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Subchapter V Trustee Role in Chapter 11 Bankruptcy

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Chapter 11 Subchapter V cases are a relatively new animal in the bankruptcy world. Subchapter V was added to Chapter 11 of the Bankruptcy Code in February 2020 to provide an efficient and cost-effective alternative process for small businesses wishing to reorganize under Chapter 11.

Unlike regular Chapter 11 business reorganizations, Subchapter V provides for the appointment of a trustee. However, Subchapter V provides little detail about the role of these trustees. This article discusses how one court dealt with this ambiguity.

Background

In a regular Chapter 11 reorganization, no trustee is appointed. The debtor remains in control of the business and takes on a new title of “Debtor in Possession.” The appointment of trustees has been historically limited to Chapter 7 liquidation cases. If the Chapter 7 debtor is a business, the trustee manages its affairs until its assets are liquidated and business is wound down.

Like Chapter 7 cases, the appointment of a trustee in a Subchapter V case is made by the US Trustee's Office. Unlike Chapter 7 trustees, however, a Subchapter V trustee is a “non-operating” trustee. That is, the Subchapter V trustee does not take control of the business. Like a normal Chapter 11 reorganization, the debtor remains in control. Thus arises the question: What exactly is the Subchapter V trustee's role?

‘Honest Brokers’

In a recent case, a bankruptcy court explained that the role of the Subchapter V trustee is to provide oversight of the debtor in possession and to help facilitate negotiations among the parties who will be voting on the plan of reorganization in order to build consensus. *In re Corinthian Commc'ns, Inc.*, 642 B.R. 224 (Bankr. S.D.N.Y. 2022). The court dubbed them the “honest brokers” and explained that they provide “credibility in evaluating the debtor's business's prospects for a successful reorganization and facilitate[] negotiation of a plan of reorganization with the debtor's stakeholders, thereby enabling a small business to reorganize.”

Allowing the owner of a small business to stay at the helm and run the business increases the chances of a successful reorganization. Small business owners have often built the business and have personal relationships with their customers, employees, and suppliers. Removing the owner from the bankruptcy process can torpedo a successful reorganization. The drafters of Subchapter V considered this when deciding against making the trustee in these proceedings operating trustees.

But what if the small business owners present obstacles to a successful reorganization? In *Corinthian Communications*, the owners filled out fraudulent loan applications and engaged in gross mismanagement of the company. Their conduct included failure to follow corporate formalities and shuffling funds between the debtor business and the owners' other businesses.

They also demonstrated a lack of credibility and transparency by failing to disclose important corporate and financial information in the bankruptcy pleadings, including the insider ownership of a trust controlling the debtor company's landlord. They additionally failed to include copies of significant checks in the required monthly operating reports filed with the court. The court decided to expand the Subchapter V trustee's duties.

Expansion of Subchapter V Trustee Powers

Section 1185(a) of the Bankruptcy Code allows for the removal of 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 the commencement of the case.” Further, if the debtor is removed as the debtor in possession, Section 1185(b)(5) provides for the Subchapter V trustee's duties to be expanded to operating the business.

Thus, the debtor could be ousted for its problematic behavior and the Subchapter V trustee substituted in as an “operating trustee.” However, the court in *Corinthian Communications* was concerned with how that would affect the likelihood of a small business being able to reorganize. Given the personal relationship dynamics involved with so many small businesses, removing the owner could prevent a successful reorganization.

The court settled on a middle ground remedy. Section 1183(b)(2) permits a court “for cause and on request of a party in interest, the trustee, or the United States Trustee” to order that a Subchapter V trustee's powers be expanded to include the powers to “investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business, and any other matter relevant to the case or to the formulation of a plan” of reorganization. Once the investigation is completed, the trustee reports to the court on the findings of the investigation.

The court found that cause to support the Subchapter V trustee's powers exists when there are “significant questions such as the debtor's true financial condition, what property is property of the estate, the debtor's management of the estate as debtor in possession, and the accuracy and completeness of the debtor's disclosures and reports.” The court also determined that a bankruptcy court can sua sponte make the determination that the Subchapter V trustee's powers should be expanded, even though section 1183(b)(2) does not explicitly provide for a sua sponte order.

Conclusion

The takeaway from *Coninthian Communications* is that the Subchapter V trustee's powers and responsibilities will generally be limited to that of a “non-operating” trustee, who simply provides oversight of the debtor company, provides an impartial third-party evaluation of the debtor's prospects for a successful reorganization, and facilitates negotiations among the parties in interest so that the debtor arrives at a consensual plan of reorganization. However, when matters involving the owners or management of the small business go awry, the bankruptcy court may step in on its own, or upon the request of a party-in-interest.

The court could start with a less aggressive approach, directing the Subchapter V trustee to investigate and report back. Or it may completely remove the owners from control and place the debtor business in the hands of the Subchapter V trustee.

While bankruptcy trustees are a long-standing staple in the bankruptcy sphere, this expanded role places the Subchapter V trustee in somewhat uncharted territory. Trustees have historically been a creature of Chapter 7, the goal of which is to liquidate and allocate assets. Unlike chapter 7, the goal in a Subchapter V proceeding is to reorganize and for the business to successfully emerge from bankruptcy. This may put a strain on the trustees who typically handle a heavy caseload and will certainly be a factor in considering the full expansion of powers to “operating trustee” status in Subchapter V cases.