By Richard R. Thames

Sub V and the Condo Association: A Not-so-Perfect Solution

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

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The Small Business Reorganization Act of 2019 (SBRA), codified at 11 U.S.C. § 1181-1195, created a new subchapter of reorganizations known as subchapter V "to streamline the bankruptcy process by which small business debtors reorganize and rehabilitate their financial affairs."[1] Among the many advantages of subchapter V is the ability to confirm a reorganization plan without an accepting class or application of the absolute-priority rule. Subchapter V also permits a debtor to simply devote projected disposable income toward funding a reorganization plan over a three-to-five-year period.[2] One might be tempted to believe that subchapter V is the perfect solution for dealing with large judgments or liability claims against condominium associations. But as noted sportscaster Lee Corso would say, "Not so fast, my friend."

Consider the typical condominium association — it is usually set up as a nonprofit corporation responsible for maintaining the common areas of a condominium complex, with the individual unit owners being the "members" of the association. The common areas are either owned by the association itself, or, as is the case in Florida, by the members of the association as tenants in common. Management is vested in a board of directors whose duties are derived from the declarations of the condominium (referred to herein as "declarations") running with the land. Expenses are paid through assessments against the members. Budgets are usually set on an annual basis, with the directors maintaining the right to make special assessments to meet extraordinary expenses with the consent of a designated percentage of the members.

For the most part, condominium associations pay their bills in a timely fashion and, as a consequence, will usually not have debts beyond those necessary to fund capital improvements. However, the condominium association may occasionally encounter unexpected repair bills, personal-injury claims or attorneys' fees for various forms of litigation.

With the relaxed confirmation standards of subchapter V, one might be tempted to think that subchapter V is the perfect solution for dealing with such issues, particularly the ability to confirm a plan over the objection of a problematic creditor. However, the unique attributes of a condominium association do not lend themselves to such an easy option, making the subchapter V reorganization path far from certain.

Issue of Retained Collection Rights

The most difficult hurdle for a condominium association debtor to overcome may be the best-interests-of-creditors test embodied in 11 U.S.C. § 1129(a)(7), made applicable to subchapter V cases by virtue of § 1191(a), which states:

> (7) With respect to each impaired class of claims or interests —
>
> (A) each holder of a claim or interest of such class —
>
> (i) has accepted the plan; or
>
> (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive *or retain* if the debtor were liquidated under chapter 7 of this title on such date.[3]

In the typical chapter 11 case, the best-interests test is met by simply establishing the value of the debtor's assets, then deducting administrative expenses, secured claims and the costs of liquidation to derive the potential "pot" distributable to creditors. However, a condominium association is a different animal, as it is established by declarations running with the land and will continue to exist until terminated in accordance with state law. Because there is no discharge available to a corporate debtor, the question arises as to whether a creditor's *retained* post-chapter 7 collection rights must be considered in the best-interests-of-creditors analysis.

A very strong argument can be made that they must. The analysis begins with a comparison of § 1129(a)(7) to the best-interests tests found in §§ 1325, 1225 and 1173. Under § 1325(a)(4), the

1 H.R. Rep. No. 116-71, at 1 (2019).
2 11 U.S.C. § 1191(c)(2).
3 11 U.S.C. § 1129(a)(7) (emphasis added).

chapter 13 best-interests test limits the court's analysis to the value to be distributed from a liquidation of "*the estate of the debtor*." Section 1225(a)(4) employs the same terminology. Subchapter IV, titled "Railroad Reorganizations," also contains a best-interests-of-creditors test that, like the chapter 12 and 13 tests, focuses on the value to be received following a liquidation of the railroad lines and "*the other property of the estate*."[4] Section 1129(a)(7) contains no such limitation. Because Congress chose not to reference "property of the estate" in § 1129(a)(7) when it expressly did so in §§ 1325(a)(4), 1225(a)(4) and 1173(a)(2), it is presumed that the omission was intentional:

> [W]hen Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.[5]

Keep in mind that the courts must also interpret statutes in a manner that gives meaning to every term contained within the statute. Arguably, any interpretation of § 1129(a)(7) that fails to account for the value of the creditor's *retained* rights would render the retention language contained within the statute superfluous.

