AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Mediation Matters

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The Quirks of Mediation in Sub V

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Mediation has become one of the most important tools in a chapter 11 debtor's toolbox, particularly in large chapter 11 cases, which often require challenging multi-party negotiations and consensus-building among key stakeholders and creditors. A relatively new creature under the Bankruptcy Code is subchapter V of chapter 11, established pursuant to the Small Business Reorganization Act of 2019 (SBRA), which went into effect on Feb. 19, 2020.

Under the SBRA's original text, in order to file a subchapter V case, the debtor had to be engaged in commercial or business activities (other than primarily owning or operating a single piece of real property) with combined total secured and unsecured debts of $2,725,625 or less as of the petition date, not less than 50 percent of which arose from the commercial or business activities of the debtor.[1] The debt cap for qualifying as a subchapter V debtor was increased to $7.5 million by the Coronavirus Aid, Relief and Economic Security Act of 2020 and, through an extension via the Bankruptcy Threshold Adjustment and Technical Corrections Act of 2022, will continue at that level through June 21, 2024. There is considerable support in the restructuring profession for making the current debt cap permanent.[2]

Small businesses vastly outnumber large businesses in the U.S., and likewise make up a larger percentage of chapter 11 business debtors. However, small businesses are less likely to successfully reorganize and emerge from bankruptcy.[3] This has remained true notwithstanding the amendments to the Bankruptcy Code under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which created special streamlined procedures for small business chapter 11 debtors.[4]

Subchapter V was created for three key reasons: to (1) make chapter 11 more efficient and economically feasible for small business debtors; (2) allow them to successfully reorganize while retaining control of the business; and (3) reduce unnecessary and expensive procedural burdens in chapter 11 that provided relatively little utility for small business debtors.[5] So far, it appears that subchapter V has largely succeeded in its aims. Compared to non-subchapter V chapter 11 small business debtors, subchapter V debtors are about twice as likely to get a plan confirmed, and half as likely to get their cases dismissed.[6]

Moreover, the median months to confirmation for non-subchapter V small business debtors is more than 10 months, while the median months to confirmation for subchapter V debtors is only 6.4 months.[7] As subchapter V becomes an increasingly favored format for chapter 11 reorganization of small businesses, largely as a result of its speed and more debtor-favorable provisions, it is worthwhile to assess the value and complications of mediation in the context of subchapter V.

Balance of Power Between Debtors and Creditors in Subchapter V

There are a number of key changes to the provisions governing cases under subchapter V of the Bankruptcy Code that aim to streamline the chapter 11 process and cut unnecessary financial burdens

1 *See* 11 U.S.C. § 1182(1)(a).
2 *See, e.g.*, "Task Force Releases Preliminary Report Recommending Congress Maintain the $7.5 Million Debt Eligibility Limit for Small Businesses Looking to Reorganize Under Subchapter V," ABI Subchapter V Task Force (Dec. 15, 2023), *available at* subvtaskforce.abi.org ("[B]ankruptcy professionals overwhelmingly support making the current [$7.5 million] debt cap permanent.").
3 *See* Small Business Reorganization Act of 2019, H. Rept. 116-71, 116th Cong., at 3 (2019), *available at* congress.gov/116/crpt/hrpt171/CRPT-116hrpt171.pdf (unless otherwise specified, all links in this article were last visited on Feb. 26, 2024).
4 *Id.* at 4.
5 *Id.*
6 *See* "Chapter 11 Subchapter V Statistical Summary Through January 31, 2024," U.S. Trustee Program, *available at* justice.gov/ust/page/file/1499276/dl?inline.
7 *Id.*; *see also* Preliminary Report of ABI Subchapter V Task Force, *supra* n.2 ("The overwhelming consensus of bankruptcy professionals, bankruptcy judges, and academics is that Subchapter V is functioning as Congress intended. Many have commented that Subchapter V is the most effective and useful bankruptcy legislation passed since enactment of the Bankruptcy Code in 1978. Subchapter V debtors are confirming plans at higher rates, more quickly, and at lower costs than non-Subchapter V small business cases and regular Chapter 11 cases.").

on small business debtors. Many of the changes are premised on the generalization that "creditors in these smaller cases do not have claims large enough to warrant the time and money to participate actively in these cases."[8] Some of these key changes in subchapter V include the following:

1. the elimination of an official committee of unsecured creditors;[9]
2. the elimination of the requirement for a debtor to file a separate disclosure statement accompanying the plan;[10]
3. the mandate that only the debtor may file a chapter 11 plan;[11]
4. the elimination of the absolute-priority rule;[12] and
5. a debtor's ability to confirm a plan without any consenting creditors.[13]

There are strong practical justifications for these changes. Unsecured creditors' committees can precipitously drive up the costs of chapter 11 cases and provide minimal utility in small business cases when there is little meaningful creditor participation. Likewise, when there is little meaningful creditor participation, there is limited usefulness in requiring a debtor to invest significant resources to prepare a disclosure statement.

