Changes for Small Business Debtors

1. Current Law for Small Business Debtors

In 2005, Congress signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA").[1] BAPCPA ushered in many changes to the Bankruptcy Code, including special provisions for debtors filing bankruptcy under chapter 11 that qualified as "small business debtors." These small business provisions were enacted by Congress for the express purpose of "instituting a variety of time frames and enforcement mechanisms designed to weed out small business debtors who are not likely to reorganize."[2] The other purpose of these provisions was to require the United States Trustee and the bankruptcy courts to monitor these cases more actively.[3]

BAPCPA added definitions to Section 101 of the Bankruptcy Code for "small business case" and "small business debtor."

Under BAPCPA changes, a small business debtor is defined, generally, in 11 U.S.C. § 101(51D) as a person engaged in commercial or business activity with debts of no more than $2,725,625 (excluding debts owed to insiders and as adjusted on April 1, 2019) and where an unsecured creditors committee has not been appointed or, if appointed, has been determined to be ineffective by the bankruptcy court.[4] Excluded from this definition is (i) a single debtor that falls under the debt limit but is a part of a group of affiliated debtors where the aggregate debts exceed the aforementioned limit and (ii) a debtor whose primary business is the ownership and operation of real property and the activities incidental thereto.[5]

A small business case is defined as a case filed under chapter 11 where the debtor is a small business debtor.[6]

The most important distinctions between being a regular chapter 11 debtor and a small business chapter 11 debtor under the BAPCPA amendments are:

a. A small business debtor must either file with its bankruptcy petition its most recent balance sheet, statement of operations, cash flow, and federal tax return or a sworn statement as to why those documents cannot be filed;[7]

b. In a small business case, the debtor has the exclusive right to file a chapter 11 plan for 180 days.[8] In a regular chapter 11 case, the debtor is only granted the exclusive right to file the plan for the first 120 days;[9]

[1] S. 256, 109th Cong. (2005).
[2] H.R. Rep. No. 109-31, at 19 (2005).
[3] Id.
[4] 11 U.S.C. § 101(51D)(A).
[5] 11 U.S.C. § 101(51D)(A) and (B).
[6] 11 U.S.C. § 101(51C).
[7] 11 U.S.C. § 1116(a)(1).
[8] 11 U.S.C. § 1121(e)(1).
[9] 11 U.S.C. § 1121(c).

c. A small business debtor can ask the court to waive the requirement that it file a disclosure statement; ask the court to conditionally approve the disclosure without notice and a hearing; or ask that the hearing for approval of the disclosure statement be combined with the hearing regarding confirmation of the Plan. Non-small business debtors are not afforded these opportunities and must seek approval of a disclosure statement before it can solicit ballots voting on its chapter 11 Plan;[10] and

d. In a small business case, the court shall confirm a plan that complies with the applicable provisions of Title 11 and that is filed in accordance with Section 1121(e) not later than 45 days after the plan is filed. This significantly expedites the timeline for the normal chapter 11 plan confirmation process and can impose an undue burden on small business debtors if they are unable to obtain an extension of this 45-day deadline. Also, this deadline can only be extended if the bankruptcy court enters an order granting the extension prior to the expiration of the deadline.[11]

The provisions in chapter 11 regarding small businesses are mandatory if a chapter 11 debtor qualifies as a "small business debtor" and must be complied with by any small business debtor.

2. Changes Available to Small Business Debtors Pursuant to the SBRA

According to the Report from the House Judiciary Committee on the SBRA, since the enactment of BAPCPA in 2005, small businesses that file chapter 11 have continued to struggle.[12] The SBRA creates an entirely new subchapter to chapter 11 of the Bankruptcy Code that applies only to small business debtors and contains a much more stripped down and expedited chapter 11 process that is meant to assist small business debtors in obtaining a successful reorganization. The SBRA goes into effect 180 days from the date that it was signed into law. The SBRA was signed into law on August 23, 2019, meaning that it will go into effect on February 19, 2020.

