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Untangling the Sub V Eligibility Criteria for Individual Debtors

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

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Section 1182(1) of the Bankruptcy Code[1] defines who may be a "debtor" under subchapter V of chapter 11. Among the requirements to be a subchapter V debtor under § 1182(1)(A) are that the debtor must be "engaged in commercial or business activities," and that not less than 50 percent of the debtor's eligible debts must have arisen "from the commercial or business activities of the debtor."[2] Although much of the early dialogue around the Small Business Reorganization Act of 2019 (SBRA)[3] focused on business-entity debtors and their reorganizations, the SBRA also allows eligible individuals to elect into subchapter V.[4]

Now, more than three years and 5,000 cases into the SBRA,[5] there is growing consensus around the broad scope of the "commercial or business activities" requirements, including for individual debtors. How courts will interpret and apply § 1182(1)(A)'s dual "commercial or business activities" requirements remains murky for some potential individual subchapter V debtors considering their bankruptcy options. Fact patterns continue to arise that test the boundaries of § 1182(1)(A), with courts sometimes reaching different conclusions under at least somewhat similar facts. This article explores how courts are interpreting § 1182(1)(A) for individual debtors, searches for common ground where possible, and considers what these decisions might indicate for individuals hoping to benefit from the protections and powers of subchapter V.

"Commercial or Business Activities" Is Extremely Broad

Many individual debtors (and their counsel) considering whether to file for subchapter V must wade through a body of sometimes conflicting case law regarding the eligibility requirements. Because the Bankruptcy Code does not define "commercial or business activities," a threshold statutory interpretation issue that all courts face when presented with an eligibility objection is distinguishing commercial or business activities from noncommercial, personal or consumer activities. Although bankruptcy courts have reached different outcomes when applying facts to law, one common thread prevails: Courts generally agree that the phrase "commercial or business activities" was intended by Congress, and should be interpreted, to be "very broad and encompassing."[6]

In searching for a workable definition of what constitutes "commercial or business activities," courts have looked at the dictionary definitions of the terms, the SBRA's legislative history, case law and how similar terms are interpreted in other statutes. Most courts also apply a "totality of the circumstances" standard when analyzing the scope of "commercial or business activities."[7]

For example, the *Ikalowych* bankruptcy court arrived at a broad definition of "commercial or business activities" that included "any private sector actions related to buying, selling, financing, or using goods, property, or services, undertaken for the purpose of earning income (including by establishing, managing, or operating an incorporated or unincorporated entity to do so)."[8] Adopting a slightly different — and perhaps narrower — interpretation, the *Blue* bankruptcy court concluded that "a person is engaged in commercial or business activities when she participates in the purchasing or 'selling of economic goods or services for a profit.'"[9] Applying its test, the *Blue* court found that the debtor's work as an information-technology consultant and full-time employee was sufficient. On the other hand, the *Johnson* bankruptcy court applied a "for profit" test similar to *Blue* and held that being an employee was insufficient to constitute "commercial or business activities."[10] (Several other courts have declined to

1 11 U.S.C. § 101, *et seq. See also* Hon. Elizabeth L. Gunn & Don Mago, "Eligible or Ineligible Debt? Further Developments in the Definition of the Subchapter V Debt Limitation", XLII *ABI Journal* 9, 18-19, 53, September 2023, *available at* abi.org/abi-journal (unless otherwise specified, all links in this article were last visited on July 25, 2023).
2 11 U.S.C. § 1182(1)(A).
3 Pub. L. No. 116-54, 133 Stat. 1079 (2019).
4 Individuals are eligible for subchapter V because § 101(41) of the Bankruptcy Code defines a "person" to include both individuals and business entities.
5 To view subchapter V cases by month, click the "Bankruptcy Statistics" section of ABI's SBRA Resources website, *available at* abi.org/sbra.
6 *In re Ikalowych*, 629 B.R. 261, 276-77 (Bankr. D. Colo. 2021) (noting that phrase "commercial or business activities" is "exceptionally broad"); *see also In re Ellingsworth Residential Cmty. Ass'n Inc.*, 619 B.R. 519, 521 (Bankr. M.D. Fla. 2020) ("Congress could have chosen different terms or added other exclusions when drafting the SBRA but instead chose very broad language" by using "commercial or business activities.").
7 *In re RS Air LLC*, 638 B.R. 403, 410 (B.A.P. 9th Cir. 2022) (citation omitted); *In re Bennion*, No. 22-00102-NGH, 2022 WL 3021675, at *2 (Bankr. D. Idaho July 29, 2022).
8 *In re Ikalowych*, 629 B.R. at 276.
9 *In re Blue*, 630 B.R. 179, 189 (Bankr. M.D.N.C. 2021) (quoting *In re Johnson*, No. 19-42063-ELM, 2021 WL 825156, at *8 (Bankr. N.D. Tex. March 1, 2021)).
10 *In re Johnson*, 2021 WL 825156, at *8.

