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# UNDERSTANDING A SMALL BUSINESS REORGANIZATION UNDER NEW SUBCHAPTER V OF THE BANKRUPTCY CODE: DIFFERENCES FROM A TRADITIONAL CHAPTER 11, ITS IMPACT ON TRADE CREDITORS, AND HOW IT HAS WORKED SO FAR

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# SMALL BUSINESS REORGANIZATION ACT

## SUMMARY

- Small Business Reorganization Act of 2019 (“SBRA”) added new Subchapter V to the Bankruptcy Code
- New Subchapter V is
  - Still part of Chapter 11
  - Generally a Chapter 11 filing, but with modifications
    - Modifications are intended to streamline the process
      - More efficient for the debtor
      - Less expensive for the debtor
    - But strips away certain elements of a traditional Chapter 11 that are beneficial to creditors

# SMALL BUSINESS REORGANIZATION ACT

## SUMMARY

- SBRA adds new Subchapter V to Bankruptcy Code
  - Effective for all cases filed after February 19, 2020
  - For small business debtors
    - Debtor's aggregate, noncontingent, liquidated, secured and unsecured debt cannot exceed \$7,500,000
      - When SBRA became law, Subchapter V threshold was originally \$2,725,625
      - CARES Act increased eligibility threshold to \$7,500,000
        - » March 27, 2021 sunset, at which time eligibility threshold would revert back to \$2,725,625
        - » COVID-19 Bankruptcy Relief Extension Act signed into law on March 27, 2021 extends increased \$7,500,000 threshold for another year, through March 27, 2022
        - » Extended again in 2022 for another two years
          - » Expectation is that increased threshold will become permanent

# SMALL BUSINESS REORGANIZATION ACT

## ELIGIBILITY

- Generally, a “small business debtor” is a business entity or individual
  - “engaged in commercial or business activities”
  - with noncontingent, liquidated debts of not more than \$7,500,000
    - at least 50% of which is business debt
  - Bankruptcy Code excludes certain debtors from the small business designation, including
    - any debtor whose primary business is owning single asset real estate
    - any member of a group of affiliated debtors that has aggregate debts in excess of the debt limit
    - any corporate debtor subject to the reporting requirements of the Securities Exchange Act of 1934 (SEA)
    - any debtor that is affiliated with an “issuer,” as defined in the SEA

# SMALL BUSINESS REORGANIZATION ACT

## SIMILARITIES WITH CONVENTIONAL CHAPTER 11

- Automatic stay
  - Allows breathing room for debtor to reorganize
- Ability to reject burdensome contracts
- Ability to reject burdensome leases for underperforming or unneeded locations
- Ability to sell assets free and clear of liens, claims and encumbrances
  - Good option to monetize assets if reorganization is not primary focus or is otherwise not viable
- Ability to obtain debtor-in-possession financing

# SMALL BUSINESS REORGANIZATION ACT

## KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- No automatic appointment of creditors' committee
  - Instead, a Subchapter V trustee is appointed from a panel of Subchapter V trustees
    - Trustee has limited powers versus a traditional Chapter 7 trustee – more of an oversight role
      - Monitor debtor's compliance with SBRA requirements
      - Facilitate development of consensual plan of reorganization
      - Ensure debtor commences making timely payments under the plan
      - In the event of gross mismanagement by the debtor, trustee can be empowered to take over debtor's business
  - Keeps case less expensive – creditors' committees can be a drain on estate resources – but strips unsecured creditors from having a seat at the table in the same manner as in a traditional Chapter 11
  - A committee can be appointed, though, on request of any party-in-interest and upon approval of the court “for cause”
    - Cumbersome process and not a given that court will approve the request

# SMALL BUSINESS REORGANIZATION ACT

## KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- Trustee's role primarily consists of
  - Oversight
  - Reconcile claims
  - Object to debtor's discharge, if appropriate
  - Investigate the debtor's finances and operations if the court so orders
  - Appear at any status conference and hearings concerning valuation of property subject to a lien, plan issues, and sale of property of the estate
  - Ensure that debtor commences making plan payments timely
  - Take over operation of debtor if debtor-in-possession is removed for cause
  - Facilitate development of a consensual plan of reorganization