Before looking into the major changes associated with the SBRA, it should be noted that, once the SBRA goes into effect, the provisions of Subchapter V of Title 11 are not mandatory (unlike the previous small business provisions enacted by BAPCPA) and will only apply if a small business debtor elects that Subchapter V shall apply.[13]

It should also be noted that, if a small business debtor does not elect to file under Subchapter V, the small business provisions enacted by BAPCPA have not been abrogated and compliance with these provisions is still mandatory.

a. *Universal Changes that Apply to Small Business Debtors Regardless of whether They Elect to File under Subchapter V of Chapter 11*

[10] 11 U.S.C. § 1125(f).
[11] 11 U.S.C. § 1129(e).
[12] H.R. Rep. No. 116-171, at 4 (2019).
[13] 11 U.S.C. § 103(i).

The first universal change that comes with the enactment of Subchapter V is the change to the definition of "small business debtor" and "small business case" in Sections 101(51C) and (51D) of the Bankruptcy Code.

The definition of "small business debtor" has been amended to mean a person engaged in business activity with debts as of the date of filing of $2,725,625 or less (excluding debts owed to affiliates or insiders) with at least 50% of the debt being related to the debtor's commercial or business activities.[14] The following are excluded from the definition: (1) a person whose primary business is owning single asset real estate;[15] (2) a single debtor that falls under the debt limit but is a part of a group of affiliated debtors where the aggregate debts exceed the aforementioned limit; and (3) corporate debtors or affiliates of corporate debtors whose stock is exchanged on a national stock exchange.[16]

The definition of "small business case" has been amended to mean a case filed under chapter 11 in which the debtor is a small business debtor and has not elected to file under Subchapter V.[17]

b. *Changes which only Apply to Small Business Debtors Filing under Subchapter V*

Once it goes into effect, Subchapter V will add Sections 1181 – 1195 to chapter 11 of the Bankruptcy Code. The major changes are as follows:

i. **Appointment of a Trustee**

Typically, in a chapter 11 bankruptcy, no trustee is appointed, and the debtor remains in possession of its assets. The debtor-in-possession ("DIP") has the same general rights, powers, and duties as a chapter 11 trustee as set forth in chapter 11.[18] A trustee is typically only appointed after a party-in-interest files a motion and the court finds that the appointment of a trustee is necessary for the protection of the bankruptcy estate and the creditors.[19]

Section 1183 of the Subchapter V provides that a trustee is automatically appointed in a case filed under that subchapter.[20] Even though a trustee is appointed, the debtor remains in possession of its assets, and the trustee has a limited role that is defined in the statute.[21]

ii. **Property of the Estate**

Property of the estate under all chapters of the Bankruptcy Code is defined by Section 541 of the Bankruptcy Code and, for chapter 11 cases, is supplemented by Section 1115. For business

[14] 11 U.S.C. § 101(51D)(A), as amended by H.R. 3311, 16th Cong. (2019).
[15] "Single Asset Real Estate" is defined in Section 101(51B).
[16] 11 U.S.C. § 101(51D)(A) and (B), as amended by H.R. 3311, 116th Cong. (2019).
[17] 11 U.S.C. § 101(51C), as amended by H.R. 3311, 116th Cong. (2019).
[18] 11 U.S.C. § 1107.
[19] 11 U.S.C. § 1104.
[20] 11 U.S.C. § 1183.
[21] 11 U.S.C. § 1183(b).

entities in chapter 11, property of the estate includes all assets (with few exceptions) owned by the entity on the petition date.[22] For individuals in chapter 11, property of the estate includes all assets (also with some exceptions) owned by the individual on the petition date plus any property acquired after the petition date and prior to the date that the case is closed, dismissed, or converted and all of the individual's post petition earnings prior to closure, dismissal or conversion of the case.[23]