read any actual profit-motive requirement into § 1182(A)(1), thus, for example, ensuring that nonprofits can be eligible.[11])

In the context of whether a debt "arose from commercial or business activities," other courts have analyzed the purpose of the debt at issue in subchapter V against § 101(8)'s definition of "consumer debt,"[12] which is defined as a "debt incurred by an individual primarily for personal, family, or household purpose."[13] Under this approach, courts have found that "commercial or business activities consist of any activities not of a personal, family, or household nature connected with business operations."[14] Relatedly, the *Ikalowych* court contrasted commercial or business activities with "consumer consumption transactions," which "generally are not considered to be 'commercial or business activities' ... since such transactions are not undertaken to earn income."[15] In other words, looking broadly, "commercial or business activities" are anything but a narrow category of purely personal activities.

Although most courts have determined that the eligibility standard for individuals under subchapter V is broad, the standard is not limitless. For example, the debtor in *In re Bennion* (a trained tree-cutter for the U.S. Forest Service) was injured while cutting down trees on his mother's property, leaving the debtor with significant medical debt.[16] Finding the debtor ineligible, the bankruptcy court noted that the debtor did not charge his family for the services and was not working in a business capacity or for any economic purpose, but rather for a family purpose.[17]

Similarly, the *Sullivan* bankruptcy court found that the debtor was ineligible for subchapter V because the debt incurred in buying out the debtor's ex-wife's interest in a business was "grounded in the equitable termination of their marriage," which was "inherently a personal and family-related purpose."[18] Finally, the *Reis* bankruptcy court found that the debtor's incurrence of student loans 10 years before opening a business did not constitute a "commercial or business activity" because the debtor's "education had nothing to do with buying, selling, financing, or using goods; rather it gave [the d]ebtor the opportunity, as a person, to practice a profession."[19]

Employment Plus Something More Probably Is Needed

Although courts have adopted different definitions for identifying "commercial or business activities," most courts — with limited exceptions — have held that earning a wage as an employee—absent ownership or some other "plus" factor—is insufficient to constitute sufficient "commercial or business activities." Even when an individual once owned or actively managed a business, individuals face an uphill eligibility battle when that business was fully liquidated prior to the bankruptcy case.

As the Ninth Circuit Bankruptcy Appellate Panel summarized, "Courts are less likely to find sufficient commercial or business activities for [the] purposes of § 1182(1)(A) where the debtor is an individual who owns a non-operating business, especially where the business has been dissolved under applicable state law."[20] For example, the *McCune* bankruptcy court ruled that the debtors were ineligible for subchapter V when the businesses they owned had closed years ago and the debtors were not actively involved in operational or winddown activities as of the filing.[21] Similarly, the *Thurmon* bankruptcy court found that the debtors were not "engaged in commercial or business activities" when they "sold the business with no intent to return to it" because "[t]he plain meaning of 'engaged in' means to be actively and currently involved."[22] These cases suggest that an individual considering subchapter V in coordination with a business wind-down should act timely in seeking bankruptcy protection.

Courts have also held that simply working for a company and receiving a paycheck is most likely insufficient to demonstrate engagement in "commercial or business activities," and a debtor must have more "skin in the game" to tip the scales in favor of eligibility.[23] In *Johnson*, the bankruptcy court held that when the debtor did not have an ownership interest in the company, he was "nothing more than an employee ... with heightened obligations to the company on account of his role as an officer," which the court found insufficient.[24] Similarly, the *Rickerson* bankruptcy court found that the ordinary meaning of the phrase "commercial or business activities" did not encompass "an employee who is in an employment relationship with an employer — at least where the employee has no ownership or other special interest with the employer."[25]

However, other courts have suggested perhaps a slightly more forgiving standard relative to wage-earners. In *Blue*, the debtor was the sole owner and president of a corporation, and worked full-time and as an information-technology consultant.[26] The bankruptcy court found that the debtor's consulting services constituted "commercial or business activities" when those services were delivered "in exchange for a profit."[27] In *Ikalowych*, the court applied the "exceptionally broad scope" of the "commercial or business activities" requirement when considering the activities of a debtor who was a salaried employee selling products.[28] The court concluded that the debtor's work as a wage-earner constituted "commercial or business activities" because he was "selling a product in the private marketplace in order to make money for himself and his employer."[29] Although *Ikalowych* may be an outlier in terms of accepting employment activity

