

# SUBCHAPTER V TRUSTEE'S LIMITED POWERS

## Do Not Fill Void Arising From Absence of Creditors' Committee

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SINCE ITS ENACTMENT IN FEBRUARY 2020, SUBCHAPTER V OF CHAPTER 11 HAS BECOME A POPULAR VEHICLE FOR ELIGIBLE SMALL BUSINESSES THAT ARE LOOKING TO REORGANIZE OR OTHERWISE ADDRESS OPERATIONAL ISSUES, LIQUIDITY ISSUES AND EXCESSIVE DEBT. CONGRESS ENACTED SUBCHAPTER V TO MAKE CHAPTER 11 MORE APPEALING FOR SMALL BUSINESSES THAT WERE PREVIOUSLY DETERRED FROM FILING CHAPTER 11 DUE TO ITS COSTS AND RISKS. SUBCHAPTER V PROVIDES A LESS EXPENSIVE AND MORE STREAMLINED PROCESS YET GIVES DEBTORS THE ABILITY TO REAP LARGELY THE SAME BENEFITS AS CHAPTER 11.

From a trade creditor's perspective, perhaps the biggest difference between Subchapter V and the pre-existing Chapter 11 process is that no official committee of unsecured creditors is appointed in a Subchapter V case. A creditors' committee plays a critical role as a fiduciary for all the debtor's unsecured creditors. Among other things, a committee is empowered to investigate and potentially commence litigation to challenge the security interests of a debtor's prepetition lenders and prosecute prepetition causes of action that a debtor may have against third parties, including the debtor's lenders and insiders (e.g., owners, affiliates, spouses and directors and officers). A committee can leverage these powers through negotiations or litigation to potentially increase distributions for unsecured creditors. And the best part? The fees and expenses a committee incurs in fulfilling its duties are paid by the debtor's estate!

Subchapter V does away with the creditors' committee, instead relying on a Subchapter V trustee to serve as a check against the debtor and its secured lender and insiders. However, it is questionable whether a Subchapter V trustee can truly fill the void left by the absence of a creditors' committee, particularly in light of the limited scope of a Subchapter V trustee's powers. A Subchapter V trustee is not automatically bestowed with the power to investigate causes of action and, in *In re Ghatanfard*, the U.S. District Court for the Southern

District of New York held the bankruptcy court cannot grant a Subchapter V trustee the power to prosecute estate causes of action. This removes a significant protection for unsecured creditors and makes it less likely that a Subchapter V plan will achieve optimal outcomes for unsecured creditors—especially if the creditors in the case don't roll up their sleeves and protect their own interests!

### THE SUBCHAPTER V TRUSTEE

Section 1183 of the Bankruptcy Code provides for the appointment of a standing trustee—i.e., the Subchapter V trustee—in any case filed under Subchapter V of Chapter 11. Section 1183 sets forth the duties and powers of the Subchapter V trustee. Among other things, a Subchapter V trustee shall:

- Facilitate the development of a consensual plan;
- Ensure the debtor commences timely payments under the plan;
- Perform certain duties that a Chapter 7 trustee would have, such as examining proofs of claim, opposing the debtor's discharge and making a final report and accounting of the administration of the debtor's bankruptcy estate; and
- Appear and be heard at any hearing concerning (i) the value of property subject to a lien, (ii) confirmation of the plan, (iii) modification of the plan or (iv) the sale of property of the debtor's bankruptcy estate.

**SUBCHAPTER V DOES AWAY WITH THE CREDITORS' COMMITTEE, INSTEAD RELYING ON A SUBCHAPTER V TRUSTEE TO SERVE AS A CHECK AGAINST THE DEBTOR AND ITS SECURED LENDER AND INSIDERS.**

THE GHATANFARD  
DECISION STATES THAT  
A SUBCHAPTER V  
TRUSTEE CANNOT  
BE ENLISTED TO  
PURSUE AVOIDANCE  
ACTIONS—SUCH  
AS PREFERENCES—  
AGAINST TRADE  
CREDITORS.

Section 1183 also states that the court may grant a Subchapter V trustee additional powers that are held by a debtor-in-possession (or Chapter 11 trustee, if appointed) in a Chapter 11 case. One of these additional powers is the power to “investigate the acts, conduct, assets, liabilities and financial condition of the debtor, the operation of the debtor’s business and the desirability of the continuance of such business and any other matter relevant to the case or to the formulation of a plan.” However, these additional powers may only be granted by the bankruptcy court, “for cause.” And, conspicuously, the enumerated powers do not include the ability to commence a lawsuit to recover an estate cause of action.

