The Small Business Reorganization Act And Its Evolving Case Law

By James S. LaMontagne

On Feb. 19, 2020, the Small Business Reorganization Act was enacted. The SBRA amended the Bankruptcy Code to add Subchapter V, a new streamlined Chapter 11 process for small businesses and individuals. It has now been almost a year and a half since its enactment and indications are that the SBRA is a success. According to the American Bankruptcy Institute's SBRA Resource Page, as of June 2021, 2,130 Subchapter V cases have been filed in the United States and the 2021 filings are outpacing the 2020 filings. As the Subchapter V cases have increased in number, the case law interpreting Subchapter V has also evolved, providing guidance to debtors, creditors and attorneys.

To date, many of the decisions entered in Subchapter V cases have tackled the issue of whether a debtor is eligible to be in Subchapter V but there have also been some interesting decisions addressing conversion to Subchapter V.

The cases that address debtor eligibility commonly revolve around the issue of whether a debtor is "engaged in commercial or business activities." In *In re Blue*, a North Carolina bankruptcy court ruled that to be "engaged" requires a debtor to be presently participating in business or commercial activities as of the petition date. The court then ruled that the debtor was engaged in business or commercial activities because the debtor was a part-time IT consultant for two clients (a delivery of service for profit) and while the debtor had another full-time job, nothing in section 1182 of the Code required that such activities be the debtor's only income. *In re Blue*, 2021 Bankr. LEXIS 1378 (Bankr. M.D.N.C. 2021).

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In *In re Offer Space, LLC*, 2021 Bankr. LEXIS 1077 (Bankr. UT 2021), the bankruptcy court ruled that a company that sold its assets and had no intention of resuming or reorganizing its business was still engaged in commercial or business activities by having active bank accounts and accounts receivable, managing the debtor's equity interests and winding down the business.

In contrast, the court in *In re Thurman*, 625 B.R. 417 (Bankr. W.D. MO. 2020), sustained the United States Trustee's objection to debtors' designation as a subchapter V small business debtor, as the debtor was not engaged in commercial or business activities on the petition date because the debtor had sold the business with no intent to return to it and was otherwise not active or involved in any commercial or business activities. The court ruled that keeping the empty shell of the former business entity open with the secretary of state's office did not render the debtor "engaged" in business activities.

In a decision decided shortly after SBRA was enacted, the court in *In re Wright*, 2020 LEXIS 1240 (Bankr. S.C. 2020), ruled that the definition of "small business debtor" was not limited to debtors currently engaged in business or commercial activities and allowed the debtor to proceed under Subchapter V even though he was "addressing residual business debt" from businesses that had ceased operating more than a year earlier. While the Wright decision was later followed in *In re Bonert*, 2020 Bankr. LEXIS 1783 (Bankr. C.D. Cal 2020), the support for this line of cases is weakening significantly.

Finally, on the issue of eligibility, and specifically, the issue of debt limits within Subchapter V, the bankruptcy court in *In re Parking Management*, 620 BR 544 (Bankr. MD 2020), held that the Subchapter V debtor's lease rejection claims (which caused the debtor to exceed the $7,500,00 Subchapter V debt limit) would not be considered in the debt limitation determination under section 1182 of the Code because the rejection claims were contingent claims as of the petition date.

Another issue that has garnered attention from the courts is whether or not to extend status conference and plan deadlines (60 and 90 days after the order for relief, respectively) (the "Deadlines") when a debtor converts to Subchapter V after the Deadlines have expired. Under the Code, the Deadlines can only be extended if the need for the extension is attributable to circumstances for which the debtor should not justly be held accountable.

In *In re Seven Stars on the Hudson Corp*., 618 B.R. 333 (Bankr. S.D. Fl 2020), the court denied a debtor's request to extend the deadlines after conversion, finding that where a debtor elects to proceed under Subchapter V after the statutory deadlines have passed, it cannot be said that the need for an extension of the deadlines is attributable to circumstances for which the debtor should not justly be held accountable. The court went on to write "that decision by a debtor should not foist upon creditors all of the added powers of a Subchapter V debtor without one of the most significant protections afforded to creditors — that the case proceed expeditiously."