In a case under Subchapter V, if the plan is confirmed under Section 1191(b) rather than 1191(a)[24], all assets and all earnings acquired post petition become property of the estate. For individuals, this is nothing new, but, for business entities, this is a drastic change from the normal parameters of chapter 11.

iii. **Removal and Reinstatement of the Debtor as DIP**

In a typical chapter 11 case, the DIP can be removed and a trustee can be appointed.[25] This usually occurs when a party-in-interest (or several parties-in-interest) files a motion with the court seeking the appointment of a chapter 11 trustee. These motions are usually based on fraud; gross mismanagement; diminution of the estate and a reasonable likelihood that a plan will not be confirmed; as well as many other similar grounds.[26]

Under Subchapter V, there is already a trustee in place. However, the DIP can be removed for the same reasons that a trustee would be appointed in a typical chapter 11 case.[27] However, unlike a typical chapter 11, upon motion of a party-in-interest and after a hearing before the court, the DIP can be reinstated.[28] Subchapter V is not clear as to what the party seeking to have the DIP reinstated would have to prove in order to prevail on its motion.

iv. **No Disclosure Statement**

Section 1125 provides that the debtor shall file a disclosure statement.[29] A disclosure statement is usually filed at the same time as the debtor's plan, and it is intended to provide creditors with operational and financial information regarding the debtor's business to allow the creditors to make an informed decision as to whether they will vote to accept or reject the plan. In addition to general background information and a summary of everything that has happened during the pendency of the bankruptcy, the disclosure statement is required to contain a liquidation analysis, which provides an analysis of what the creditors will receive under a chapter 7 liquidation

[22] 11 U.S.C. § 541 and 11 U.S.C. § 1115.
[23] Id.
[24] Under 1191(a), the court shall confirm a plan if all of the requirements of 1129(a), except for 1129(a)(15), are met. Under 1191(b), the court shall confirm a plan if all requirements of 1129(a), except for (a)(8), (a)(10), and (a)(15) are met and the court finds that the plan does not discriminate unfairly and is fair and equitable with respect to all impaired classes that have not voted to accept the plan. The basic difference is that, under 1191(a), the court is confirming a plan that has been accepted by at least one class of impaired creditors whereas, under 1191(b), the court is confirming a plan in which no impaired classes have voted in favor of the plan.
[25] 11 U.S.C. § 1104.
[26] 11 U.S.C. § 1104(a).
[27] 11 U.S.C. § 1185(a).
[28] 11 U.S.C. § 1185(b).
[29] 11 U.S.C. § 1125.

vs. what they will receive under the chapter 11 plan, and a feasibility analysis, which includes future projections of the debtor's business operations and analyzes the feasibility of the debtor's ability to make the payments required under the plan.[30] In addition to the requirement of preparing and filing a disclosure statement, the court has to have a hearing regarding approval of the disclosure statement and the debtor cannot solicit votes on its plan until the court approves the disclosure statement as containing "adequate information."[31]

Subchapter V abrogates the requirement that a disclosure statement be filed unless the court orders otherwise.[32] Instead, the debtor will be required to provide the information typically required by a disclosure statement in its plan.[33] This will allow the debtor to save time and money on professional fees by consolidating the disclosure statement and plan into one document and one hearing.

v. **Who May File a Plan**

In a chapter 11 case, in the first 120 days from the date a case is filed, a debtor has the exclusive right to file a chapter 11 plan, and, in a small business case, a debtor has the exclusive right to file a chapter 11 plan for 180 days.[34]

Subchapter V provides that only the debtor may file a plan.[35] Based on the differences between the definition of debtor and DIP in Subchapter V, it appears that, even if the debtor is removed as the DIP, the debtor remains the only entity that is allowed to file a plan.[36]

vi. **Timeline for Filing a Plan**

Under the current provisions of chapter 11, other than the timelines referenced above for allowing a chapter 11 debtor exclusivity to file a plan, there is no deadline within which a debtor must file the plan. The South Carolina Local Bankruptcy Rules do require a debtor or trustee to file a plan no later than 180 days from the petition date,[37] but the Bankruptcy Code itself does not place a deadline within which a plan must be filed.

