



## New York Bankruptcy Court Ruling Highlights Subchapter V Trustee's Role in Small Business Bankruptcy Case

The Bankruptcy Code contemplates that a Subchapter V trustee act as the proverbial “honest broker” of small business bankruptcies. Unlike traditional chapter trustees, the Subchapter V trustee is uniquely charged with the statutory duty to *facilitate* the development of a consensual plan of reorganization. This duty calls upon the trustee to act more as a mediator than an adversary or party in interest.

Rule 9019 of the Federal Rules of Bankruptcy Procedure is a powerful mechanism to aid the Subchapter V trustee's satisfaction of this mandate. The rule provides that “[o]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement,” thus providing a path to memorialize and bind the estate to any proposed resolutions brokered by the Subchapter V trustee amongst the parties. While public policy generally favors compromise and settlement over costly and protracted litigation, the bankruptcy court has sole discretion to approve any such resolution.

In a recent decision in *In re Mallett, Inc.*, No. 21-11619 (JLG), 2024 WL 150628 (Bankr. S.D.N.Y. Jan. 12, 2024), the Honorable James L. Garrity, Jr. of the United States Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”) approved a compromise brokered by the Subchapter V trustee amongst certain non-debtor affiliate entities to bring a final resolution to an underlying controversy between the non-debtor affiliates and the debtor's landlord.

At the heart of that controversy was the final allowance of the non-debtor affiliates' general unsecured claims, which jeopardized the landlord's substantial recovery under the debtor's confirmed plan of reorganization. The plan allowed the full aggregate sum of the non-debtor affiliates' claims as listed in the debtor's schedules, totaling \$11,879,791. Aside from minimal administrative expense claims (which must be paid in full, ahead of general unsecured claims), the only other claims against the estate were additional general unsecured claims totaling \$2,207,819, which were almost entirely held by the debtor's landlord for a pre-petition judgment and lease-rejection damages.

The Subchapter V trustee attempted to facilitate negotiations between the affiliates and the landlord. When discussions with the landlord failed, the trustee brokered a compromise among the affiliates, who agreed to reduce their respective claims by 15% in exchange for the claims' allowance in the aggregate sum of \$10,097,823. The Subchapter V trustee then moved under Bankruptcy Rule 9019 to approve the compromise with the Bankruptcy Court. Even though the proposed compromise improved the landlord's recovery to 27.5 cents on the dollar (up from 24 cents), the landlord objected.

The Bankruptcy Court balanced seven interrelated factors to determine whether the proposed compromise was fair and equitable in accordance with the Second Circuit's decision in *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007), finding that each factor weighed in favor of approving the compromise over the landlord's objection as follows:

*Factor 1 – Litigation's Possibility of Success and the Compromise's Future Benefits.* In an extensive analysis, the Bankruptcy Court acknowledged that while the landlord would not likely succeed in challenging the sufficiency of the documentation supporting the non-debtor affiliates' claims and asserting the applicable statute of limitations, it possibly could succeed in re-characterizing some of the affiliates' claims as equity. Nevertheless, the Bankruptcy Court held that this limited prospect of success with respect to reducing the non-debtor affiliates' claims did not tip the scales against the overwhelming benefits to the estate offered by the compromise.

*Factor 2 – The Costs, Inconveniences, and Risks Associated with Litigation.* The Bankruptcy Court held that even if litigation were to be solely between the landlord and the affiliates, the claim objections would be complex and time-consuming to resolve.

*Factor 3 – The Creditors' Paramount Interests and Their Positions on the Compromise.* The Bankruptcy Court reasoned that while the 3.5% increase in recovery was modest from the landlord's perspective, this interest was not paramount amongst the body of unsecured creditors. The compromise offered all of the non-affiliate creditors (not just the landlord) better recoveries than those encompassed under the debtor's plan, and the entire estate stood to benefit from avoiding continued litigation.

*Factor 4 – Whether Other Parties in Interest Support the Compromise.* This factor was immaterial to the Bankruptcy Court's consideration.

*Factor 5 – The Competency and Experience of Counsel.* The Bankruptcy Court noted that the Subchapter V trustee and the affiliates were represented by skilled counsel during the compromise's negotiations.

*Factor 6 – The Nature and Breadth of Any Proposed Releases.* The compromise did not include any proposed releases.

*Factor 7 – Whether the Compromise Is the Product of Arm's-Length Bargaining.* The Bankruptcy Court held that there was nothing to suggest that the Subchapter V trustee's negotiations with the non-debtor affiliates were collusive or without due care.

Based upon the foregoing, the Bankruptcy Court granted the Subchapter V trustee's motion to approve the proposed compromise.

## **Conclusion**

The recent decision *in In re Mallett, Inc.* highlights the important and unique role that the Subchapter V trustee serves in facilitating the efficient administration of the bankruptcy estate in a small business bankruptcy case. The Subchapter V trustee took an active and meaningful role in the case, utilizing Bankruptcy Rule 9019 to facilitate a compromise and prevent protracted litigation in a particularly contentious reorganization.

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