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The USTP's Positions on Select SBRA Legal Issues



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On Feb. 19, 2020, the Small Business Reorganization Act (SBRA)¹ became effective and dramatically changed the way most chapter 11 small business debtors reorganize. The SBRA has resulted in a more efficient and cost-effective process for distressed small business owners and creditors alike² that, by all current measures, works as Congress intended.³

Consistent with its mission to promote the integrity and efficiency of the bankruptcy system, the U.S. Trustee Program (USTP) plays an important and active role in the administration of subchapter V cases.⁴ U.S. Trustees not only select and supervise subchapter V trustees,⁵ they also enforce bankruptcy laws and ensure that those involved in the subchapter V process, including debtors, creditors, attorneys and other professionals, fulfill their legal obligations.

This article highlights several significant legal issues that have arisen since the SBRA became effective, and details the USTP's interpretative and enforcement efforts. In particular, subchapter V confers significant benefits on the debtor, including eliminating a creditors' committee unless the court directs the appointment for cause, and allowing the owners of the business to retain their interests and confirm a plan without paying a dissenting class of creditors in full. Thus, the USTP works to preserve the integrity of the bankruptcy process and prevent abuse by ensuring that debtors who elect subchapter V satisfy the statutory requirements for eligibil-

ity. The USTP also provides guidance to subchapter V trustees, including on the timing of termination after confirmation and on the ability to receive retainer payments.

Subchapter V Debtor-Eligibility Requirements

To be eligible to proceed under the SBRA, a debtor must be a person⁶ (1) engaged in commercial or business activities; (2) whose primary activity is not the business of owning single-asset real estate (SARE); (3) with aggregate noncontingent, liquidated secured and unsecured debts at filing not exceeding the debt limit of \$7.5 million⁷ (excluding debts owed to one or more affiliates or insiders); and (4) having debts, of which 50 percent or more arise from commercial or business activities.⁸ In addition, such a debtor *does not* include the following: (1) any member of a group of affiliated debtors that has aggregate noncontingent, liquidated secured and unsecured debts that do not exceed the debt limit of \$7.5 million (excluding debts owed to one or more affiliates or insiders); (2) any debtor that is a publicly traded corporation; or (3) any debtor that is an affiliate of a publicly traded corporation.⁹

Although new to subchapter V, some of these statutory requirements utilize definitions long seen elsewhere. For example, the exclusion for holders of SARE means that the existing body of law on SARE debtors directly informs subchapter V eligibility determinations. Therefore, the USTP has objected

1 Pub. L. No. 116-54, 133 Stat. 1079 (codified in 11 U.S.C. §§ 1181-1195 and scattered sections of 11 U.S.C. and 28 U.S.C.).

2 These SBRA cases will be referred to as subchapter V cases in the body of this article.

3 The USTP's data reflects that through June 30, 2022, nearly 4,000 debtors have elected subchapter V, and these cases have been confirmed at twice the rate and dismissed at half the rate of other small business cases. In addition, the median time to confirmation has been four months faster for subchapter V cases than for other small business cases, and approximately 70 percent of confirmed plans in these subchapter V cases have been consensual.

4 Chapters 1-4, *United States Trustee Program Legal Manual*.

5 11 U.S.C. § 1183(a) and 28 U.S.C. § 586.

6 The term "person" generally includes individuals, partnerships and corporations. 11 U.S.C. § 101(41).

7 Under the Bankruptcy Threshold Adjustment and Technical Corrections Act, Pub. L. No. 117-151, 136 Stat. 1298, the debt limit was raised to \$7.5 million through June 20, 2024, after which the debt limit will revert to the amount previously applicable under 11 U.S.C. § 101(51D), which is approximately \$2.7 million.

8 11 U.S.C. § 1182(1)(A).

9 11 U.S.C. § 1182(1)(B).

to improper subchapter V designations from SARE debtors when necessary to uphold the eligibility limitations imposed by Congress.¹⁰

“Engaged in Commercial or Business Activities” as a Present Requirement

In enacting the SBRA, Congress specifically intended to support “[s]mall businesses — typically family-owned businesses, startups, and other entrepreneurial ventures [that] form the backbone of the American economy.”¹¹ Congress designed the SBRA to allow debtors “to remain in business, which not only benefits the owners, but employees, suppliers, customers, and others who rely on that business.”¹² Consequently, the law expressly requires that a subchapter V debtor be “engaged in commercial or business activities.”