11 *In re RS Air LLC*, 638 B.R. at 413 ("[N]o profit motive is required for a debtor to qualify for subchapter V relief."); *In re Ellingsworth Residential Cmty. Ass'n Inc.*, 619 B.R. at 522 ("Any corporation that conducts any 'commercial or business activity' can be a small business debtor, whether they operate for profit or not.").
12 *In re Sullivan*, 626 B.R. 326, 331 (Bankr. D. Colo. 2021); *In re Ellingsworth Residential Cmty. Ass'n Inc.*, 619 B.R. at 521; *In re Bennion*, 2022 WL 3021675, at *2-3.
13 11 U.S.C. § 101(8).
14 *In re Ellingsworth Residential Cmty. Ass'n Inc.*, 619 B.R. at 521 (emphasis removed).
15 *In re Ikalowych*, 629 B.R. at 276.
16 2022 WL 3021675, at *1.
17 *Id.* at *2-3.
18 626 B.R. at 333.
19 *In re Reis*, No. 22-00517-JMM, 2023 WL 3215833, at *6 (Bankr. D. Idaho May 2, 2023).
20 *In re RS Air LLC*, 638 B.R. at 410.
21 635 B.R. 409, 420-21 (Bankr. D.N.M. 2021).
22 *In re Thurmon*, 625 B.R. 417, 422-23 (Bankr. W.D. Mo. 2020).
23 *See In re Ikalowych*, 629 B.R. at 287.
24 *In re Johnson*, 2021 WL 825156, at *8.
25 636 B.R. 416, 426 (Bankr. W.D. Pa. 2021).
26 630 B.R. at 183.
27 *Id.* at 190.
28 *In re Ikalowych*, 629 B.R. at 286.
29 *Id.*

continued on page 67

from page 39

as sufficient, the same court limited the scope of that holding through its interpretation of the requirement that 50 percent of the debtor's debts must have arisen from the same commercial or business activities in which the debtor was engaged around the petition date.[30]

The "Nexus" Test: A New Requirement?

Even if the debtor is engaged in commercial or business activities as of the petition date, the debtor must still meet the second "commercial or business activities" requirement in § 1182(1)(A): At least 50 percent of the relevant debts must arise from the debtor's "commercial or business activities."[31] At least two courts have adopted the view that the commercial or business activities must be the same for both tests.

In *Ikalowych*, the bankruptcy court narrowed its broad definition of what constitutes "commercial or business activities" by imposing the requirement that the commercial or business activities from which 50 percent of the debts arose must be the same activities in which the debtor was engaged around the time of the petition date.[32] The *Hillman* bankruptcy court later adopted *Ikalowych*'s nexus test, finding the analysis persuasive.[33]

However, other courts have noted that § 1182(1)(A) does not state that the "commercial or business activities" must be the "same" activities for both prongs to be satisfied. For example, the *Blue* court rejected any nexus requirement, finding that subchapter V permitted the debtor "to address both defunct and nondefunct commercial and business activities, and the more straightforward interpretation of § 1182(1)(A) does not require a connection of debts to current business activities."[34] The *Reis* court agreed, declining to read a nexus requirement into the statute where the language did not require one and treating each reference to "commercial or business activities" as separate analyses.[35]

What Do These Cases Mean for Individual Debtors?

In general, bankruptcy courts continue to apply the subchapter V eligibility criteria in a broad fashion. Doing so makes sense given the statute's broad language and the SBRA's intended goal of making chapter 11 reorganizations more accessible to small businesses and their owners, as well as to focus cases on the debtor's ability to reorganize.[36]

Although eligibility challenges will continue, a broad interpretation of eligibility should also have the long-term benefit of discouraging disputes at the case's outset and instead focusing on the bankruptcy exit and viability of the reorganization. Nonetheless, eligibility is not limitless. Individuals considering subchapter V must carefully consider whether they can meet the threshold requirements, identify the right time to file given their relationship to the business and present activities, and build a compelling narrative from the totality of their activities to pass the test. abi

30 *Id.* at 283-87.
31 11 U.S.C. § 1182(1)(A).
32 *In re Ikalowych*, 629 B.R. at 288 ("In this context, 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' which the Debtor was engaged in as of the Petition Date.").
33 *In re Hillman*, No. 22-10175, 2023 WL 3804195, at *5 (Bankr. N.D.N.Y. June 2, 2023) (finding reasoning in *Ikalowych* "persuasive" and adopting nexus requirement).
34 *In re Blue*, 630 B.R. at 191.
35 2023 WL 3215833, at *4.
36 *See, e.g.*, H.R. Rep. No. 116-171, at 2-3 (2019); Charles Grassley, *et al.*, "The Small Business Reorganization Act," *available at* grassley.senate.gov/imo/media/doc/Bankruptcy,%2004-09-19,%20Small%20Business%20Reorganization%20Act%20Fact%20Sheet.pdf; "Bipartisan Colleagues Introduce Legislation to Help Small Businesses Restructure Debt," Press Release (April 9, 2019), *available at* grassley.senate.gov/news/news-releases/grassley-bipartisan-colleagues-introduce-legislation-help-small-businesses-0.