Subchapter V will substantially expedite the timeline by requiring that a debtor file the plan no later than 90 days from the petition date.[38]

vii. **Employment of Professionals**

[30] Id.
[31] 11 U.S.C. § 1125(b).
[32] 11 U.S.C. § 1187(c).
[33] 11 U.S.C. § 1190.
[34] 11 U.S.C. § 1121.
[35] 11 U.S.C. 1189(a).
[36] See 11 U.S.C. § 1182(1) (the term 'debtor' means a small business debtor). See also 11 U.S.C. § 1182(2) (the term 'debtor in possession' means the debtor, unless removed as debtor in possession under section 1185(a) of this title).
[37] SC LBR 3016-1(a).
[38] 11 U.S.C. § 1189(b).

Generally speaking, in all bankruptcies, an attorney is not allowed to file a bankruptcy on behalf of a debtor that has unpaid attorney's fees that have not been waived by the attorney. However, Subchapter V allows an attorney to represent a debtor under Subchapter V so long as that attorney is owed no more than $10,000 as of the petition date.[39]

viii. **Absolute Priority Rule and Cramdown**

The Bankruptcy Code classifies creditors in different categories which determines the priorities by which these creditors will be paid.[40] In corporate bankruptcies, a principle called the "absolute priority rule" governs, which requires that, absent consent, a senior class of creditors must be paid in full before junior classes or creditors and equity holders can receive any money or property under the plan.[41] Because of the absolute priority rule, it can be difficult for equity security holders to maintain their equity interests in a post confirmation chapter 11 debtor[42], and it requires individual chapter 11 debtors to pay all classes of creditors in full or obtain consent from those creditors to pay them a discounted amount in order for the individuals to retain their assets post confirmation.[43]

Further, in a chapter 11 case where the debtor is an entity, the debtor can "cramdown" the plan over the dissent of impaired classes, as long as the plan is "fair and equitable" and as long as one dissenting class has voted to accept the plan.[44] The definition of "fair and equitable" treatment differs depending on the nature of the creditors' claims.[45] For secured creditors, it generally means that the plan is proposing to pay the secured claim in full or provide the creditor with the indubitable equivalent of its claim.[46] For unsecured creditors, it generally means that the plan does not violate the absolute priority rule.[47]

As noted above, the absolute priority rule requires individual chapter 11 debtors to either have the consent of their creditors or pay all of their creditors in full under their plan in order to confirm their chapter 11 plans.[48]

The changes being made by Subchapter V will expand a chapter 11 debtor's ability to cramdown a chapter 11 plan over dissenting creditors. Subchapter V provides that a debtor can obtain confirmation of a chapter 11 plan even if none of the impaired classes vote in favor of the plan so long as the plan does not discriminate unfairly and is fair and equitable with respect to the impaired classes.[49] Further, the term "fair and equitable," as that term pertains to unsecured creditors in Subchapter V, is defined differently from the definition of fair and equitable set forth

[39] 11 U.S.C. § 1195.
[40] 11 U.S.C. § 507.
[41] *In re Maharaj*, 681 F.3d 558, 562 (4th Cir. 2012).
[42] There is an exception to the absolute priority rule for equity holders when the debtor is an entity rather than an individual, called the "new value exception," but we will not get into detail in this article regarding the new value exception.
[43] *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012).
[44] 11 U.S.C. § 1129(b)
[45] 11 U.S.C. § 1129(b)(2).
[46] 11 U.S.C. § 1129(b)(2)(A).
[47] 11 U.S.C. § 1129(b)(2)(B).
[48] *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012).
[49] 11 U.S.C. § 1191(b).

