generate tax depreciation on the aircraft that would flow through to the debtor's owner.

Judge Brand said that the "few courts that have addressed [the issue] have held that § 1182(1)(A) does not require a debtor to be engaged in for-profit business to qualify for subchapter V." Among the authorities, she cited the case of a nonprofit homeowners' association that was held eligible for Subchapter V on appeal in district court.

Judge Brand noted that Congress did not exclude nonprofit entities from Subchapter V. It "makes sense," she said, because nonprofit organizations are permitted to file in chapters 11 and 7. She also noted that Congress had only excluded single-asset real estate owners and reporting companies and their affiliates.

Judge Brand held that "no profit motive is required for a debtor to qualify for subchapter V relief." She added, "To hold otherwise would wrongfully exclude nonprofits and other persons that lack such a motive. That [the debtor] had no profit motive did not render it ineligible for subchapter V."

## What Are Sufficient Business Activities?

Having concluded that the debtor was not categorically barred from Subchapter V, Judge Brand turned to whether the debtor had the requisite "commercial or business activities" on the filing date.

The bankruptcy court had found that the debtor was sufficiently engaged in business by litigating with the lessor, paying aircraft registry fees, remaining in good standing as a Delaware corporation, filing tax returns and paying taxes.

Judge Brand held that "the activities identified by the bankruptcy court are 'commercial or business activities' within the meaning of § 1182(1)(A)" and that the debtor "was 'engaged in' these activities on the petition date."

## Burden of Proof

The bankruptcy court believed that the lessor had the burden of proof to show that the debtor was ineligible for Subchapter V. Judge Brand disagreed, but the error was harmless.

The Bankruptcy Code and Rules are silent on the burden of proof regarding Subchapter V eligibility, and neither the circuit nor the BAP had answered the question. On the other hand, debtors have the burden of proof regarding eligibility in chapters 12 and 9.

"Nearly every court" that has confronted the issue has put the burden on the debtor in Subchapter V, Judge Brand said, "especially considering the many advantages subchapter V offers debtors over a 'traditional' chapter 11."

The error was harmless because the debtor had nonetheless elicited sufficient facts to shoulder the burden. The BAP therefore affirmed both the confirmation order and the order upholding the debtor's eligibility for Subchapter V.

Case citation: NetJets Aviation Inc. v. RS Air LLC (In re RS Air LLC), 21-1227 (B.A.P. 9th Cir. April 26, 2022)

*Published May 3, 2022*

# District Judge Barred Redesignation to SBRA in a Case Pending 16 Months

## Redesignation under the SBRA might become a hot topic once again when (if) Congress raises the cap back to $7.5 million.

In a chapter 11 case that had been pending for 16 months before the Small Business Reorganization Act was enacted, District Judge William F. Kuntz, II reversed the bankruptcy court's order allowing the debtor to proceed under the Small Business Reorganization Act given "substantial prejudice" to the secured lender.

### The 'Ordinary' 11 Was Facing Defeat

The debtor owned an historic mansion that she had converted to bed-and-breakfast lodging. As the local law required, she lived in the facility as her principal residence.

In a previous bankruptcy, the debtor had shed personal liability on the mortgage of some $1.7 million. The property was worth about $1 million when she filed an "ordinary" chapter 11 petition to forestall foreclosure long before the SBRA became law.

The debtor had lost "exclusivity," and the bankruptcy judge had ruled that she was prohibited from modifying the mortgage under Section 1123(a)(5). The debtor's plan was not confirmable, but the lender had filed a plan proposing to sell the property. The lender had obtained the requisite votes for its plan, which was scheduled for confirmation a few days after the SBRA came into effect.

The bankruptcy judge postponed the confirmation hearing to allow the debtor to amend her petition to elect treatment as a small business debtor.

The bankruptcy judge overruled the lender's objection to redesignation and allowed the case to proceed under the SBRA. *In re Ventura,* 615 B.R. 1 (Bankr. E.D.N.Y. 2020). To read ABI's report on the bankruptcy court's opinion in *Ventura*, click here.

Now under Subchapter V, the lender no longer had the right to file a plan, and the debtor had the right potentially to modify the lender's mortgage. *See* Sections 1189(a) and 1190(3).

In short, the SBRA turned the debtor's imminent defeat into possible success. The lender appealed and won in an April 21 opinion by Judge Kuntz, sitting in Brooklyn, N.Y., the Eastern District of New York.

## 'Substantial Prejudice' Barred Redesignation

Judge Kuntz said that the outcome turned on whether the debtor had the right under Bankruptcy Rule 1009(a) to redesignate the case for treatment under the SBRA. The rule says that a debtor "may" amend a "voluntary petition, list, schedule, or statement . . . at any time before the case is closed."