# SMALL BUSINESS REORGANIZATION ACT

## KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- Status conference within first 60 days of case
  - Purpose is to “to further the expeditious and economical resolution of a case under this subchapter”
- At least 14 days prior to status conference, debtor must file a report with the court that outlines steps it is taking to reach a consensual plan of reorganization

# SMALL BUSINESS REORGANIZATION ACT

## KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- Plan filing
  - Only debtor may file a plan – debtor retains exclusive right to file a plan
    - In traditional Chapter 11, after expiration of “exclusive period” for debtor to file a plan, other parties may file a plan
  - No requirement for a separate disclosure statement
    - Combined plan and disclosure statement that includes
      - Brief history of debtor’s business
      - Liquidation analysis
      - Projections showing debtor’s ability to make plan payments
  - Must be filed within 90 days of commencement of bankruptcy case absent extension
    - Extension can only be granted if based on circumstances beyond debtor’s control
    - Moves much more quickly than traditional Chapter 11

# SMALL BUSINESS REORGANIZATION ACT

## KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- Modified plan confirmation standards that greatly benefit small business debtors
  - Modification of absolute priority rule
    - In traditional Chapter 11, debtor's ownership may not retain equity over an impaired creditor's objection unless unsecured creditors are paid in full (or existing ownership injects new capital into the business)
    - Under SBRA, existing owners may retain ownership of the business, even without paying unsecured creditors in full, if debtor pays unsecured creditors all "projected disposable income" over a three-to-five year period
      - "Disposable Income" is defined under the Code as "income that is received by the debtor and that is not reasonably necessary to be expended . . . for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor."  
11 U.S.C. § 1191(d)

# SMALL BUSINESS REORGANIZATION ACT

## KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- Modified plan confirmation standards that greatly benefit small business debtors (cont'd.)
  - Modification of absolute priority rule (cont'd.)
    - Payment of administrative claims:
      - Traditional Chapter 11: must be paid in full at confirmation in order to confirm plan
      - Subchapter V: can be paid over time under the terms of a plan
        - » Administrative claims do not need to be paid at confirmation in order to obtain confirmation of plan

# SMALL BUSINESS REORGANIZATION ACT

## KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- Modified plan confirmation standards that greatly benefit small business debtors (cont'd.)
  - Impairment – no creditor support required to confirm a Subchapter V plan
    - Traditional Chapter 11: at least one class of impaired creditors must vote to accept plan in order to for plan to be confirmed
    - Subchapter V: No requirement that at least one class of impaired claims accept the plan
      - Plan can be confirmed (assuming debtor proves to the court that plan is confirmable) even without a single class of impaired creditors voting to accept plan

# SMALL BUSINESS REORGANIZATION ACT

## KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- Modified plan confirmation standards that greatly benefit small business debtors (cont'd.)
  - Plan must provide “fair and equitable” treatment of creditors
    - In a Subchapter V bankruptcy, “fair and equitable” treatment means
      - With respect to unsecured claims, the plan must provide that the debtor’s projected disposable income for a three- to five-year period will be applied to plan payments, or for the debtor to distribute an equivalent value of property under the plan
        - » Debtor’s financial projections must also show that there is a reasonable likelihood that the debtor will be able to make all payments under the plan
        - » Plan must provide remedies in case the debtor defaults on payments

# SMALL BUSINESS REORGANIZATION ACT

## KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- No quarterly US Trustee fees
- If debtor completes all plan payments, it is discharged from remaining debts
- Subchapter V plan may modify the rights of a secured creditor that holds a security interest in real property that is the principal residence of the debtor if the loan proceeds were not used to purchase the real property and were used in connection with the small business

# SMALL BUSINESS REORGANIZATION ACT

## KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- Debtor can be removed as debtor-in-possession and stripped of right to operate debtor “for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor”
- If that happens, Subchapter V trustee takes over operation of debtor
  - Creditors are stuck with the Subchapter V trustee, whoever that is, running the business through bankruptcy
  - No basis in Subchapter V to elect or appoint a different trustee
    - Only if case is converted to Chapter 7

# SMALL BUSINESS REORGANIZATION ACT

## IMPACT ON SUPPLIERS

- Suppliers still retain the same general rights and remedies available as in a traditional Chapter 11
  - Secured and unsecured claims
  - 503(b)(9) claims
  - Reclamation
  - Seek to compel assumption / rejection of contracts and leases in appropriate circumstances
  - Object to plan (subject to modified confirmation standards in Subchapter V)
  - Sell or not sell to a debtor post-bankruptcy