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Eliminating the ability of nondebtor parties to file competing plans further streamlines chapter 11 cases and shortens the runway to confirmation by preventing creditors from holding out on a deal until the debtor's exclusivity expires.[14] Eliminating the absolute-priority rule significantly improves a subchapter V debtor's chances of getting a plan confirmed by allowing the debtor to cram down a plan on nonconsenting creditors, and allowing owners to retain their equity without paying all nonconsenting creditors' claims in full. Finally, permitting the debtor to confirm a plan without any consenting creditors fixes a longstanding problem of small business reorganizations failing simply due to lack of creditor involvement.

These changes fundamentally disrupt the balance of power between debtors and those creditors that wish to be actively involved in chapter 11 cases, and thereby impact plan and claim negotiations among interested parties. Subchapter V substantially weakens the rights, powers and protections of creditors to streamline and reel in the costs of the chapter 11 process for small debtors.[15] As a result, creditors may have a difficult time negotiating better outcomes from their weakened bargaining position, even with the help of a qualified mediator.

The Subchapter V Trustee's Role

Another notable feature is the U.S. Trustee's appointment of a disinterested subchapter V trustee to oversee the chapter 11 case. The subchapter V trustee, among other things, is tasked with facilitating the development of a consensual reorganization plan.[16] The U.S. Trustee's *Handbook for Small Business Chapter 11 Subchapter V* provides that facilitation of a consensual plan is a principal duty of the subchapter V trustee, and instructs that a trustee should: (1) "[a]s soon as possible ... begin discussions with the debtor and principal creditors about the plan [that] the debtor will propose"; (2) "encourage communication [among] all parties in interest as the plan is developed"; and (3) "be proactive in communicating with the debtor and debtor's counsel and with creditors, and in promoting and facilitating plan negotiations."[17]

The trustee can do this remotely in a cost-effective manner by reaching out to interested parties, shuttling information between opposing parties and facilitating direct communications between opposing parties — whether via conference call, video conferencing or in-person meetings. Having a nondebtor neutral primarily focused on helping the debtor propose a feasible and confirmable plan, and facilitating the resolution of any disputes that could create a barrier to confirmation, uniquely provides a subchapter V debtor with the crucial support through the chapter 11 process that is unavailable to non-subchapter V chapter 11 debtors and debtors proceeding under any other Bankruptcy Code chapter.

In ruling on a final fee application of a subchapter V trustee, one bankruptcy court detailed the uniqueness of the trustee's role, emphasizing that trustees in chapter 7, 11 or 13 cases tend to be adversarial to the debtor — in that they have a duty to protect the estate and its creditors.[18] In contrast, subchapter V trustees only take possession of estate property if the debtor is removed and the subchapter V trustee's powers are expanded, and are only required to investigate the debtor's financial affairs if the court orders them to do so for cause and upon a party's request.[19] The court concluded that the subchapter V trustee's role was intentionally designed to be less adversarial, and he/she in fact "acts more like a mediator than an adversary."[20]

In some cases, the active participation of a subchapter V trustee could negate any need for a mediator to resolve disputes. Assuming that the

8 Small Business Reorganization Act of 2019, *supra* n.3.
9 11 U.S.C. § 1181(b).
10 11 U.S.C. §§ 1181(b), 1190(1).
11 11 U.S.C. § 1189(a).
12 11 U.S.C. § 1181(a).
13 11 U.S.C. § 1191(b).
14 *See, e.g., In re Lost Cajun Enters. LLC*, 634 B.R. 1063, 1073 (Bankr. D. Colo. 2021).
15 *Id.* ("Subchapter V ... eliminated the 'absolute-priority rule,' creditor[s'] committees, the requirement for approval of disclosure statements, and the requirement of at least one accepting class of impaired creditors. Effectively, it lowered the bar for confirmation.").
16 *See* 11 U.S.C. § 1183(b)(7); *see also In re Ozcelebi*, 639 B.R. 365, 381 (Bankr. S.D. Tex. 2022) (this duty is "unique" to subchapter V trustees).
17 *Handbook for Small Business Chapter 11 Subchapter V Trustees*, U.S. Dep't of Justice, Exec. Office for U.S. Trustees (February 2020), at 2-2, 3-9, *available at* justice.gov/ust/file/subchapterv_trustee_handbook.pdf/download.
18 *See In re 218 Jackson LLC*, 631 B.R. 937, 947 (Bankr. M.D. Fla. 2021).
19 *Id.*
20 *Id.* (citing *In re Seven Stars on the Hudson Corp.*, 618 B.R. 333, 346 n.81 (Bankr. S.D. Fla. 2020) ("A substantial part of the Subchapter V trustee's preconfirmation role, therefore, should be to serve as a *de facto* mediator between the debtor and its creditors.")).

subchapter V trustee's hourly rate is lower than a mediator's rate or fees in the jurisdiction, this could also reduce the costs of proceeding under subchapter V. Taking this route could arguably be what was intended by the SBRA, in that it would promote the goals of cost savings and expeditious resolutions. When a subchapter V trustee is serving as a *de facto* mediator, it would likely be more akin to a typical negotiation process facilitated by the trustee than a formal mediation.