Limiting the seemingly broad language in the rule, Judge Kuntz cited a nonprecedential opinion where the Second Circuit said that an amendment under Rule 1009(a) cannot be permitted "without regard to prejudicial reliance." *Cash v. Thaler*, 319 Fed. App'x 4, 5 (2d Cir. 2009).

Judge Kuntz also cited a bankruptcy court decision from his district saying that the bankruptcy court has discretion to reject an amendment that was filed in bad faith or was fraudulent or prejudicial to creditors. He cited a Colorado bankruptcy court for saying that a pre-SBRA debtor may amend the petition to proceed under Subchapter V if the prejudice to the objecting party does not override the debtor's right to amend.

Still, the test is not whether the creditor will recover less or be adversely affected by the amendment. Rather, Judge Kuntz quoted the First Circuit Bankruptcy Appellate Panel for saying that the test is whether the creditor detrimentally relied on the debtor's initial position.

Judge Kuntz said that the bankruptcy court "failed to consider properly the substantial prejudice [the lender] faces due to the Debtor's belated amendment." Over the debtor's 16 months in chapter 11, he said that "both the parties and the Bankruptcy Court spent considerable time and resources to get to a point in which [the lender] was posed to confirm its plan."

With the lender's plan on the "cusp" of confirmation, Judge Kuntz said that "the Debtor's amendment had the further prejudicial effect of terminating [the lender's] right to pass *any* plan, thereby 'completely chang[ing] the rights of [the lender] as a creditor' and resetting the 'litigation posture' of the proceedings."

Reversing the bankruptcy court, Judge Kuntz said that the prejudice to the debtor did not outweigh the prejudice to the lender because the debtor would remain in chapter 11.

## Observation

By its inaction, Congress allowed the debt limit for the SBRA to return to $2.725 million on March 27. If the House follows the Senate and raises the cap once again to $7.5 million, redesignation may become a live issue for cases filed after March 27.

The Senate bill has language that would seem to allow redesignation for cases filed after March 27. However, the ability to redesignate does not necessarily mean that a court is precluded from exercising equitable powers in the manner demonstrated by Judge Kuntz.

Our readers may wish to consider whether all courts would side with Judge Kuntz.

Keep two facts in mind: (1) The debtor could not be faulted for the delay in redesignation under Subchapter V; and (2) Congress typically says so in a bankruptcy statute if the amendment is to be applicable only to cases filed after the effective date.

Case citation: Gregory Funding v. Ventura, 20-1949 (E.D.N.Y. April 21, 2022)

*Published April 28, 2022*

# Ordinary Excuses Won't Justify Plan-Filing Delays in Subchapter V

## A fight between creditors justifies granting a Subchapter V debtor more time to file a plan, Judge Lane says.

A Subchapter V debtor was entitled to more time for filing a plan when the delay was occasioned by a fight between the landlord and the lender, for reasons explained by Bankruptcy Judge Sean H. Lane of New York.

Permitting the lender and the landlord to litigate in state court, Judge Lane modified the automatic stay because the lender stipulated that the outcome would not impair the debtor's rights.

The debtor operated a 160-bed nursing home that opened in 2019. To build the facility, the debtor's landlord arranged financing from a lender that claimed to have an assignment of rents as additional security.

Before bankruptcy, the landlord sued the debtor, contending that the lease was terminated. The debtor removed the suit to bankruptcy court after filing a petition for reorganization under Subchapter V of chapter 11.

Also before bankruptcy, the lender initiated foreclosure against the landlord in state court, alleging that the landlord had defaulted. The foreclosure was dismissed in view of the state foreclosure moratorium.

In bankruptcy, both the landlord and the lender were claiming the right to receive rent payments from the debtor. In connection with approval of final DIP financing, Judge Lane concluded that the landlord was entitled to rent because the lender had not perfected the assignment of rent.

### The Plan Extension Motion

The debtor filed a motion for more time to file a plan. Aiming to foreclose the landlord, the lender filed a companion motion to modify the automatic stay. Judge Lane decided both motions in his February 1 opinion.

Subchapter V puts the debtor on a short leash under Section 1189(b) by requiring the debtor to file a plan within 90 days of filing. The statute goes on to say that the "court may extend the period if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable."

Judge Lane said that Section 1189(b) creates a "stringent and a higher standard than the 'for cause' standard in Section 1121(d)(1) that governs extensions of time to file a plan in a traditional Chapter 11 case." He said that the heavier burden on the debtor is designed to "move a case forward expeditiously."