# DECEMBER 2020 APPROPRIATIONS BILL

## IMPACT ON BANKRUPTCY

- Consolidated Appropriations Act
  - Signed into law on December 27, 2020
  - Temporarily extends bankruptcy relief provisions that were enacted as part of the CARES Act
  - New provisions expire on December 27, 2022

# DECEMBER 2020 APPROPRIATIONS BILL

## IMPACT ON BANKRUPTCY

- PPP loans
  - Makes it clear that debtors in bankruptcy are eligible to receive PPP loans
    - Amends Bankruptcy Code to permit debtors to seek authority to obtain PPP funding on an expedited basis
    - Voids contractual provisions and non-bankruptcy law that prohibit a debtor from incurring other debt
    - PPP loans received post-bankruptcy are entitled to administrative priority status (if not forgiven)
      - Administrative claims must be paid in full, ahead of general unsecured claims
      - New law allows SBRA debtors to pay loan over time, according to standard loan repayment terms, rather than immediately at plan confirmation (different from other administrative claims)

# DECEMBER 2020 APPROPRIATIONS BILL

## IMPACT ON BANKRUPTCY

- Greater tenant protections
  - For two years, Chapter 11 debtors will have 90 additional days to decide whether to assume or reject nonresidential (i.e., commercial) real estate leases
    - Formerly had 120 days
    - Now have 210 days (with the possibility of extension to 300 days on request to the court upon a showing of “cause” by the debtor)
      - Additional extensions require consent of applicable landlord
    - Any claim arising from this extension is treated as an administrative priority expense for purposes of confirmation of a Subchapter V plan
      - Which can be paid over time under a Subchapter V plan
    - This amendment is effective through December 27, 2022, but the provisions continue to apply to bankruptcy cases filed before the sunset date

# DECEMBER 2020 APPROPRIATIONS BILL

## IMPACT ON BANKRUPTCY

- Greater tenant protections (cont'd.)
  - Bankruptcy courts may now extend SBRA debtor's time to pay postpetition rent on nonresidential real property leases if experiencing material financial hardship due to COVID
    - Formerly could not extend beyond 60 days after bankruptcy filing
    - Now can extend up to 120 days after filing if the “debtor is continuing to experience a material financial hardship due, directly or indirectly, to the coronavirus disease 2019 (COVID-19) pandemic”
    - In addition, Subchapter V debtors that receive this extraordinary relief may repay the delayed administrative rent over time under Subchapter V plan rather than in full at plan confirmation
      - This means that a Subchapter V debtor may not only delay payment of rent for the first 120 days of its bankruptcy case, but may also stretch that deferred rent out over 3-5 years after plan confirmation

# DECEMBER 2020 APPROPRIATIONS BILL

## IMPACT ON BANKRUPTCY

- New Section 547(j) added to Bankruptcy Code relating to forbearance agreements with landlords and vendors
  - Protection from preference liability for payments made to, and received by, landlords and vendors after entry into a forbearance agreements after March 13, 2020
  - Intended to incentivize landlords and vendors to enter into forbearance agreements with their tenants / customers
    - Applies so long as forbearance agreement covers amounts agreed to under a contract or lease before March 13, 2020 or that came due under supply contracts executed before March 13, 2020

# DECEMBER 2020 APPROPRIATIONS BILL

## IMPACT ON BANKRUPTCY

- Section 547(j) prevents a debtor or trustee from recovering the following pre-bankruptcy payments as a preference:
  - “rental arrearages” in connection with an “agreement or arrangement” made between a commercial landlord and tenant on or after March 13, 2020 “to defer or postpone rent and other periodic charges”; or
  - “supplier arrearages” in connection with an “agreement or arrangement” made on or after March 13, 2020 between a company and a “supplier of goods or services to defer or postpone the payment of amounts due under an executory contract for goods and services”

# SUBCHAPTER V BANKRUPTCIES

## DEVELOPING CASE LAW AND CURRENT TRENDS

- Early after enactment of SBRA, parties (both debtors and creditors) and their counsel were faced with uncertainties in light of the lack of any case law clarifying vagaries under Subchapter V
- Now, some case law has developed to offer clarification on various points