Not all courts are as rigid as *Seven*

CASE LAW *continued on page 33*

Bankruptcy from page 30

rejection damages should be capped in bankruptcy cases. *See In re Kupfer*, 63 Banker. Ct. Dec. 136 (9th Cir. 2016). The "El Toro" test is considered a "simple" test that asks: Assuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than reject it?

Courts in the Third Circuit have followed the lead of the Ninth Circuit and similarly adopted the El Toro test. For now, the First Circuit has yet to adopt the El Toro test for determining what claims of a landlord are subject to the Section 502(b)(6) cap.

As the challenges of the COVID-19 pandemic continue to unfold, the burden of lease obligations may rise to the forefront. As tenants consider options, landlords must understand how claims may be treated if the tenant's possibilities include a potential bankruptcy filing and rejection of a lease. With that understanding, the landlord can consider lease modification requests or evaluate the risks of a bankruptcy filing.

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Tools from page 31

(Bankr. E.D. Cal. Dec. 15, 2020) (finding that the general nature of the allegations in the trustee's complaint suggested a lack of pre-filing due diligence, it dismissed the preference action). While the court granted the trustee leave to amend the complaint, presumably the trustee would need to allege the requisite due diligence to defeat a further motion.

Another court considering a motion to dismiss on the grounds that the trustee failed to plead facts necessary to satisfy the due diligence requirement declined to reach the question. Pointing to allegations in the complaint that noted the trustee had reviewed bank and wire records and invoices relating to the preference defendant transactions with the debtor, the court found that enough had been done to reach the prerequisite if one exists. *See In re Trailhead Eng'g LLC*, No. 18-32414, 2020 WL 7501938 (Bankr. S.D. Tex. Dec. 21, 2020).

Together, these opinions suggest that if a complaint is filed with no demand letter having been sent and it is lacking allegations that establish the trustee has assessed defenses, raising the issue will be a valuable tool to reach a better resolution for the defendant.

Recognizing the burden on defendants to defend away from their home jurisdiction, the SBRA also amended Section 1409(b) of Title 28, a venue provision, increasing the monetary threshold from $13,650 to $25,000. Actions to recover a non-consumer debt against a non-insider defendant below that amount must be brought where the defendant resides, not where the bankruptcy case is pending. It is unclear if the provision applies to preference actions and while the weight of authority suggests no, some courts have indicated it does. Compare *In re Munson, Inc.* 627 B.R. 507 (Bankr. C.D. Ill. 2021), with *Dynamerica Mfg. LLC v. Johnson Oil Co., LLC*, No. 08-11515 (KG), 2010 WL 1930269 (Bankr. D. Del. May 10, 2010). Raising venue in a smaller dollar case may also help achieve a favorable result.

Finally, newly enacted Section 547(j) provides a safe harbor for commercial landlords and sellers of goods and services who choose to work with businesses impacted by the pandemic. A debtor or trustee may not avoid payments (other than fees, penalties, or interest the debtor would have owed without the deferral) made by a debtor during the preference period for rent or supplier arrearages provided that the debtor and creditor amended the lease or contract after March 13, 2020, and the amendment deferred or postponed payments that were otherwise due under the lease or contract. The provision sunsets on Dec. 27, 2022, but still applies to cases filed before that date.

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Case Law from page 32

Stars however: *In re Trepetin*, 617 B.R. 841 (Bankr. MD. 2020) (extending deadlines because debtor acted timely in filing his requested extensions in connection with the conversion of his Chapter 7 and since a Chapter 7 debtor is not required or permitted to file a plan, the debtor has not been dilatory in the plan process itself and appears to have complied with all his obligations under Chapter 7 of the Code); *See also, In re Ventura*, 615 B.R. 1, 6 (Bankr. E.D.N.Y. 2020) and *In re Twin Pines*, LLC, 2020 Bankr. LEXIS 1217 (Bankr. NM 2020) (debtor, who commenced its Chapter 11 case as a small business case approximately one year before the SBRA went into effect, could amend its petition to elect subchapter V treatment 387 days after commencing the bankruptcy case, with the court exercising its discretion to grant an extension of the deadlines).

In conclusion, with an increasing number of Subchapter V cases will come good court decisions allowing debtors, creditors, attorneys and judges to better administer Subchapter V cases for the benefit of small business and individual debtors.

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