Judge Lane said that "generalized excuses" that suffice in ordinary chapter 11 cases will not work in Subchapter V. The debtor, however, had a good and sufficient excuse.

The treatment of the landlord would be the key element of the plan, especially because the lease gave the debtor a purchase option. Having been removed to bankruptcy court, the lawsuit between the landlord and the debtor was operating under a truncated schedule laid down by Judge Lane. The outcome would decide whether the lease had terminated before bankruptcy and whether the debtor retained a purchase option.

Judge Lane said that "it is hard to see how the Debtor could be blamed for unduly delaying adjudication of the lease issue," given that the judge himself had set the schedule for the litigation. He said that "it does not appear practical, fair, or wise to require the Debtor to file a plan when the central issue of the lease remains unresolved."

Without prejudice to further applications, Judge Lane gave the debtor a 60-day extension of the plan-filing deadline, by which time he would have heard summary judgment motions on the lease issues.

## The Automatic Stay

Aiming to foreclose the landlord in state court, the lender wanted Judge Lane to modify the automatic stay or declare that it did not apply to a dispute between two nondebtors. The landlord opposed stay modification.

A difficult decision was made easier with two stipulations by the lender.

The lender agreed that the debtor would not be a party in the foreclosure action. The lender also agreed that the debtor's purchase option would "remain intact."

Judge Lane concluded that the lender had satisfied the standards for stay modification. Prominently, the foreclosure action would not impinge on the debtor's rights, and the foreclosure action would be "the most expeditious and economical way to resolve the dispute between these two non-debtors."

Case citation: In re HBL SNF LLC, 21-22623 (Bankr. S.D.N.Y. Feb. 1, 2022)

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ABI EXCLUSIVE

APRIL 7, 2023

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

Listen to Article 0:00 / 6:31

> In the Alex Jones corporate Subchapter V case, Bankruptcy Judge Christopher Lopez said that the later chapter 11 filing by Jones himself, with about $1.5 billion in debt, didn't kick the corporate debtor out of Subchapter V and into 'ordinary' chapter 11.

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.

## Opinion Link

**PREVIEW**

# Faculty

**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.

**Soneet R. Kapila, CPA, CFF, CFE, CIRA** is a founding partner of KapilaMukamal, LLP in Fort Lauderdale, Fla., and ABI's President-Elect. For more than 25 years, he has concentrated his efforts in the areas of consulting in insolvency, fiduciary and creditors' rights matters. Mr. Kapila is a federal bankruptcy trustee and serves as an examiner, CRO, chapter 7 and 11 trustee, subchapter V trustee, liquidating trustee, corporate monitor (SEC appointments), and as a state and federal court-appointed receiver. He has been appointed in numerous matters in the Southern and Middle Districts of Florida. As a trustee plaintiff, Mr. Kapila has managed complex litigation in significant cases. He advises and represents debtors, secured creditors and creditors' committees in formulating, analyzing and negotiating plans of reorganization. As a recognized expert in fraudulent conveyance, Ponzi schemes and insolvency issues, Mr. Kapila has provided expert testimony and litigation-support services to law firms involving complex insolvency issues and commercial damages. He has worked in conjunction with the SEC, FBI and U.S. Attorney's Office, and he has served both as a consultant and expert witness for litigation matters in state and federal courts. Mr. Kapila has spoken to various groups, including ABI, New York Law School, St. Thomas University Law School, and the National Conference of Bankruptcy Judges, Southeastern Bankruptcy Law Institute, National Association of Bankruptcy Trustees (NABT), Receiver's Forum, Association of Insolvency and Restructuring Advisors, Florida Institute of Certified Public Accountants, Turnaround Management Association, University of Miami School of Law, Florida International University School of Law, American Bar Association and the

National Business Institute on topics related to insolvency, underperforming businesses and insolvency taxation. He is a Fellow of the American College of Bankruptcy and a past-president and past-chairman of the Association of Insolvency & Restructuring Advisors, for which he serves on its board of directors. Mr. Kapila has served on the advisory boards of ABI's Southeast Bankruptcy Workshop and Caribbean Insolvency Symposium. He also co-authored ABI's *Fraud and Forensics: Piercing Through the Deception in a Commercial Fraud Case* (2015). Mr. Kapila received his M.B.A. in 1978 from Cranfield School of Management.