# SUBCHAPTER V BANKRUPTCIES

## ELIGIBILITY ISSUES

- *In re Ellingsworth Residential Community Association, Inc.*, 619 B.R. 519 (Bankr. M.D. Fla. 2020)
  - Nonprofit association satisfied requirement that Subchapter V debtors must be engaged in commercial or business activities
- *In re Thurmon*, No. 20-41400-can11, 2020 WL 7249555 (Bankr. W.D. Mo. Dec. 8, 2020)
  - Debtors were not eligible to proceed under Subchapter V because they ceased operating their businesses and sold their assets before filing the case and, thus, were not “engaged in commercial or business activities”

# SUBCHAPTER V BANKRUPTCIES

## ELIGIBILITY ISSUES

- *In re Offer Space, LLC*, No. 20-27480, 2021 WL 1582625 (Bankr. D. Utah Apr. 22, 2021)
  - Rejecting argument that section 1182 requires the debtor to be engaged in business operations and finding debtor was eligible because business activities does not mean business operations, and the debtor was engaged in business activities including, without limitation, (1) having active bank accounts; (2) having accounts receivable; (3) analyzing and exploring counterclaims in a lawsuit; (4) managing its stock; and (5) winding down its business and taking reasonable steps to pay its creditors and realize value for its assets
- *In re Blue*, No. 21-80059, 2021 WL 1964085 (Bankr. M.D.N.C. May 7, 2021)
  - Agreeing with *Offer Space* and finding that section 1182 does not require an operating business

# SUBCHAPTER V BANKRUPTCIES

## ELIGIBILITY ISSUES

- *In re Rickerson*, 2021 Bankr. Lexis 3403 (Bankr. W.D. Pa. 2021)
  - Debtor held not eligible for SBRA relief where at filing the entities through which she conducted her medical practice were no longer operating and she was working as an employee of an insurance company at filing

# SUBCHAPTER V BANKRUPTCIES

## ELIGIBILITY ISSUES

- *In re Johnson*, No 19-42063, 2021 WL 825156 (Bankr. N.D. Tex. Mar. 1, 2021)
  - The “engaged in” inquiry focuses on contemporaneous activity and assesses a debtor’s current state of affairs at the time of filing the bankruptcy petition, rather than focusing on previous or retrospective business activities which were present sometime in the past, and debtor, as an employee/president of non-debtor company is not “engaged in commercial or business activities” when “not engaged in buying or selling economic goods or services of their own for profit” or the debtors’ indirect profit

# SUBCHAPTER V BANKRUPTCIES

## ELIGIBILITY ISSUES

- All claims count toward aggregate debt limit
  - Both unsecured and secured claims
  - What happens if debtor files Subchapter V, claiming it is under debt limit, but it undervalues certain claims that would place it over debt limit?
    - No clear answer (yet)
  - Do contingent and unliquidated claims count?
    - At least one court says no – see next slide
  - *Regus* example
    - Court denied Subchapter V status where many affiliated single purpose LLCs filed separate cases
      - Each individually was under debt limit
      - But all operated together as a single integrated business operation

# SUBCHAPTER V BANKRUPTCIES

## ELIGIBILITY ISSUES

- *In re Serendipity Labs, Inc.*, 620 B.R. 679 (Bankr. N.D. Ga. 2020)
  - Debtor was not eligible under Section 1182 to proceed under Subchapter V because more than 20% of its voting stock was held by entity with publicly traded stock and, thus, qualified as an “issuer”

# SUBCHAPTER V BANKRUPTCIES

## ELIGIBILITY ISSUES

- *In re ENKOGS1, LLC*, 626 B.R. 860 (Bankr. M.D. Fla. 2021)
  - Finding hotel owner *and operator* was eligible to proceed under Subchapter V and rejecting argument that the debtor was a single asset real estate debtor
- *In re Caribbean Motel Corp.*, No. 21-01831-EAG, 2022 WL 50401 (Bankr. D.P.R. Jan. 5, 2022)
  - Finding *ENKOGS1* persuasive, and finding motel was eligible to proceed under Subchapter V, rejecting argument the debtor was a single asset real estate debtor