Consistent with the plain meaning and well-worn interpretations of similar language in other statutes, the USTP’s position is that eligibility requires present commercial or business activities. In other words, the mere fact that a debtor once engaged in such business before the petition date does not itself satisfy the law’s eligibility requirements. The USTP litigates to uphold this standard by objecting to and moving to strike improper subchapter V designations when necessary.¹³

Most courts have adopted the USTP’s balanced interpretation and have held that a debtor must be presently engaged in commercial or business activities at filing to proceed under subchapter V.¹⁴ In the first prominent decision addressing the issue,¹⁵ the bankruptcy court agreed with the USTP and expressly departed from earlier contrary decisions.¹⁶ There, the court held that debtors who sold a business and had no intention to return to it were ineligible. Unlike the earlier decisions, the court confronted the fact that several existing Bankruptcy Code provisions (such as 11 U.S.C. § 101(19A)’s definition of “family fisherman”) and numerous other federal statutes use similar “engaged in” language, which courts have consistently interpreted to require current and active involvement under a plain-meaning analysis.¹⁷ Any other interpretation “renders the phrase ‘engaged in commercial or business activities’ superfluous” because 11 U.S.C. § 1182(1)(A) separately specifies that the relevant debts arise from commercial or business activities.¹⁸ Fortunately for the debtors, the finding of ineligibility did not preclude reorganization under chapter 11’s non-subchapter V provisions.¹⁹

Even as a present requirement, courts have also confronted difficult factual questions in determining whether a debtor is engaged in commercial or business activities. While some have concluded that the presence of wind-down activities may alone suffice,²⁰ the USTP rejects the notion that any eco-

omic activity equates to engagement in commercial or business activities. For example, the USTP successfully moved to strike the subchapter V designation of an individual debtor who was working as a full-time employee for a business she did not own following the shuttering of several prior business enterprises that she had no intention of reactivating.²¹ In agreeing with the USTP, the court rejected contrary *dicta* and stated that it “does not believe that in common language an individual who has a job as an employee for someone else would be understood as thereby engaging in a commercial or business activity.”²² The court rightly observed that any broader reading of the phrase “threatens to virtually drain it of any meaning.”²³

These examples provide a mere sampling of the eligibility disputes that have arisen since the SBRA’s enactment. Other debtors have sometimes taken aggressive and untested positions on other eligibility requirements, such as companies who enter subchapter V with ties to larger corporate conglomerates and large debts owed to affiliates. The USTP will continue meeting its watchdog role in the bankruptcy system by reviewing the facts in each case and taking a balanced approach to ensure that subchapter V remains open for the small businesses that Congress intended to support.

Termination of Subchapter V Trustees After Confirmation

The USTP adheres to the Code’s clear rules in determining when a subchapter V trustee is terminated in a case. The timing generally turns on whether the court confirmed a consensual plan under § 1191(a) or a nonconsensual plan under § 1191(b). The trustee’s services terminate upon the substantial consummation of a consensual plan.²⁴

By contrast, the Code requires that the trustee remain in place for the life of every nonconsensual plan.²⁵ This is true even when a nonconsensual plan’s terms or confirmation order relieves the trustee from the obligation to make plan payments.²⁶ In those cases, trustees must ensure that debtors commence making timely plan payments²⁷ and be heard on any efforts to modify the plan after confirmation.²⁸ These trustees also must remain in service in the event that a debtor fails to perform on its plan obligations and is removed from possession as provided by statute.²⁹ By only providing for a trustee’s reappointment in cases with consensual plans,³⁰ Congress presumed that the Code already dictated that trustees remain in service in all other cases. For all of these reasons, the USTP insists that subchapter V trustees remain in place until the completion of every nonconsensual plan.

Retainers for Subchapter V Trustees

The USTP has separately worked to develop consistent and predictable guidance to subchapter V trustees so that

10 See, e.g., *In re Manhattan Student Housing*, No. 22-20010-11 (Bankr. D. Kan. filed Jan. 10, 2022).

11 H.R. Rep. No. 116-171, at 1 (2019).

12 *Id.* at 4 (internal quotations omitted).

13 See *infra*.

14 *In re RS Air LLC*, 638 B.R. 403, 409 (B.A.P. 9th Cir. 2022).

15 *In re Thurmon*, 625 B.R. 417 (Bankr. W.D. Mo. 2020) (retired owners of closed pharmacies were not “engaged” in business at filing and therefore were not eligible to be subchapter V debtors).

16 *In re Wright*, 2020 WL 2193240 (Bankr. D.S.C. 2020); *In re Bonert*, 619 B.R. 248 (Bankr. C.D. Cal. 2020); *In re Blanchard*, 2020 WL 4032411 (Bankr. E.D. La. 2020).

17 *Thurmon*, 625 B.R. at 421-23.

18 *Id.* at 423.

19 *Id.* at 424-25.

20 See, e.g., *In re Ikalowych*, 629 B.R. 261 (Bankr. D. Colo. 2021); *In re Offer Space LLC*, 629 B.R. 299 (Bankr. D. Utah 2021).

21 *In re Rickerson*, 636 B.R. 416 (Bankr. W.D. Pa. 2021).

22 *Id.* at 426.

23 *Id.*

24 11 U.S.C. § 1183(c)(1).

25 11 U.S.C. § 1183(b).

26 11 U.S.C. § 1194(b).

27 11 U.S.C. § 1183(b)(3)(C).

28 11 U.S.C. § 1183(b)(4).

29 11 U.S.C. § 1185(a) (“[The] court shall order that the debtor shall not be a debtor in possession for cause, including ... failure to perform the obligations of the debtor under a plan.”).