Surprisingly, very few courts have tackled this issue in the condominium association context. *In re Oak Park Calabasas Condominium Association*[6] from California appears to be directly on point. In this case, the creditor objected to a reorganization plan that did not provide for full payment of its claims, arguing that since the association would continue to exist following a chapter 7 proceeding, the claim would eventually be paid in full from future assessments. The court agreed:

> In general, chapter 7 results in the liquidation of non-individual debtors since there are no exemptions to allow them to maintain assets or other property. In most cases this means that no debtor entity would remain from which ECC [Construction Inc.] could collect. But a homeowner association is unique, since California law requires that it continue to exist and collect monies from the homeowners and that only a portion of those amounts are exempt from execution. Therefore, a homeowner association would survive chapter 7 and so would its liabilities.... Since the [homeowners' association] cannot be liquidated and it or its alter-ego must continue to operate, there will be a source of repayment for creditors even after the trustee administers and distributes all assets of the estate.[7]

The *In re Oak Park Calabasas Condominium Association* court thus held that § 1129(a)(7)(A)(2) requires that the right of the judgment creditor to levy on future assessments be included in the analysis:

> Section 1129(a)(7)(A) requires that a holder of a claim who has not accepted the plan must (1) receive or retain property under the plan, which has a value on the effective date, (2) which is at least as much as the holder would receive *or retain* if the debtor were liquidated under chapter 7 on the plan's effective date.... [B]ecause 11 U.S.C. § 102(5) states that "or" is not exclusive, *I need to determine not only the amount that ECC [Construction Inc.] would receive through the Plan or from a chapter 7 trustee, but the present value as of the effective date of any remaining right to execute on its judgment*.[8]

In re Oak Park Calabasas Condominium Association is consistent with other decisions focusing on the retention language of § 1129(a)(7), including *In re Quigley Co. Inc.*[9] and *In re Ditech Holding Corp.*[10] Therefore, § 1129(a)(7) may prove to be an insurmountable hurdle for achieving plan confirmation for a condominium association absent payment of creditor claims in full.

Chapter 7 Trustee's Assessment Rights

An entirely different result may arise in a jurisdiction that does not include post-chapter 7 collection rights in the best-interests analysis. In that situation, the creditor might be tempted to argue that the chapter 7 trustee can step into the directors' shoes to directly assess the members to satisfy claims against the estate. That is not necessarily the case, however.

A chapter 7 trustee derives authority from § 704 of the Bankruptcy Code, which requires the trustee to, among other things, "collect and reduce to money the property of the estate [that] such trustee serves." While "property of the estate" is generally construed broadly, in the condominium association context "property of the estate" includes only those receivables and assessments owed as of the petition date or, in the hypothetical liquidation scenario, on the conversion date. Future assessments *are not* property of the estate, and the trustee has no right to assess or collect same.

A case on point is Florida's *In re Westwood Community Two Association Inc.* case.[11] The chapter 7 trustee assessed the members for the amounts needed to satisfy the claims against the estate. A committee of condominium owners objected, arguing that the trustee did not have the authority to make the assessment. The bankruptcy court disagreed, finding further that the committee members did not have standing to challenge the assessment.

On appeal, the Eleventh Circuit found that as aggrieved persons, the committee had standing to challenge the assessment.[12] The bankruptcy court's decision was reversed and remanded back for further proceedings.[13] At that point, the bankruptcy court reversed itself and found that the trustee had no authority to make the assessment. The committee of unit owners then filed and successfully pursued an action against the chapter 7 trustee and his professionals to require

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4 11 U.S.C. § 1173(a)(2).
5 *Barnhart v. Sigmon Coal Co. Inc.*, 534 U.S. 438, 452 (2002) (internal quotations omitted).
6 302 B.R. 665 (Bankr. C.D. Cal. 2003).
7 *Id.* at 673.
8 *Id.* at 667 (emphasis added).
9 437 B.R. 102 (Bankr. S.D.N.Y. 2010) (rights of nonsettling defendants to pursue derivative claims against third parties must be considered under best-interests test).
10 606 B.R. 544 (Bankr. S.D.N.Y. 2019) (valuation of creditors' successor-liability claims against third parties was necessary component of best-interests test).
11 266 B.R. 223 (S.D. Fla. 2001).
12 *In re Westwood Cmty. Two Ass'n Inc.*, 293 F.3d 1332 (11th Cir. 2002).
13 *Id.* at 1338.

