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"Venue" Make a Change, Be Sure to Get It Right

Two Bankruptcy Code Changes that Fall Short

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Editor's Note: *To stay current on the effects of this legislation, bookmark ABI's SBRA Resources website at abi.org/sbra.*

On Aug. 23, 2019, the Small Business Reorganization Act of 2019 (SBRA)[1] was enacted into law. Although the SBRA's main purpose was to create a process for small businesses to reorganize under a new subchapter of chapter 11, it also implemented changes intended to make it easier to defend preference actions. The SBRA purports to do this in two ways.

First, as of Feb. 19, 2020, the SBRA increased the venue threshold limit in 28 U.S.C. § 1409(b) for non-consumer debts, raising it from its prior amount of $13,650[2] to $25,000. The intent is to require preference plaintiffs to sue in the defendant's home district if the amount at issue is less than $25,000. Second, it added language to 11 U.S.C. § 547 requiring a preference plaintiff to take into account known or reasonably knowable defenses in drafting its complaint.

If these changes work as legislators intend, they will significantly aid in defending preference actions. The change to the venue limit should deter many small preference actions. It will be hard for a debtor in Delaware or New York to justify the expense of filing and prosecuting a preference action that seeks less than $25,000 in, say, Mississippi or Michigan. Likewise, requiring a plaintiff to evaluate a defendant's defenses should discourage filings where the plaintiff knows there is a strong defense but sues anyway, hoping that the cost of litigation will force the defendant to offer something in settlement.

Will the SBRA's changes have the desired effects? It is unclear. For the venue-change question, there is a significant amount of case law that holds that 28 U.S.C. § 1409(b) simply does not apply to preference actions (although to be fair, there are older cases where courts implemented the intent of the statute rather than its express language). Likewise, what exactly does it mean to require a plaintiff to "take into account" preference defenses? These issues call into question how effective the SBRA will be with respect to preference actions.

1 Pub. L. No. 116-54, 133 Stat 1079 (2019).
2 The amount encoded in the statute is $10,000, but it is adjusted every three years as required by 11 U.S.C. § 104(a). "Revision of Certain Dollar Amounts in the Bankruptcy Code Prescribed Under Section 104(a) of the Code," 84 *Fed. Reg.* 3488-01 (Feb. 12, 2019).

Venue: Fixing the Wrong Problem

To understand the first issue, it helps to start with a brief review of how venue works in bankruptcy. District courts have jurisdiction over all cases arising under chapter 11.[3] They also have jurisdiction over "civil proceedings arising under title 11, or arising in or related to cases under title 11."[4] They may (and most — if not all — do) automatically refer bankruptcy cases to their corresponding bankruptcy courts.[5] This is usually achieved by local rule or general order.

Most courts hold that preference actions "arise under" title 11 because they invoke a substantive right created by federal bankruptcy law and could not exist outside of a bankruptcy case.[6] With this background, it is time to turn to the text of 28 U.S.C. § 1409(b). It formerly read:

> Except as provided in subsection (d) of this section, a trustee in a case under title 11 may commence a proceeding arising in or related to such case to recover a money judgment of or property worth less than $1,000 or a consumer debt of less than $15,000, or a debt (excluding a consumer debt) against a noninsider of less than $10,000,[7] only in the district court for the district in which the defendant resides.

The SBRA raised the venue limit for debts other than consumer debts to $25,000.[8] The problem is that because preference actions arise *under* the Bankruptcy Code, and 28 U.S.C. § 1409(b) limits venue for proceedings "arising in or related to" a bankruptcy case, the statute does not apply literally to preference cases (which "arise under" a case). At least four courts have been willing to look past the omission of "arising under" from the statute's language to the statute's legislative history, and thus apply the limitation nonetheless.[9] Indeed, one Delaware court declared that the omission of "arising under" from the statute must be "unintentional," effectively reading it into the statute.[10]

3 28 U.S.C. § 1334(a).
4 28 U.S.C. § 1334(b).
5 28 U.S.C. § 157(a).
6 *See, e.g., Browning v. Levy*, 283 F.3d 761, 773 (6th Cir. 2002); *see also Glinka v. Murad (In re Housecraft Indus. USA Inc.)*, 310 F.3d 64, 70 (2d Cir. 2002); *Wood v. Wood (In re Wood)*, 825 F.2d 90, 96 (5th Cir. 1987).
7 Now $13,650 after adjustments required by 11 U.S.C. § 104(a).
8 SBRA, Pub. L. No. 116-54, 133 Stat. 1079, 1085 (2019).

However, the majority have held that when a statute is unambiguous, they cannot resort to legislative history and thus interpret the statute as written. These cases hold that the omission of "arising under" from 28 U.S.C. § 1409(b) means that it does not apply to preference actions.[11] Articles in the *ABI Journal* have agreed that the majority has it right.[12] In fact, the authors are not aware of any decisions after 2011 that hold that 28 U.S.C. § 1409(b) applies to preference actions.