30 11 U.S.C. § 1183(c)(1).

they may receive compensation for their important work. To that end, the USTP's *Chapter 11 Legal Manual*³¹ sets forth its legal position on compensating case-by-case subchapter V trustees:³²

Subchapter V case-by-case trustees are compensated through section 330(a)(1)(A), which allows for “reasonable compensation for actual, necessary services rendered by the trustee ... and by any paraprofessional person employed by any such person.” The trustee may also be reimbursed for “actual, necessary expenses” pursuant to section 330(a)(1)(B).

These section 330 compensation provisions apply regardless of whether the case-by-case trustee makes disbursements of estate funds. [The] SBRA specifically excludes all subchapter V trustees from section 326(a), which sets limits on other chapter 11 trustees' compensation based on the moneys they disburse or turn over. Pub. L. No. 116-54, § 4(a)(4)(A). And subchapter V case-by-case trustees are not subject to the section 326(b) limitation of compensation to 5 percent of plan payments that is applicable to standing chapter 12 and 13 case trustees. *See* 11 U.S.C. § 326(b), as amended by Pub. L. No. 116-54, § 4(a)(4)(B).³³

Of course, subchapter V trustees will only be paid in cases if sufficient funds exist to pay them. Attempts to address this concern have involved providing subchapter V trustees with reasonable retainers or advance payments during the case to ensure that funds will be available to pay them, especially if the debtor is later determined to be ineligible to proceed under subchapter V, or the case gets dismissed.

Just as trustee fees must be reasonable, retainers likewise must be reasonable and comport with the law. The USTP offers the following parameters when determining trustee retainers:

1. Subchapter V trustee retainers or advanced payments should be approved by the court or by local rule. Because professional fees must be approved by the court under § 330, so should advance payments or retainers to trustees. Some courts have entered scheduling or standing orders to require debtor's counsel to pay monthly retainers to subchapter V trustees as a condition of operation,³⁴ and some have also required that debtors include anticipated trustee fees in cash-collateral budgets or pay the fees as a condition of dismissing a case.
2. A retainer or advanced payment should not be in an amount that adversely affects the debtor's cash flow or its ability to reorganize. Subchapter V is intended to allow “debtors to file [for] bankruptcy in a timely, cost-

effective manner.”³⁵ Paying trustee retainers or advanced fees that are prohibitive to a debtor's ability to reorganize would defeat this purpose.

3. Retainers should not be drawn down by the subchapter V trustee without court approval and should be deposited in a trust account and remain property of the estate until fees are paid. Just like for any other estate-paid professional, retainers remain property of the estate until the court approves a corresponding fee request under § 330.

4. Trustee retainers or advanced payments should not keep the debtor from paying administrative expenses over time in the case of a nonconsensual plan under § 1191(e). One advantage given to a subchapter V debtor that confirms a nonconsensual plan is to allow the payment of certain administrative expenses over a period of time extending beyond the effective date. Therefore, requiring the debtor to pay significant monthly retainers or trustee fees may obviate or infringe upon these rights.

Taken together, these guideposts promote the dual goals of ensuring that subchapter V trustees receive payment for their important work while maintaining professional accountability consistent with statutory requirements.

Conclusion

The USTP has undertaken extensive efforts to support the SBRA through the development of robust guidance and through litigation when necessary. The USTP will continue to monitor this new law's progress, analyze case data and adjust as appropriate to ensure that subchapter V practice adheres to the plain meaning and the overall objectives dictated by Congress. To these ends, the USTP has started posting a public report with SBRA case data that will be updated regularly.³⁶ **abi**

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³¹ Section 3-17.15.2, *United States Trustee Program Legal Manual*, available at justice.gov/ustf/volume_3_chapter_11_case_administration.pdf/download (unless otherwise specified, all links in this article were last visited on Oct. 4, 2022).

³² While the statute permits the USTP to appoint standing or case trustees, the USTP has only appointed case trustees.

³³ Section 326(b) provides, in part, that the court may allow reasonable compensation to case trustees in chapter 12 and 13 cases, not to exceed 5 percent upon all payments under the plan. The SBRA amended § 326(b) to make it clear that the court may not award compensation to subchapter V standing trustees under § 330(a), but the SBRA did not further revise § 326(b) to provide that the 5 percent cap on plan payments expressly applies to subchapter V case-by-case trustees. Instead, the 5 percent cap remains effective only as to chapter 12 and 13 case-by-case trustees appointed under §§ 1202(a) and 1302(a), respectively. As a result, there appears to be no express statutory limit on the compensation that can be awarded to subchapter V case-by-case trustees beyond the general “reasonableness” requirement imposed by § 330(a).

³⁴ *See, e.g.*, Order Prescribing Procedures in Chapter 11 Subchapter V Case, Setting Deadline for Filing Plan, and Setting Status Conference (Bankr. M.D. Fla.).

³⁵ H.R. Rep. No. 116-171, at 4.

³⁶ To view the most recent subchapter V public report, *see* justice.gov/ust/chapter-11-information.