By David Cox and Caleb Chaplain

Must the Sub V Debtor's Debts Be Linked to Its Current Business?

David Cox
Cox Law Group, PLLC
Lynchburg, Va.

Coordinating Editor Caleb Chaplain
U.S. Bankruptcy Court (W.D. Va.)
Harrisonburg, Va.

David Cox is the founding member of Cox Law Group in Lynchburg, Va., and serves on ABI's Board of Directors. Caleb Chaplain is the career law clerk for Hon. Rebecca B. Connelly of the U.S. Bankruptcy Court for the Western District of Virginia, a 2022 ABI "40 Under 40" honoree and an adjunct professor at Washington and Lee University School of Law.

Editor's Note: *ABI's Subchapter V Task Force, launched in April, is studying practitioners' experiences with the three-year-old law, culminating in a final report to be released in 2024. Learn more at subvtaskforce.abi.org.*

Under § 1182(1), in order to properly elect to proceed under subchapter V, a debtor must not only be "engaged in commercial or business activities," but also "not less than 50 percent" of the debtor's "noncontingent liquidated secured and unsecured debts" must have "ar[isen] from the commercial or business activities of the debtor."[1] Reading these separate criteria together to establish eligibility seems straightforward, yet some courts have read the two elements closely together to require a nexus between the two, and a split of authority has emerged.

Some courts interpret the 50 percent requirement to mean simply that 50 percent of the debt as of the petition date arose from *any* of the debtor's commercial or business activities (not just from activities the debtor was actively engaged in on the petition date).[2] These courts keep the "engaged in business" and 50 percent inquiries separate, with the former analyzing the debtor's "present" as of the petition date and the latter examining the debtor's pre-petition past.[3] However, other courts have adopted an alternative reading and have enforced a "nexus requirement."[4] These courts require that 50 percent (or more) of the debtor's debts must have arisen from the *same* commercial or business activities that the debtor relied on to satisfy the "person engaged in commercial or business activities" requirement for subchapter V eligibility.

Does the language of § 1182 necessitate a nexus requirement? If do, does this impediment to subchapter V eligibility also comport with the legislative goals in enacting subchapter V? This article explores whether the nexus requirement appropriately limits eligibility to those entities subchapter V was designed to help, or whether it unnecessarily restricts access to the bankruptcy system.

And "The" Has Made All the Difference

Bankruptcy courts imposing a nexus requirement require a "nexus," or significant connection, between 50 percent (or more) of the debtor's debts and the commercial and business activities the debtor was presently engaged in on the petition date. This reading is certainly not illogical. Because the phrase "commercial or business activities" is repeated in § 1182(1)(A)'s "debtor" definition, courts have "grouped the requirements together for legal scrutiny" and have concluded that "[t]he requirements must be read in tandem."[5]

These courts have emphasized the inclusion of the definite article "the" in the relative clause "of which arose from *the* commercial or business activities of the debtor." In English grammar, "[a] definite article points to a definite object"[6]; that is, "the" typically denotes that the noun following it is one that has already been referenced or that is readily identifiable. Had Congress *not* intended that there be a nexus requirement, it could have omitted the "the" and simply required that the debtor have at least 50 percent of its debt arising "from commercial or business activities."

One of the earliest reported decisions describing the nexus requirement for subchapter V eligibility is *In re Ikalowych* from the U.S. Bankruptcy Court for the District of Colorado. Following the failure of various business ventures, and in light of personal guarantees of debts for those ventures, John Ikalowych filed a chapter 11 case and elected to proceed under subchapter V.[7] The U.S. Trustee objected to Ikalowych's election.[8]

First, the court addressed whether the debtor was even "engaged in business" as of the petition date. The *Ikalowych* court adopted an "expansive view" of the "very broad and encompassing phrase" "commercial and business activity" for subchapter V eligibility, ultimately concluding that the debtor's wind-down work (and his employment by an insurance company) qualified.[9] The court then turned to the "not less than 50 percent" requirement.

Describing the nexus requirement, the court explained that "[f]or the debt to have 'ar[isen] from the commercial or business activities of the debtor,' the debt must be directly and substantially connected to

1 11 U.S.C. § 1182(1)(A).
2 *See, e.g., In re Reis*, Case No. 22-00517-JMM, 2023 WL 3215833, 2023 Bankr. LEXIS 1169 (Bankr. D. Idaho May 2, 2023); *In re Blue*, 630 B.R. 179 (Bankr. M.D.N.C. 2021).
3 *Reis*, 2023 WL 3215833, at *4.
4 *In re Hillman*, Case No. 22-10175, 2023 WL 3804195, 2023 Bankr. LEXIS 1448 (Bankr. N.D.N.Y. June 2, 2023); *In re Ikalowych*, 629 B.R. 261 (Bankr. D. Colo. 2021).
5 *Ikalowych*, 629 B.R. at 275-76.
6 *The Chicago Manual of Style* ¶ 5.71 (17th ed. 2017).
7 *Ikalowych*, 629 B.R. at 267.
8 *Id.*
9 *Id.* at 276-78.

the 'commercial or business activities' of the debtor."[10] In conducting such an analysis, the court "may also look back in time before the Petition Date to ascertain whether the debt arose from the same general types or categories of 'commercial or business activity' [that] the Debtor was engaged in as of the Petition Date."[11] Given that 86 percent of Ikalowych's debt came from the guarantee claims related to the business he was winding up as of the petition date, the court easily found that he met the 50 percent threshold, even applying the nexus requirement.