Regardless of which line of cases is correct, the question would be wholly unnecessary if Congress had added "arising under" to the statute when it raised the dollar limit. Fortunately, there are indications that further modifications to the Bankruptcy Code might be coming.

For example, many commentators have recommended increasing the dollar limits under the SBRA to allow more debtors to qualify for small business reorganization.[13] The temporary increase to the dollar limit (currently to $7.5 million to cope with the COVID-19 pandemic) might be made permanent. If so, that would be an ideal time to correct the apparently inadvertent (yet continuing) omission of "arising under" from the venue-exception statute, and make it clear that it applies to preference actions.

"Reasonably Knowable" That Taking Defenses into Account Will Lead to Confusion

The SBRA also revises 11 U.S.C. § 547(b), which specifies the elements that must be met in order for a trustee or debtor in possession to avoid (or "claw back") a payment that was made prior to the filing of the bankruptcy petition. Up until now, a trustee generally had to show that there was (1) a transfer (2) of the debtor's property (3) to or for the benefit of a creditor (4) for or on account of an antecedent debt (5) made while the debtor was insolvent (6) within 90 days before the original filing of the petition, (7) which enables the creditor to receive more than it would receive under a chapter 7 liquidation on the petition date.[14]

Insolvency is presumed, but rebuttable, during the 90 days immediately pre-petition.[15] The trustee has the burden of proving these elements, and defendants have the burden of proving the applicability of one or more of the statutory defenses provided in subsection (c).[16] The SBRA includes a provision[17] that amended the first sentence of § 547(b) as follows:

> Except as provided in subsections (c) and (i) of this section, the trustee may, based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses under subsection (c), avoid any transfer of an interest of the debtor in property.

The changes intended by the SBRA are well intentioned and much needed. But further refinement is necessary.

The underlined language seemingly requires a trustee to make a reasonable inquiry into defenses before filing, then to file complaints that seek to recover only amounts that are net of obvious defenses. However, what *exactly* is the trustee required to do? The amendment is vague on that point.[18]

On the one hand, it seems clear that the new language requires the plaintiff to allege in its complaint *something* that it did in order to "take into account" a defendant's defenses. Simply alleging that the plaintiff performed reasonable due diligence and took into account reasonably knowable defenses, without more, would seem to run afoul of the *Iqbal*[19] and *Twombly*[20] pleading requirements. However, what steps must a plaintiff take (or allege it has taken)? Does a plaintiff need to fully analyze a defendant's defenses? Does the plaintiff need to amend its complaint if it learns of facts that give rise to "reasonably knowable affirmative defenses?" Will it suffice for a plaintiff to allege something along the lines of, "I engaged a financial advisor, who examined the debtors' books and records and determined that no transfers are shielded by defenses"? It is hard to say, which is another way of saying, "[E]xpect litigation on this point."[21]

There are a number of ways to bring greater certainty to this new requirement. One proven (albeit slow) way is to let the courts figure it out, piecing together the case law as it evolves to come to an answer. A quicker way would be to add a statutory "safe harbor" to the statute, something that would tell a plaintiff, "[I]f you do this much, you will be all right." As an opening suggestion, consider a possible new subsection (j) that states:

9 *Muskin v. Strippit (In re Little Lake Indus. Inc.)*, 158 B.R. 478, 484 (B.A.P. 9th Cir. 1993); *Miller v. Hirn (In re Raymond)*, No. 09-6177, 2009 WL 6498170 (Bankr. N.D. Ga. June 17, 2009); *Dynamerica Mfg. LLC v. Johnson Oil Co. (In re Dynamerica Mfg. LLC)*, No. 08-11515, 2010 WL 1930269 (Bankr. D. Del. May 10, 2010); *see also N1 Creditors' Trust v. Crown Packaging Corp. (In re Nukote Int'l Inc.)*, 457 B.R. 668 (Bankr. M.D. Tenn. 2011) (holding preference actions that "arise in" bankruptcy cases).

10 *Dynamerica Mfg.*, 2010 WL 1930269, at *2.