### RELEVANT BACKGROUND REGARDING THE GHATANFARD DECISION

The Debtor, Davoud Ghatanfard, was a restaurateur who had owned and operated several restaurants. On June 22, 2022, the lead plaintiff, in a class action brought on behalf of former employees of the Debtor’s businesses obtained an approximately \$5 million judgment against the Debtor and commercial entities that operated the Debtor’s restaurants. Throughout their post-judgment collection efforts, the class members discovered that the Debtor had rendered himself insolvent through various transfers to the Debtor’s “lifetime partner.” The class members alleged these transfers were fraudulent conveyances valued at approximately \$6.7 million. On July 5, 2023, the U.S. District Court for the Southern District of New York issued an order temporarily restraining transfers of funds or assets by the lifetime partner outside of the ordinary course. The District Court thereafter extended the terms of the temporary restraining order, in light of “the suspicious nature of the activity between Debtor and [his lifetime partner], including that Debtor still lived in the Southampton property and enjoyed the funds he transferred to [his partner] by using her credit card for personal expenses.”

On Nov. 13, 2023, the Debtor commenced a Subchapter V bankruptcy case with approximately \$50,000 in assets and \$6 million in liabilities (including the approximately \$5 million judgment in favor of the class members—who were the Debtor’s most significant unsecured creditors). The Debtor proposed a Subchapter V plan under which distributions to creditors would be funded by \$1,700 in monthly payments by the Debtor and \$500,000 from the Debtor’s partner.

The lead plaintiff, on behalf of the class member creditors, opposed confirmation of the plan and filed a motion to convert the Subchapter V case to a liquidating case under Chapter 7, arguing that the Debtor was

acting in bad faith in proposing a plan based on settling the approximately \$6.7 million in fraudulent transfer claims against his partner—an “insider” as defined by the Bankruptcy Code—for merely \$500,000. In response, the Debtor sought to authorize the Subchapter V trustee to pursue the fraudulent transfer claims on the Debtor’s behalf to address the apparent conflict of interest in the Debtor’s pursuit of such claims. The lead plaintiff opposed this request, contending that there is no basis under the Bankruptcy Code or existing case law for giving a Subchapter V trustee the authority to pursue avoidance actions against third parties. The Subchapter V trustee supported the lead plaintiff’s request stating that, based on his research, the trustee’s duties could only be expanded to include investigative powers and reporting to the court—not the power to prosecute claims or administer assets.

The bankruptcy court agreed, holding that it lacked authority to authorize the Subchapter V trustee to commence litigation to recover on the fraudulent transfer claims absent the consent of the parties. The bankruptcy court further concluded that expanding the trustee’s powers just to allow an investigation and report, as allowed under section 1183, would be a half-measure and cause needless delay. In light of this, the Bankruptcy Court decided to convert the case to Chapter 7 so a Chapter 7 trustee may investigate and pursue the claims. The Debtor appealed the decision to the U.S. District Court for the Southern District of New York.

### THE DISTRICT COURTS’S DECISION

The District Court affirmed the Bankruptcy Court’s decision to convert the case to Chapter 7. That included affirming the Bankruptcy Court’s holding that the court lacked authority to permit the Subchapter V trustee to prosecute the estate’s fraudulent transfer claims.

The District Court explained that the Debtor had failed to cite any case law supporting his position that a Subchapter V trustee has the power to commence litigation to recover on estate causes of action. For example, in *In re Corinthian Communications*, the U.S. Bankruptcy Court for the Southern District of New York expanded the powers of a Subchapter V trustee, but only to investigate the affairs of the debtor and report to the bankruptcy court as permitted by the Bankruptcy Code section 1183.

The District Court was also influenced by a previous decision by the U.S. Bankruptcy Court for the Southern District of Texas in *In re Turkey Leg Hut & Co. LLC*. In that case, a Subchapter V trustee had filed a complaint on behalf of the debtor’s estate to enjoin the spouse of the debtor’s representative from interfering with the debtor’s affairs. The Houston-based bankruptcy court



reviewed all of the duties bestowed on a Subchapter V trustee under section 1183 of the Bankruptcy Code and concluded that “[n]one of the subchapter V trustee’s general duties authorize the Subchapter V Trustee to pursue claims belonging to the estate, [or] on behalf of the estate.” Rather, the Houston bankruptcy court held that the debtor-in-possession has exclusive standing to pursue estate causes of action.

The *Ghatanford* decision isn’t all bad for creditors. The decision states that a Subchapter V trustee cannot be enlisted to pursue avoidance actions—such as preferences—against trade creditors. The decision also shows that interested creditors may put pressure on a debtor by seeking to convert the Subchapter V case to Chapter 7 in the event they believe there are valuable estate causes of action that the Subchapter V debtor will not diligently pursue. But regardless, the *Ghatanford* case illustrates the adverse impact the absence of a creditors’ committee may have on unsecured creditors in a Subchapter V case. A creditors’ committee might have uncovered the significant fraudulent transfer claims via an investigation funded by the debtor’s estate and might then have had a path to negotiate a Chapter 11 plan under which the committee could have appointed a litigation trustee with funding to pursue the estate’s fraudulent transfer claim against the debtor’s insider. However, in the absence of a creditors’ committee, the individual creditors had to expend their own time and resources representing their interests in the case. **BC**



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