More recently, in *In re Hillman*, more than 50 percent of Michelle Hillman's debt arose from her personal guarantee of a defaulted commercial lease agreement originally entered into by an entity that no longer operated but in which she held a 50 percent equity interest.[12] The creditor, which was involved in commercial lease litigation against Hillman and the defunct entity, objected to the subchapter V election.[13]

The U.S. Bankruptcy Court for the Northern District of New York first found that the lease litigation was a sufficient "commercial or business activity" to satisfy the "engaged in business" requirement.[14] In adopting a nexus requirement, the court found the reasoning in *Ikalowych* "to be persuasive" and agreed that the use of the definite article "the" in § 1182(1)(A) was clearly intentional.[15] Fortunately for Hillman, there was a nexus between the wind-down litigation and most of her debt.[16] The court permitted her to proceed under subchapter V. However, the inquiry is not so nuanced in other jurisdictions.

There Is No "Those" There

Some bankruptcy courts that have considered the issue have not imposed a nexus requirement. In *In re Blue*, the U.S. Bankruptcy Court for the Middle District of North Carolina considered the case of an individual debtor who owned and operated a corporation providing information-transport consulting services that had ceased operating almost two years before the filing of her chapter 11 petition.[17]

At the time of the bankruptcy filing, Gwendolyn Blue was a salaried employee with a law firm but also offered services as an information-transport consultant for two other entities as an independent contractor.[18] Although the Bankruptcy Administrator and subchapter V trustee objected to the debtor's eligibility because the majority of her scheduled debt arose from her prior defunct business, the court concluded that the more "straightforward" reading of the statutory language would not implicate a nexus requirement between the commercial or business activities on the petition date and the commercial or business activities from which the debt arose.[19]

Under the court's analysis, to rule otherwise would "disqualify meritorious small businesses from the remedial purposes of subchapter V simply by having significant debts from former operations."[20] The court opted against the more narrow and limiting interpretation urged by the Bankruptcy Administrator and subchapter V trustee, and overruled their objections as to the debtor's subchapter V eligibility.[21]

In *In re Reis*, the U.S. Bankruptcy Court for the District of Idaho two years later joined in the *Blue* court's more expansive interpretation of § 1182. The *Reis* court concluded that eligibility under § 1182(1)(A) requires satisfaction of two distinct and separate tests: (1) Does the debtor have business activities on the petition date; and (2) has at least 50 percent of the debt arisen from commercial or business activities?[22] According to the *Reis* court, the first question "looks at the present — the petition date," but "[t]he latter determination is necessarily backward-looking, as it would be rare for all of a debtor's commercial or business debts to have been incurred on or around the petition date."[23]

The *Reis* court concluded that nothing in the statutory language requires a "direct linkage" between the commercial or business activities that led to the majority of the debt shown on schedules and the commercial or business activities engaged in by the debtor as of the petition date. Simply put, the commercial or business activities for purposes of the two tests could arise from distinctly different business ventures. According to the court, "[h]ad Congress intended to require an absolute nexus, it could have used the phrase 'not less than 50 percent of [the debt] ... arose from *those* commercial or business activities of the debtor.'"[24] Ultimately, the *Reis* court determined that the debt relied on by the debtor to support her subchapter V eligibility did not arise from commercial or business activity; plan confirmation was therefore denied based on the debtor's ineligibility for subchapter V.[25]

Intent in Enacting the SBRA

Plain-language arguments aside, "the brief legislative history of the [Small Business Reorganization Act of 2019 (SBRA)] indicates it was intended to improve the ability of small businesses to reorganize and ultimately remain in business."[26] One purpose underlying the SBRA was to "streamline the bankruptcy process by which small business debtors reorganize and rehabilitate their financial affairs," because "small business chapter 11 cases continue[d] to encounter difficulty in successfully reorganizing" despite the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[27] However, does the imposition of a nexus requirement comport with such intention?