# SUBCHAPTER V BANKRUPTCIES

## ELIGIBILITY ISSUES

- *In re 218 Jackson, LLC*, No. 6:21-bk-00983-LVV, 2021 Bankr. LEXIS 2284 (Bankr. M.D. Fla. June 2, 2021)
  - Finding debtor was eligible to proceed under Subchapter V because the debtor owns two properties with two different purposes, and common ownership and financing were not sufficient to find a single project for purposes of analyzing whether debtor's primary activity was single asset real estate

# SUBCHAPTER V BANKRUPTCIES

## DEBT REQUIREMENTS

- *In re Wright*, No. 20-01035-HB, 2020 WL 2193240, at \*3 (Bankr. D.S.C. April 27, 2020)
  - Debtor who was not currently engaged in business operations qualified as “small business debtor” where 56% of its debt amounted to residual business debt
- *In re Parking Management, Inc.*, 620 B.R. 544 (Bankr. D. Md. 2020)
  - Neither post-petition rejection damages claims nor claims based on the undetermined obligation to repay PPP funds should be included in debt calculation for purposes of determining eligibility because the claims were contingent and unliquidated on the petition date

# SUBCHAPTER V BANKRUPTCIES

## DEBT REQUIREMENTS

- *In re 305 Petroleum, Inc.*, 622 B.R. 209 (Bankr. N.D. Miss. 2020)
  - Debts of jointly administered Subchapter V cases had to be aggregated with debts of affiliate single asset real estate debtor for eligibility purposes and, thus, the cases could not proceed under Subchapter V
- *In re McGrath*, 3:20-bk-03689-RCT, 2021 WL 1784079 (Bankr. M.D. Fla. Mar. 15, 2021)
  - Debtors were eligible to proceed under Subchapter V because the Bank owned the rents generated by their commercial property since before the petition date, and they owned no property that generated substantially all of their gross income

# SUBCHAPTER V BANKRUPTCIES

## “FAIR AND EQUITABLE” TREATMENT

- *In re Pearl Resources, LLC*, 622 B.R. 236 (Bankr. S.D. Tex. 2020)
  - Creditors objected to proposed Subchapter V plan because it “provides absolutely no specifics on the anticipated amount of Disposable Income, the dates when Disposable Income will be available, or even how Debtors will calculate or report Disposable Income.”
  - Court nonetheless confirmed the plan, giving great weight to uncontroverted testimony of debtor’s managing member that it is reasonably likely that the debtors will generate sufficient income to pay claims in full within two years
    - And if that fails, debtor has sufficient assets that it can sell to pay claims in full

# SUBCHAPTER V BANKRUPTCIES

## “FAIR AND EQUITABLE” TREATMENT

- *In re Ellingsworth Residential Community Association*, No. 6:20-bk-01346, 2020 Bankr. LEXIS 2897 (Bankr. M.D. Fla. Oct. 16, 2020)
  - Court found that proposed plan was fair and equitable based on testimony of debtor’s president that debtor, a homeowner’s association, could obtain \$300,000 to pay into the plan via a special assessment to be approved by debtor’s members
  - Court, however, also required debtor to obtain members’ approval of the assessment within a “reasonable time” after plan confirmation, absent which debtor would be in default under the plan

# SUBCHAPTER V BANKRUPTCIES

## RETROACTIVE SUBCHAPTER V ELECTION

- *In re Progressive Solutions, Inc.*, 615 B.R. 894 (Bankr. C.D. Cal. 2020)
  - Small business designated Chapter 11 debtor could retroactively proceed under Subchapter V after the case had been pending approximately 15 months
- *In re Glass Contractors, Inc.*, No. 20-40185 (Bankr. E.D. Tex. February 25, 2020)
  - Small business designated Chapter 11 debtor could retroactively proceed under Subchapter V after the case had been pending approximately one month

# SUBCHAPTER V BANKRUPTCIES

## RETROACTIVE SUBCHAPTER V ELECTION

- *In re Moore Props. of Person Cty., LLC*, No. 20-80081, 2020 WL 995544, at \*7 (Bankr. M.D.N.C. February 28, 2020)
  - Small business designated Chapter 11 debtor could retroactively proceed under Subchapter V when it was not a small business debtor as defined by the Bankruptcy Code when the case was originally filed and the case had been pending just over one week

