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Changes to Federal Bankruptcy Law Will Reduce Your Preference Risk

You run a small business. Your customer needs some extra time to get through a squeeze and you work with the customer to pay down the old balance over time. Suddenly, the customer files bankruptcy and two years later you get a demand letter from a contingent-fee lawyer representing a litigation trustee seeking 80% of <u>everything</u> the customer paid you in the 90 days before the bankruptcy filing. The letter doesn't acknowledge potential defenses to the alleged "preference" and threatens suit in an unfriendly bankruptcy court far, far from home for every penny you received in that 90-day window. Sometimes, the amount sought is so low, you feel compelled to settle to avoid getting even deeper in hole.

With the recently enacted "Small Business Reorganization Act," relief will soon be here. This act was primarily enacted to help small businesses with aggregate debts of less than $2,725,625. For these businesses (including sole proprietorships), as long as "projected disposable income" over the next five years is dedicated to paying old creditors, the new law will enable a small business chapter 11 debtor to keep its business assets without paying creditors

in full, without having to infuse new capital into the business, and without having to pay for the lawyers representing a "creditors' committee" (since no such committee will be formed).

Notably for purposes of this article, the last draft of the enacted bill slipped in two important changes to the law regarding preference litigation. First, any action against non-insiders seeking to recover non-consumer debts less than $25,000 in the aggregate must be commenced in the federal district court where the defendant resides. By way of example, if your customer's bankruptcy case was filed in Delaware, your business is principally based in another state, and the amount in dispute is less than $25,000, then the litigation must be commenced in the federal district court where your business resides, not where the bankruptcy is located. This change alone will significantly deter litigation below the $25,000 jurisdictional threshold since most litigation trustees will not find it cost effective to commence such small-dollar litigation outside of the debtor's home bankruptcy forum.

Second, as a condition to even filing the preference complaint, the new law now requires that the litigation trustee conduct "reasonable due diligence, … taking into account a party's known or reasonably knowable affirmative defenses" (the most common of which are the "ordinary course" and "new value" defenses).

These two features of the new law significantly protect out-of-state preference defendants. Suppose you received $49,000 in total payments in the 90 days before the bankruptcy filing, but also advanced $25,000 in new value during that period which remains unpaid. Under the old law, the litigation trustee could sue you for the $49,000 and force you to affirmatively assert the "new value" defense. The new law, however, will require the trustee to deduct the

“new value” received in determining whether the $25,000 jurisdictional threshold has been met. In this case, since the net preference payment would be $24,000 after taking into account the “new value” defense, the new law will require the case be brought where you reside instead of in the debtor’s home court, thus meaning the case likely will not be brought at all.

Effective on February 20, 2020, a new law will be enacted that significantly improves the ability of small businesses to reorganize under federal bankruptcy law.