**Richardo I. Kilpatrick** is the managing partner of Kilpatrick & Associates, PC in Auburn Hills, Mich., and specializes in creditors' rights and insolvency law while focusing on corporate, consumer and commercial litigation and bankruptcy, real property remedies for creditors, real property transactions and general corporate counseling. He is a past president of the ABI and has served on the board of directors for the American College of Bankruptcy. Mr. Kilpatrick has concentrated his practice in the area of bankruptcy for over 30 years, first as a member of Shermeta, Chimko & Kilpatrick, P.C. and, since 2000, as the founding member and president of Kilpatrick & Associates, P.C. Since founding his firm, Mr. Kilpatrick is a Fellow of the American College of Bankruptcy (ACB) and was invited to join the National Bankruptcy Conference (NBC), where he advises members of Congress on important and key bankruptcy legislative points. He also is a member of the Advisory Committee on Bankruptcy Rules, where he works to directly craft, tweak, update and change bankruptcy rules in an ongoing effort to improve the practice of bankruptcy for all involved. Mr. Kilpatrick's involvement with the bankruptcy community has enabled him to provide expert guidance to numerous clients in all areas and types of insolvency matters and creditors' rights, including corporate, consumer and commercial litigation, real property remedies for creditors, real property transactions and general corporate counseling. He also works as a consultant to numerous companies to ensure that they are compliant in their bankruptcy practices by offering his insight and expertise on how they may structure and strengthen their bankruptcy practices in a sound, ethical and legal way. Mr. Kilpatrick received his B.A. in economics in 1973 from Harvard University and his J.D. in 1982 from the University of Michigan Law School.

**Morgan L. Patterson** is a partner with Womble Bond Dickinson in Wilmington, Del., where her practice focuses on corporate bankruptcy and creditors' rights in complex chapter 11 proceedings. She has broad experience representing debtors, creditors' committees, lenders, bondholders, secured and unsecured creditors, liquidation trustees, landlords, asset-purchasers, and other interested entities in various bankruptcy reorganization and liquidation proceedings. Ms. Patterson's bankruptcy work includes all matters of litigation and transactions, including involuntary petitions, avoidance actions, relief-from-stay proceedings, trustee motions, sale and purchase of assets, executory contracts and lease issues, post-petition financing, disclosure statements, plan confirmation, and representing liquidating trustees and plan administrators in the winding down of estates. She also has expertise with cross-border insolvency proceedings, specifically with respect to the consummation of large cross-border asset sales. Ms. Patterson is Membership chair for the International Women's Insolvency & Restructuring Confederation's Delaware Chapter and is a member of the Federal Bar Association, ABI, the Delaware Bankruptcy Inn of Court and the Delaware State Bar Association. She has been listed in *Chambers USA* as a Ranked Lawyer for Bankruptcy/Restructuring in Delaware since 2022 and was listed as a "Delaware Rising Star" in Bankruptcy by *Super Lawyers* from 2018-19. Ms. Patterson received her B.A. *magna cum laude* in 2005 from Temple University and her J.D. *magna*

*cum laude* in 2009 from Widener University School of Law, where she was Bluebook editor of the *Delaware Journal of Corporate Law*.

**Brett S. Theisen** is vice chair of Gibbons P.C.'s Financial Restructuring & Creditors' Rights Group in New York. He has experience in all aspects of debtor/creditor relations, with a particular focus on complex corporate reorganizations and liquidations, and bankruptcy and insolvency-related litigation and appeals, including trial experience. Mr. Theisen's clients include debtors-in-possession, trustees and other fiduciaries, official committees of unsecured creditors, secured creditors and lenders, indenture trustees, insurers, asset-purchasers, landlords and trade creditors. His litigation experience covers a broad range of matters in federal and state courts, including Ponzi scheme litigation, complex fraudulent transfer and preference actions, alter-ego/veil-piercing litigation, shareholder disputes such as fraud, negligence, breach of fiduciary duty and related claims, and general commercial and contract disputes. Prior to practicing law, Mr. Theisen was an analyst in the equities-trading division at a leading international investment bank. He also worked for a Manhattan-based national sports agency, where he assisted in recruiting new clients, conducting due diligence in connection with contract negotiations, and securing endorsement and marketing opportunities for existing clients. Mr. Theisen is listed in *Chambers USA Guide to America's Leading Lawyers* for Business and Bankruptcy/Restructuring, and selected to the both the *New Jersey Super Lawyers* and the *New York Super Lawyers* Rising Stars lists for Creditor/Debtor Rights, and he is a 2021 ABI "40 Under 40" honoree. He also received the Turnaround Awards "Restructuring of the Year" by The M&A Advisor in 2020. Mr. Theisen received his A.B. from Dartmouth College and his J.D. *magna cum laude* from Seton Hall University School of Law.