# SUBCHAPTER V BANKRUPTCIES

## RETROACTIVE SUBCHAPTER V ELECTION

- *In re Double H Transp. LLC*, No. 19-31830-HCM, 2020 WL 2549850 (Bankr. W.D. Tex. March 5, 2020)
  - Chapter 11 debtor could not retroactively proceed under Subchapter V when the case had been pending more than three months
- *In re Body Transit, Inc.*, 613 B.R. 400 (Bankr. E.D. Pa. 2020)
  - Small business designated Chapter 11 debtor could retroactively proceed under Subchapter V when the case had been pending 48 days

# SUBCHAPTER V BANKRUPTCIES

## RETROACTIVE SUBCHAPTER V ELECTION

- *In re Bello*, 613 B.R. 894 (Bankr. E.D. Mich. 2020)
  - Chapter 13 debtor in converted case could retroactively proceed under Subchapter V when the converted case had been pending approximately two months
- *In re Ventura*, No. 8-18-77193-REG, 2020 WL 1867898 (Bankr. E.D.N.Y. April 10, 2020)
  - Chapter 11 debtor could retroactively proceed under Subchapter V even though creditor's plan of reorganization was scheduled for hearing on confirmation and case had been pending approximately 15 months

# SUBCHAPTER V BANKRUPTCIES

## RETROACTIVE SUBCHAPTER V ELECTION

- *In re Blanchard*, No. 19-12440, 2020 WL 4032411 (Bankr. E.D. La. July 16, 2020)
  - After U.S. Trustee filed motion to dismiss or convert case that had been pending approximately one month, Chapter 11 debtor could retroactively proceed under Subchapter V, and debtor did not need to be currently engaged in business operations to constitute a “small business debtor”

# SUBCHAPTER V BANKRUPTCIES

## RETROACTIVE SUBCHAPTER V ELECTION

- *In re Seven Stars on the Hudson Corp.*, 618 B.R. 333 (Bankr. S.D. Fla. 2020)
  - Retroactive Subchapter V election is not permissible if debtor cannot comply with 90-day deadline for filing plan
- *In re Easter*, 623 B.R. 294, 296 (N.D. Miss. 2020)
  - Small business designated Chapter 11 debtor could retroactively proceed under Subchapter V when the case had been pending 10 months and debtor was unable to confirm a plan

# SUBCHAPTER V BANKRUPTCIES

## RETROACTIVE SUBCHAPTER V ELECTION

- *In re Wetter*, 620 B.R. 243 (Bankr. W.D. Va. 2020)
  - Debtor could not retroactively proceed under Subchapter V because the 90-day plan deadline had passed and the facts and circumstances, including misrepresentations by the debtor, did not warrant modification of the deadline
- *In re Greater Blessed Assurance Apostolic Temple, Inc.*, No. 6:20-bk-00148-KSJ, 2020 WL 8458164 (Bankr. M.D. Fla. Dec. 17, 2020)
  - Debtor could not elect to retroactively proceed under Subchapter V when it filed its petition after SBRA's effective date and only made the Subchapter V election once it realized it could not confirm a plan

# SUBCHAPTER V BANKRUPTCIES

## RETROACTIVE SUBCHAPTER V ELECTION

- *In re Tibbens*, No. 19-80964, 2021 Bankr. LEXIS 654 (Bankr. M.D.N.C. Mar. 19, 2021)
  - Chapter 13 debtor could not retroactively proceed under Subchapter V because debtor was responsible for numerous delays in the administration of the Chapter 13 case and did not seek conversion until five months after the SBRA took effect

# CHANGES TO PREFERENCE LAW

## NEW PREFERENCE RULES BEGINNING IN 2020

- Small Business Reorganization Act of 2019 made some key changes to preference law
  - Effective for all cases commenced on or after 2/19/20
  - Contains provisions applicable to all preference cases (not just in small business cases)

# CHANGES TO PREFERENCE LAW

## NEW PREFERENCE RULES BEGINNING IN 2020

- Two major changes to preference law
  - Preference claims must now be “based on reasonable due diligence in the circumstances of the case and taking into account a party’s known or reasonably knowable affirmative defenses”
  - Venue threshold requiring that preference lawsuits must be brought in judicial district where defendant resides rather than where bankruptcy case is pending nearly doubled
    - Was \$13,650
    - Now \$25,000