in 1129(b), which will allow a debtor's equity holders to retain their equity even if unsecured creditors are not paid in full.[50]

Subchapter V states that a plan is fair and equitable as to unsecured creditors if (i) it proposes to commit all of the debtor's disposable income for the entire term of the plan to making plan payments (or the equivalent thereof); (ii) the debtor is able to make the payments under the plan or there is a reasonable likelihood that the debtor will be able to make the payments; and (iii) the plan provides appropriate remedies, which could include the liquidation of nonexempt assets, to protect creditors if the payments are not made.[51] For secured creditors, a plan is fair and equitable if (i) – (iii) are met and if the secured creditor retains its lien on its collateral and receives either payment in full or the indubitable equivalent thereof.[52]

These changes enacted by Subchapter V will allow chapter 11 entity debtors to cram a plan down over dissenting creditors even if no one votes in favor of the plan and will allow the equity holders to retain their interests even if all creditors are not paid in full. It will allow chapter 11 individual debtors to confirm a plan without obtaining consent of its impaired creditors and without paying their creditors in full.

ix. **No UST Quarterly Fees**

In a chapter 11 case, the DIP or the Trustee is required to pay quarterly fees to the UST's office which are calculated based on a percentage of the total distributions made by the debtor during the quarter.[53] These fees can be substantial but are part of the cost of availing oneself of chapter 11 protection.

However, the amendments to Subchapter V also include an amendment to 28 U.S.C. § 1930(a)(6), which exempts chapter 11 debtors under Subchapter V from the requirement of paying the UST quarterly fees.[54]

3. <u>Additional Changes to the Bankruptcy Code as Part of the Small Business Reorganization Act of 2019 which Are Not Exclusive to Small Business Cases or Cases in which Subchapter V Applies</u>

The enactment of the SBRA contains changes to 11 U.S.C. § 547, regarding preferential transfers, and to 28 U.S.C. § 1409, concerning venue of certain actions. These changes apply to cases under all chapters of the Bankruptcy Code and are not limited to just cases under Subchapter V or small business cases.

a. *11 U.S.C. § 547*

[50] 11 U.S.C. § 1191(c).
[51] 11 U.S.C. § 1191(c)(2) and (c)(3).
[52] 11 U.S.C. § 1191(c).
[53] 28 U.S.C. § 1930(a)(6).
[54] 28 U.S.C. § 1930(a)(6), as amended by H.R. 3311, 116th Cong. (2019).

Under the existing version of Section 547, a trustee or a DIP can bring actions against all parties who received payments or other transfers within 90 days prior to filing (or up to one year if the recipient is an insider of the debtor) the bankruptcy if the transfers were on account of an antecedent debt, were made while the debtor was insolvent, and allowed the recipient to obtain more than it would have in a Chapter 7 case.[55] Section 547 also outlines numerous defenses the recipient might have to the transfers that, if valid, mean the transfers were not preferential and cannot be recovered.[56] The most oft used defense is the "ordinary course of business" defense, which means that the transfers were made within the ordinary course of business between the parties or within the particular industry.

In many instances (especially larger cases where thousands of payments were made within the 90 days prior to filing), a trustee and/or DIP will file litigation against everyone that received payments from the debtor within 90 days prior to filing without first performing any analysis of each recipient's defenses. These preference complaints are mainly form documents wherein the drafter simply changes the name of the defendant and the amount being sought from the defendant, and it is not very costly for the trustee or DIP to prepare and file these actions. On the other hand, it can be very costly for the debtor's vendors and/or former vendors to defend against these actions, especially where these vendors are creditors that are owed substantial amounts of money and have valid defenses for the payments that they received within 90 days prior to the filing.

The SBRA amends Section 547(b) to require the trustee (or DIP) to perform reasonable due diligence and consider the party's known or reasonably knowable affirmative defenses under subsection (c) before bringing the action to avoid the preference.[57] Unfortunately, the SBRA does not amend the Code to explain what the consequences are for a trustee or DIP that does not perform any due diligence or consider the recipient's defenses before bringing the action.