Therefore, to protect individual interests, parties wishing to treat the trustee as a mediator should enter into an explicit confidentiality agreement that defines the contours of the understanding among the parties and is signed by all mediating parties and the subchapter V trustee. Local bankruptcy rules related to mediations and negotiations of contested matters or adversary proceedings in bankruptcy and the confidentiality thereof can vary a great deal based on the jurisdiction. In some cases, local rules protecting the confidentiality of mediation in bankruptcy cases only apply when mediation was formally approved by the court.[21] For this reason, it is prudent to ensure that all parties engaging in mediation are fully protected by a confidentiality agreement instead of relying on local rules to provide the necessary protection.

While it may be convenient and cost-effective in some cases to look to the subchapter V trustee to serve as a *de facto* mediator, it could be more productive in other cases to instead retain a designated mediator. A mediator retained by the parties would be a disinterested third party with no prior exposure to or judgments about the bankruptcy case, issues therein, or interested parties.

Inevitably, a subchapter V trustee who tries to facilitate the resolution of a dispute between the debtor and another party will have already formed opinions about the parties and the positions through a review of filings and attendance at court hearings. Moreover, even if mediation is unsuccessful, the subchapter V trustee likely will not exit the case. Even if there were explicit, agreed-upon confidentiality terms protecting the items discussed during mediation from disclosure, parties may feel that participating in mediation with complete candor or zealous advocacy could impact their relationship with the subchapter V trustee further along in the case if the mediation proves unsuccessful.

There is also an inherent conflict of interest in having the subchapter V trustee serve as a mediator, because the trustee is not truly disinterested in the outcome; he/she has a primary purpose of facilitating a successful reorganization, while creditors are primarily concerned with maximizing the recovery on their claims. In addition, creditors may feel uncomfortable having the subchapter V trustee serve as mediator when the trustee has worked closely with the debtor from the outset of the case.

In working closely with the debtor, the subchapter V trustee is supposed to utilize his/her specialized knowledge and experience to guide the debtor to the proposal and confirmation of a feasible, consensual plan. However, it is crucial for debtors to remember that the subchapter V trustee is not a debtor professional, therefore his/her presence in email threads, private calls or meetings between the debtor and its counsel would negate the attorney/client privilege that would otherwise protect the communications.[22]

Moreover, although the subchapter V trustee has the same general interest as the debtor — achieving confirmation of a feasible plan — and is supposed to aid the debtor in achieving a successful reorganization, the common-interest privilege would not attach to communications between the trustee and debtor's counsel. The strictest (and most prevalent) interpretation of the common-interest privilege requires different persons or entities to have an "identical legal interest" and a "legal, not solely commercial" interest.[23] Even more flexible interpretations of the common-interest privilege that do not require interests between the parties to be precisely "identical" typically still require the common interest to be substantially similar and to be "legal," not just "factual or strategic."[24]

Conclusion

Subchapter V, particularly with the increased debt cap of $7.5 million for eligible debtors, has made chapter 11 reorganization more accessible and viable for small businesses by streamlining bankruptcy proceedings, eliminating significant barriers to confirmation unique to small business debtors, and significantly reducing costs incurred by small business debtors in chapter 11. Many of the changes strengthen the negotiating position of small business debtors proceeding under subchapter V and correspondingly weaken the negotiating position of their creditors.

A qualified subchapter V trustee, particularly one with mediation training and/or experience, can provide invaluable assistance in driving the debtor toward confirmation by facilitating the resolution of disputes among interested parties, potentially negating any need for a costly designated mediator. However, all interested parties must carefully consider practical risks and confidentiality parameters before involving subchapter V trustees in negotiations. abi

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21 *See, e.g.*, D. Del. Local Bank. Rule 9019-5(d).

22 *See In re Teleglobe Comm. Corp.*, 493 F.3d 345, 361 (3d Cir. 2007) ("A communication is only privileged if it is made 'in confidence.' *Restatement (Third) of the Law Governing Lawyers* § 68. In other words, if persons other than the client, its attorney or their agents are present, the communication is not made in confidence, and the privilege does not attach. The disclosure rule operates as a corollary to this principle: if a client subsequently shares a privileged communication with a third party, then it is no longer confidential, and the privilege ceases to protect it.").

23 *Id.* at 365 (citing *Duplan Corp. v. Deering Milliken Inc.*, 397 F. Supp. 1146, 1172 (D.S.C. 1974)).

24 *Id.*