11 *Ehrlich v. Am. Express Travel Related Servs. Co. (In re Guilmette)*, 202 B.R. 9 (Bankr. N.D.N.Y. 1996); *Van Huffel Tube Corp. v. A&G Indus. (In re Van Huffel Tube Corp.)*, 71 B.R. 155 (Bankr. N.D. Ohio 1987); *Neiman v. Brown (In re Brown)*, No. 87-0109, 1988 WL 1571404 (Bankr. S.D. Iowa Jan. 8, 1988); *Ryan v. Wolter (In re Nashmy)*, No. 07-1068, 2007 WL 2305672 (Bankr. D.N.M. Aug. 6, 2007); *Moyer v. Bank of Am. NA (In re Rosenberger)*, 400 B.R. 569 (Bankr. W.D. Mich. 2008); *Redmond v. Gulf City Body & Trailer Works Inc. (In re Sunbridge Capital Inc.)*, 454 B.R. 166 (Bankr. D. Kan. 2011); *Schwab v. Peddinghaus Corp. (In re Excel Storage Prods. LP)*, 458 B.R. 175 (Bankr. M.D. Pa. 2011); *Straffi v. Gilco World Wide Mkts. (In re Bamboo Abbott Inc.)*, 458 B.R. 701 (Bankr. D.N.J. 2011); *Ross v. Buckles (In re Skyline Manor Inc.)*, No. A15-8035, 2015 WL 9274105 (Bankr. D. Neb. Dec. 18, 2015); *Klein v. ODS Techs. LP (In re J&J Chem. Inc.)*, 596 B.R. 704 (Bankr. D. Idaho 2019); *Webster v. Rep. Nat'l Distrib. Co. (In re Tadich Grill of Washington DC LLC)*, 598 B.R. 65 (Bankr. D.D.C. 2019); *Bruton v. High Speed Capital LLC (In re Cirino Constr. Co.)*, No. 20-06077, 2020 WL 2989750 (Bankr. M.D.N.C. May 22, 2020); *see also Polinski v. Am. Express Centurion Bank (In re Polinski)*, No. 5-98-00006A, 1998 WL 918876 (Bankr. M.D. Pa. Sept. 22, 1998); Byron C. Starcher, "Second Thoughts on Home Court Advantage for Small-Dollar Preference Defendants," *ABI Journal*, Vol. XXV, No. 2, p. 10, March 2006, *available at* abi.org/abi-journal; *Novak v. Parts Auth. LLC*, No. 20-2948, 2020 WL 4034897 (E.D.N.Y. July 16, 2020) (transferring matter to District of Connecticut where bankruptcy matter is pending and citing ABI article in support of this conclusion).

12 Michael L. Temin & Martha B. Chovanes, "Venue in Small-Value Preference Cases After the SBRA: Congress Should Have Amended 28 U.S.C. § 1409(b)," XXXIX *ABI Journal* 4, 38-39, 83-84, April 2020, *available at* abi.org/abi-journal.

13 *See, e.g.*, "Not Fake News: Congress Enacts New, Sensible Bankruptcy Reform," XXXVIII *ABI Journal* 10, 10, 75-78, October 2019, *available at* abi.org/abi-journal (excerpts from ABI webinar); Donald L. Swanson, "SBRA: Frequently Asked Questions and Some Answers," XXXVIII *ABI Journal* 11, 8, 77-78, November 2019, *available at* abi.org/abi-journal.

14 11 U.S.C. § 547(b).

15 11 U.S.C. § 547(f).

16 11 U.S.C. § 547(g).

17 SBRA, 133 Stat. at 1085.

18 At least one court (albeit not a bankruptcy court) has noted that "just what [the words "take into account"] mean is not entirely clear." *Ayala v. Dist. 60 Sch. Bd. of Pueblo, Colo.*, 327 F. Supp. 980, 982 (D. Colo. 1971) (interpreting "taking into account need and attendance" in National School Lunch Act).

19 *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

20 *Bell Atl. Corp. v. Twombly*, 550 U.S. 544 (2007).

21 This question does not yet appear to have been discussed in any opinions.

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(1) The determination of whether a trustee has performed reasonable due diligence and taken into account known and reasonably knowable defenses is evaluated as of the time the trustee files or amends a complaint seeking to avoid a transfer of an interest of the debtor in property.
(2) For the purpose of subsection (b), a trustee has performed reasonable due diligence and taken into account known and reasonably knowable defenses if the trustee

(A) has examined the debtor's books and records and such other information as a reasonably prudent trustee would examine and has performed sufficient analyses to determine the amount of alleged transfers that are not avoidable on account of the defenses provided in subsection (c);
(B) has ensured that the amount demanded in its complaint does not include any amount believed unavoidable as a result of this analysis; and
(C) alleges with specificity in its complaint the analyses the trustee performed and the amount by which the demand was reduced, if at all, in accord with subsection (B).

(3) A trustee's failure to comply with subsection (2) is not conclusive that the trustee has failed to perform reasonable due diligence or take into account known and reasonably knowable defenses.

This would tell courts that the new language is evaluated at the time the complaint is filed and does not need to be constantly re-evaluated throughout a case. It also would give the plaintiff guidance as to what allegations suffice. Finally, it does not lock a plaintiff into following this guidance in circumstances where the plaintiff is confident that it can convince the court that it has satisfied the requirements of subsection (b) by other means. While there might be other ways to approach this, the provision of a safe harbor is at least one way of ensuring that a plaintiff knows in advance what will definitely work, and thus should help reduce litigation of this issue.

The Road to Litigation Is Paved with Good Intentions

The changes intended by the SBRA are well intentioned and much needed. But further refinement is necessary and, in the case of the venue statute, can be easily remedied (or at least made clearer). The authors humbly submit the recommendations made herein as food for thought for the drafters of any future amendments. abi