Even so, this new language will require the plaintiff in the action to plead that it has performed reasonable due diligence and considered the defendant's defenses before bringing the action. As a result, once the SBRA goes into effect, if you are representing a defendant in a preference action, it should definitely be part of your discovery process to investigate what due diligence the trustee and/or DIP performed before bringing the action.

b. *28 U.S.C. § 1409(b)*

Currently, 28 U.S.C. § 1409(b) provides that a trustee or DIP must commence an action seeking to recover a non-consumer debt of less than $13,650 in the district where the defendant resides.[58] Section 547 provides that a trustee or DIP cannot seek to avoid a preference in a non-consumer case unless it is greater than $6,425[59], so there is only about a $7,000 difference between the minimum amount a trustee or DIP can seek to avoid and the minimum amount for the trustee or DIP to bring the action in the district where the case is pending.

[55] 11 U.S.C. § 547(b).
[56] 11 U.S.C. § 547(c).
[57] 11 U.S.C. § 547(b), as amended by H.R. 3311, 116th Cong. (2019).
[58] 28 U.S.C. § 1409(b).
[59] 11 U.S.C. § 547(c)(9).

The SBRA is amending this section to increase that amount to $25,000, which means that a trustee or DIP seeking to recover a preference of less than $25,000 has to sue the defendant in the district where that defendant is located.[60] Because it is costly for trustees or DIPs to bring litigation in districts other than where the bankruptcy is pending, this will substantially eliminate avoidance actions under $25,000 if the defendant does not reside in the district where the bankruptcy is pending.

Small business debtors will be the chapter 11 debtors most affected by this amendment, as small business debtors are much more likely to have multiple preferential transfers of $25,000 or less. As a result, this seems to be a counterintuitive amendment for the SBRA to make in light of the stated intent of the bill to help make it easier for small business debtors to successfully reorganize.

4. Unresolved Issues under the SBRA

Several provisions of the SBRA leave open questions for practitioners that will require practitioners to take special considerations into account when representing parties in cases filed pursuant to the SBRA. Some of these questions will also require further interpretation by the courts before practitioners can understand the full effect of these new statutes.

a. *Who May File a Plan when the Debtor is Removed as Debtor in Possession*

Section 1182(1) defines "Debtor" as a small business debtor. Section 1182(2) defines "debtor in possession" as a debtor, unless removed as debtor in possession under section 1185(a) of this title. Section 1189(a) provides that only the debtor may file a plan under this subchapter. Under normal circumstances, there is no problem with this, as the debtor will be a debtor in possession and will be actively involved in the case.

However, the issue comes in when a debtor has been removed as the debtor in possession. When this occurs, the Trustee essentially assumes complete control of the debtor's assets and operations. Although the trustee is now in complete control, there is nothing in the statute that allows the trustee or the other creditors to file a plan. The debtor still retains that right. There is no other chapter of the Bankruptcy Code wherein a trustee assumes complete control of the debtor but is denied the right to file a plan. This provision will have some interesting consequences and will require the trustee and creditors to keep debtors involved in cases even after they have been removed as debtors in possession.

b. *Submission of Income to the Trustee Pursuant to a Plan Confirmed under Section 1191(a)*

Section 1190(2) provides that a plan filed pursuant to the SBRA "shall provide for the submission of all or such portion of the future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan[.]"[61]

[60] 28 U.S.C. § 1409(b).
[61] 11 U.S.C. § 1190(2).

Section 1183(c)(1) provides that, if a plan is confirmed under section 1191(a) of the SBRA, then the service of the trustee shall terminate upon substantial consummation of the plan.[62] Substantial consummation in a chapter 11 bankruptcy typically occurs when the debtor makes its first payments required by the confirmed chapter 11 plan.