# CHANGES TO PREFERENCE LAW

## NEW PREFERENCE RULES BEGINNING IN 2020

- What does it mean that preference claims must now be “based on reasonable due diligence in the circumstances of the case and taking into account a party’s known or reasonably knowable affirmative defenses”?
  - A debtor or trustee filing a preference lawsuit against you must first analyze your common defenses (i.e., ordinary course of business and subsequent new value) and must account for those defenses in the lawsuit
    - In the past, a debtor or trustee would file a preference lawsuit seeking to recover the gross transfers made within 90 days before the bankruptcy filing
      - » The burden was on the defendant to come forward with defenses
    - Now, the debtor or trustee must analyze and account for your defenses and can only seek to recover the net
      - » You can still assert defenses different than or additional to what the debtor or trustee notes in the complaint. But this new rule places a much greater burden on the debtor or trustee.

# CHANGES TO PREFERENCE LAW

## NEW PREFERENCE RULES BEGINNING IN 2020

- Helps to avoid the shakedown demand letter where unwitting defendants would write a check for the gross amount demanded without considering defenses
- Unfortunately, Congress did not include in the new law a penalty for the debtor or trustee's failure to account for your defenses (in good faith or at all)
  - Time will tell how courts deal with circumstances where a debtor or trustee fails to account for a preference defendant's defenses properly or at all
    - **Proactive Pointer**: Until courts offer some guidance, you should consider moving to dismiss a preference lawsuit and seeking sanctions (i.e., your attorneys' fees to dismiss the lawsuit) if this happens to you

# CHANGES TO PREFERENCE LAW

## NEW PREFERENCE RULES BEGINNING IN 2020

- New \$25,000 venue threshold
  - Highly beneficial to vendors – requires suit to be brought where defendant is located rather than where bankruptcy case is pending if amount sought is \$25,000 or more
- **Note:** Most courts agree that preference actions fall within this rule, but some courts have held that this rule does not apply to preference actions
  - SBRA 2019 did not fix this issue
  - Know the rule in the court where the bankruptcy case is pending to know your leverage before responding to a demand letter or lawsuit
- You might still receive a demand letter, but.....
  - In light of the other new rule requiring that the trustee take your known or reasonably knowable defenses into account, the demand letter cannot be a shakedown seeking the gross amount of transfers rather than the net.....or can it???

# CHANGES TO PREFERENCE LAW

## NEW PREFERENCE RULES BEGINNING IN 2020

- The new preference statute might be read to require the trustee to take your defenses into account only when bringing a lawsuit
  - A sneaky trustee might still send you a demand letter for the gross to try to extract more out of an unwitting vendor who is unaware of this new preference provision
    - **Proactive Pointer**: If this happens to you, consider defenses – do not pay the gross amount sought by the trustee without considering defenses first

# CHANGES TO PREFERENCE LAW

## NEW PREFERENCE RULES BEGINNING IN 2020

- Possible inconsistency in new statutory language – can the trustee play games to take advantage?
  - Trustee cannot file suit where bankruptcy case is pending for claims less than \$25,000
  - Trustee now must also take account of known or reasonably knowable defenses
    - Consider this scenario:
      - Gross transfers during 90-day preference period = \$30,000
      - Known or reasonably knowable defenses are largely ordinary course of business (i.e., highly subjective) – could be anywhere from = \$2,000 – 10,000
        - » Net preference = \$20,000 – 28,000

# CHANGES TO PREFERENCE LAW

## NEW PREFERENCE RULES BEGINNING IN 2020

- Under the foregoing scenario, the trustee could file suit in the district where the bankruptcy case is pending
  - Trustee would assert that the “known or reasonably knowable defenses” are only \$2,000
    - Net preference is \$28,000 which exceeds threshold requiring trustee to file suit in district where defendant is located
  - Can defendant then move to transfer venue to district where defendant resides?
    - Defendant would argue that “known or reasonably knowable” defenses were \$10,000
      - Net preference = \$20,000
        - » Below venue threshold
        - » Thus, trustee required to bring suit where defendant is located

# CHANGES TO PREFERENCE LAW

## NEW PREFERENCE RULES BEGINNING IN 2020

- The new preference statute does not provide any guidance on this scenario
  - The first courts to face this issue will make decisions based upon their reasoned judgment that will inform how courts subsequently address this issue

# QUESTIONS



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