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disgorgement of the funds, which he collected under the illegal assessment. On subsequent appeal, the Eleventh Circuit determined that the disgorgement was proper because the *members' funds* were not property of the estate and therefore could not be administered by the chapter 7 trustee:

> [W]e affirm the district court's order affirming the bankruptcy court's disgorgement of fees because the DZ Firm had no right to keep the interim fees it received [that] it [had] derived from funds that were not property of the estate, *but instead were the proceeds of an improper assessment against non-debtor property*.[14]

However, that same rule does not apply to state court proceedings where a creditor has a right to pursue the appointment of a receiver to collect a judgment against a condominium association by means of assessment, as state court receivers are not bound by the "property of the estate" limitations of § 704. The inclusion or exclusion of a creditor's retained collection rights in the best-interests analysis will thus have a huge impact on the creditor's treatment under a subchapter V plan.

The Duty of Assessment

Another issue yet to be addressed in the subchapter V context is whether a condominium association debtor can meet the "good faith" requirements of § 1129(a)(3) without assessing its members to pay creditor claims in full, as the directors are still charged as fiduciaries with maximizing the value of the bankruptcy estate.[15] However, this duty was not eliminated on subchapter V's enactment.[16] At least one pre-SBRA court has held that directors cannot simply avoid their statutory, common law and contractual duties to assess members to pay a condominium association's bills because of any perceived hardships on the members:

> Without support in law or logic, the bankruptcy court imports and applies "the business-judgment rule" to free the Association from the fundamental obligations required by statute and memorialized in the Declaration. But the business-judgment rule is no license for a condominium association to break with impunity from an obligation that in the moment displeases the Association. If the Association can exploit the business-judgment rule to escape paying for repair of the common elements, the Association may use the business-judgment rule to escape honoring any purportedly binding document or contract, and each agreement the Association enters is entirely illusory because [they would be] only in effect so long as the Association benefits. This reasoning, like the conclusion that the unit owners may vote to rescind a binding obligation, is untenable.[17]

There is no reason to believe that this principle has changed in the subchapter V context.

Conclusion

Although subchapter V is a game-changer for many small businesses, it is no sure path for eliminating large judgments or claims against a condominium association. Therefore, practitioners must be leery of promising the elimination of extraordinary debts through the subchapter V process. The prospects of paying problematic claims over a three-to-five-year period may nonetheless justify subchapter V relief — even if the desired "haircut" is unavailable. abi

14 *In re Westwood Cmty. Two Ass'n Inc.*, Case No. 05-13753, 2006 WL 940647, *1 (11th Cir. April 12, 2006) (emphasis added).

15 *In re Innkeepers USA Trust*, 442 B.R. 227, 235 (Bankr. S.D.N.Y. 2010) ("In a bankruptcy case, it is 'Bankruptcy 101' that a debtor and its board of directors owe fiduciary duties to the debtor's creditors to maximize the value of the estate.").

16 *See, e.g., In re SRAK Corp.*, Case No. 22-40931, 2023 WL 2589252, *4 (Bankr. N.D. Tex. March 21, 2023) (subchapter V plan should be "proposed with the legitimate and honest purpose of effectively reorganizing the Debtor and maximizing the recovery to creditors in accordance with the priorities set forth in the Bankruptcy Code").

17 *In re Colony Beach & Tennis Club Ass'n Inc.*, 456 B.R. 545, 558-59 (M.D. Fla. 2011).