Section 1183 does provide that the United States Trustee may reappoint a trustee as needed for two reasons: (1) hearings that concern the post confirmation modification of a plan or (2) if the debtor is removed as the debtor-in-possession.[63]

As a result, there appears to be a conflict between the provisions of Sections 1183(c)(1) and 1190(2). Section 1190(2) requires a plan filed under the SBRA to provide for submission of future earnings to the trustee to be used to execute the plan. However, if the plan is confirmed under 1191(a), then the trustee's service as trustee shall be terminated fairly early into the life of the plan and there are no provisions to allow the trustee to remain in service to receive and distribute these payments under the plan.

c. *Reinstatement of the Debtor as Debtor-in-Possession*

Section 1185(b) provides that, if a debtor-in-possession has been removed from the case, the court may reinstate the debtor-in-possession after notice and a hearing.[64] In a chapter 11 that has not been filed under the SBRA, there are no provisions for reinstatement of a debtor-in-possession. It is unclear from Section 1185, or any other section under the SBRA, what circumstances, facts, factors, etc. a debtor would have to show in order to be reinstated as a debtor-in-possession. This area will have to be developed through further litigation and case law for practitioners to better understand what a debtor would have to show in order to be reinstated as debtor-in-possession.

d. *Standards of Pleading for Preferences*

One final area that is unclear at this time is with regard to the changes to the preference statute and the consequences that could result from those changes. As noted above, the changes to Section 547(b) require the trustee (or DIP) to perform reasonable due diligence and consider the party's known or reasonably knowable affirmative defenses under subsection (c) before bringing the action to avoid the preference.

It appears that, at the very least, this change will require trustees and/or debtors-in-possession to include additional allegations in their preference complaints regarding the efforts that the trustee/DIP undertook to ascertain the defendant's potential defenses to the preference action.

However, this raises several questions about the practical realities of preference actions going forward. The first issue is whether, after performing reasonable due diligence and considering the defendant's defenses to the preference action, the trustee/DIP can still include in

[62] 11 U.S.C. § 1183(c)(1).
[63] 11 U.S.C. § 1183(c)(1).
[64] 11 U.S.C. § 1185(b).

their complaint a request for avoidance of transfers that clearly fall within the ambit of the defendant's potential defenses, which still forces the defendant to appear and raise the affirmative defenses to those transfers. Essentially, the issue is whether the changes to Section 547 require a trustee/DIP to raise the defendant's defenses before the defendant even appears in the case.

The second and third (and very closely related to the first) issues are, if the trustee/DIP does include requests for avoidance of transfers that are very clearly subject to a defense and the inclusion of that request is prohibited by the changes to Section 547, is the conduct sanctionable? If so, what are the sanctions for doing this? These changes could very well put the trustee/DIP in the unique position of having to plead affirmative defenses on behalf of an opposing party before that party even responds to the litigation and could lead to sanctions for a trustee/DIP if they do not do that. The answers to these questions are unclear and will have to be developed through further case law and litigation.

A fourth issue is how this affects pre-preference complaint negotiations. In the majority of these situations, the trustee/DIP will send a demand to the recipient of the alleged preferential transfers requesting return of the funds by a certain date and stating that, if the funds are not received by that date, then a complaint will be filed. In many instances, this leads to negotiations between the trustee/DIP and the potential defendant, wherein the parties reach a resolution of the preference demand. Do the changes to Section 547 require a trustee/DIP to take these defenses into account before making demand? Based on the wording of the statute, it appears that the defenses only have to be taken into account before litigation is filed. As a result, trustees and DIPs will most likely still be able to make demands for the full amount received within 90 days and can still require potential defendants to perform all of the diligence and defense analysis in response to those demands.

As noted above, practitioners who represent defendants in preference litigation will be well served to amend their routine discovery requests to include information regarding the due diligence and analysis of defenses that was performed by the trustee/DIP in bringing the preference action.