The *Ikalowych* court prefaced its nexus requirement discussion by noting that this eligibility criterion "is difficult to meet" and "severely limits the use of Subchapter V for individuals."[28] Although acting as a discerning gatekeeper, the nexus requirement arguably better emphasizes the reorganizational nature of chapter 11 cases. The enactment of subchapter V "establishe[d] an expedited process for small business debtors to *reorganize* quickly, inexpensively, and

10 *Id.* at 288.
11 *Id.*
12 *Hillman*, 2023 WL 3804195, at *1-*2.
13 *Id.*
14 *Id.* at *4.
15 *Id.* at *5.
16 *Id.*
17 *Blue*, 630 B.R. at 183.
18 *Id.*
19 *Id.* at 191.
20 *Id.*
21 *Id.* at 181, 196-97.
22 *Reis*, 2023 WL 3215833, at *4.
23 *Id.*
24 *Id.* at *5.
25 *Id.*
26 *In re Wright*, No. 20-01035-HB, 2020 WL 2193240, at *3 (Bankr. D.S.C. April 27, 2020).
27 H.R. Rep. No. 116-171, at 1, 4 (2019).
28 *Ikalowych*, 629 B.R. at 287.

continued on page 57

from page 27

efficiently."[29] If a small business entity is burdened by debt from one unsuccessful commercial or business activity, perhaps reorganization is not in the best interests of all parties. Allowing a debtor that failed at one activity to try something else instead, to the detriment of its creditors, may go against the goals of subchapter V.

Small business debtors that wish to efficiently liquidate in subchapter V would remain generally unaffected by a nexus requirement. Because the winding up of business affairs qualifies as being "engaged in" that business, it seems that even nexus-requirement courts would permit a debtor to proceed under subchapter V and propose a liquidating plan. The debtors in *Ikalowych* and *Hillman* were both partly "engaged in" winding up corporate entities. If the majority of the business debt is from an unsuccessful venture, pursuit of a liquidating subchapter V plan may prove optimal.

On the other hand, imposing a nexus requirement may "be far too limiting" and "disqualify meritorious small businesses from the remedial purposes of subchapter V simply by having significant debts from former operations."[30] That is, a more liberal reading may be more in line with the intent behind the SBRA by maximizing its benefits on a larger number of small businesses. Businesses would be free to engage in whichever commercial or business activities best ensure that operations do not completely shut down.

Enhanced flexibility in present engagement not only benefits creditors by providing sustainable revenue to pay debts, it also ensures that employees remain employed. Furthermore, a more expansive eligibility reading of § 1182 allows an entity to reorganize as a new business more quickly and efficiently under subchapter V, no matter how substantially related the resulting business reflects its prior operations.

Conclusion

Although nuanced, the question of whether the debts relied on for subchapter V eligibility arise from the same commercial or business activity engaged in by the debtor on the petition date is a significant issue and potential hurdle to obtaining relief. It is not uncommon for entrepreneurs and small business owners to start (and sometimes fail with) any number of businesses over the course of their careers. Should this group of potential nonconsumer debtors be foreclosed from subchapter V's reorganization opportunities simply because their new business is unrelated to the debts they are burdened with from their prior business ventures?[31]

As with so many Bankruptcy Code sections, the language of § 1182 arguably lends itself to two "plain meanings," each having a very different impact on determining the limits of the universe of potential debtors for whom subchapter V, with its many benefits and advantages, may be an option. With what appears to be such an even split in the reported opinions, the extent to which all parties test the boundaries of eligibility over the coming months and years will be important in developing a majority view from the courts.

Notwithstanding this tension as to how expansively the eligibility provisions should be read, subchapter V has generally been welcomed as a mechanism to eliminate many of the obstacles to small business reorganizations while also providing protection for the creditors of a small business debtor.[32] With time and the addition of case law, eligibility and other critical issues will become clearer, hopefully further encouraging the use of subchapter V. It may fulfill its goals of helping small businesses and their owners file for bankruptcy "in a timely, cost-effective manner" such that they might remain in business to benefit all impacted parties, not just "the owners, but employees, suppliers, customers, and others who rely on that business."[33] abi

29 *In re Seven Stars on the Hudson Corp.*, 618 B.R. 333, 336 (Bankr. S.D. Fla. 2020) (emphasis added); *see also In re Progressive Solutions Inc.*, 615 B.R. 894, 900 (Bankr. C.D. Cal. 2020) ("But, the whole, the entire whole, of the legislative history and statements of Congress teaches the Court that the primary purpose of the SBRA is to promote successful reorganizations using the tools that are now available under current law.").

30 *Blue*, 630 B.R. at 191.

31 The Bankruptcy Code's structure, through chapter 7's rules limiting the application of the means test only to those with primarily consumer debt, arguably works to encourage those willing to start a business that may ultimately fail.

32 8 *Collier on Bankruptcy* ¶ 1180.01 (16th ed. 2023).

33 H.R. Rep. No. 116-171, at 4 (2019) (quoting comments of Rep. Ben Cline).

Copyright 2023
American Bankruptcy Institute.
Please contact ABI at (703) 739-0800 for reprint permission.