

UNITED STATES BANKRUPTCY COURT
CENTRAL DISTRICT OF WASHINGTON

In re:

PEARLY WHITES, LLC

Debtor.

Case No.: 22-00925

Chapter 11, Subchapter V

BRIGHTER SMILE, LLC

Plaintiff,

vs.

PEARLY WHITES, LLC

Defendant.

MEMORANDUM OPINION

On February 29, 2023, the court held a hearing to consider the motion filed by judgment creditor Brighter Smile, LLC (“Brighter Smile”) to dismiss the petition filed by debtor Pearly Whites, LLC (“Pearly Whites”) under Subchapter V of chapter 11. The court heard the arguments of counsel. This memorandum constitutes the court’s findings of fact and conclusions of law.

I. BACKGROUND

Brighter Smile manufactures and sells tooth whitening products to dental clinics. Until 2020, Brighter Smile employed Will Cheetham as a commission salesman. Beginning in 2020, Brighter Smile opened various pop-up retail stores in major cities. According to Cheetham, this reduced his commission income. As a result, Cheetham terminated his employment with Brighter Smile and formed Pearly Whites, a company that also manufactures and sells tooth whitening products to dental clinics. To compete with Brighter Smile, Cheetham contracted with trade vendors and leased office space from Westcoast Commercial Properties, LLC (“Westcoast”).

Brighter Smile sued Pearly Whites in Washington state court asserting patent infringement, tortious interference, and conversion. The state court found in favor of Brighter Smile on all counts and entered a judgment for \$6,700,000 against Pearly Whites.

Around the same time as the state court judgment, Pearly Whites began experiencing stiff economic headwinds. Brighter Smile’s pop-up stores undercut Pearly Whites’ prices, causing a decline in Pearly Whites’ revenue. Vendors increased prices due to supply chain issues and interest rate increases. As a result, Pearly Whites filed for

relief under chapter 11 in the Central District of Washington and elected to proceed as a small business debtor under Subchapter V.

Pearly Whites timely filed its chapter 11 plan (the “Plan”). Pearly Whites’ trade creditors filed proofs of claim totaling \$100,000, and the law firm that Pearly Whites hired to litigate the Washington state court lawsuit, Nasty Brutish & Short (“NBS”), has filed a proof of claim for \$400,000.

Initially, Pearly Whites intended to assume the Westcoast lease (the “Lease”). After the parties failed to agree to more favorable terms, Pearly Whites moved to reject the Lease (“Rejection Motion”). Westcoast and Brighter Smile objected to the Rejection Motion. The court granted the Rejection Motion after an evidentiary hearing. At the hearing on the Rejection Motion, the Court admitted the Lease as evidence without objection from any party. Westcoast filed a rejection damages claim under 11 U.S.C. § 502(g)(1) in the amount of \$500,000, which was the full amount of rejection damages as capped by 11 U.S.C. § 502(b)(6).

Brighter Smile filed a motion to dismiss the bankruptcy case under 11 U.S.C. § 1112(b), arguing that Pearly Whites is not eligible for relief under Subchapter V because

its debts exceed \$7,500,000.¹ At the hearing on the motion to dismiss, neither party introduced any new evidence, though neither party objected when the Court stated that it considered the Lease as evidence given its entry into the record at the hearing on the Rejection Motion. The court also took judicial notice of Westcoast's filed \$500,000 rejection damages claim. Pearly Whites has not yet objected to Westcoast's rejection damages claim, though it mentioned in its objection to the motion to dismiss that it intends to object to the amount of Westcoast's rejection damages claim because it fails to account for required state law mitigation efforts.

Brighter Smile argues that 11 U.S.C. §§ 365(g)(1) and 502(g)(1) render Westcoast's \$500,000 rejection claim a prepetition debt that must be included in determining the Subchapter V debt cap under 11 U.S.C. § 1182(1)(a). *See* 11 U.S.C. § 365(g)(1) (“[a] claim arising from the rejection. . . of an . . . unexpired lease . . . shall be determined . . . the same as if such claim had arisen before the date of the filing of the petition.”) Pearly Whites argues that the \$500,000 rejection claim was a contingent debt “as of the date of the filing of the petition” for purposes 11 U.S.C. § 1182(1)(a) and that sections 365(g)(1)

¹ The court asked the parties whether, if Pearly Whites were ineligible for relief under Subchapter V, the correct remedy would be to de-designate Pearly Whites as a Subchapter V debtor and allow the case to proceed under regular chapter 11, rather than dismiss the case altogether. Pearly Whites stated that it did not wish to continue outside of Subchapter V because it probably could not comply with all of the requirements of a regular chapter 11 case (such as the absolute priority rule of § 1129(b)(2)(B)(ii)).

and 502(g)(1) of the Bankruptcy Code pertain only to allowance of claims, which is not applicable in this dispute.

Pearly Whites further argues that even if Brighter Smile is correct on this legal argument, Westcoast has a duty to mitigate its rejection damages. Pearly Whites argues that because Brighter Smile did not introduce evidence proving that Westcoast's \$500,000 rejection claim reflected the required mitigation, the debt is contingent or unliquidated and does not count towards the Subchapter V debt cap. Brighter Smile countered that Pearly Whites must prove it is eligible for Subchapter V. Because Pearly Whites did not adduce any evidence on the mitigation issue, Pearly Whites failed to prove that the rejection claim is contingent or liquidated. Brighter Smile further argued that the Lease was in evidence and supported Westcoast's rejection damages calculation under 11 U.S.C. § 502(b)(2). Thus, Brighter Smile argued that the \$500,000 rejection damages claim must count towards the Subchapter V debt cap, rendering Pearly Whites ineligible for Subchapter V.

II. JURISDICTION AND DECISIONAL POWER

The court has jurisdiction over this matter under 28 U.S.C. § 1334 and the Order of Reference entered by the U.S. District Court for this District. This is a core proceeding under 28 U.S.C. § 157(b).

III. DISCUSSION

Before the court is Brighter Smile's motion to dismiss the bankruptcy case as ineligible under 11 U.S.C. § 1112(b). The court must decide (1) whether the debtor or creditor bears the burden of proof regarding Subchapter V eligibility, and (2) whether Pearly Whites' future payment obligations under its unexpired lease are noncontingent and liquidated debts for purposes of Subchapter V's eligibility formula. The court holds that the creditor bears the burden of proof regarding eligibility and that Brighter Smile failed to meet its burden.

(1) The moving creditor must prove that the debtor is not eligible under Subchapter V.

i. Subchapter V generally.

Subchapter V contains multiple benefits for debtors:² a trustee is appointed in part to help the debtor confirm a plan, only the debtor may propose and modify a plan, the

² Subchapter V is a relatively new chapter of bankruptcy, passed in 2019. Small Business Reorganization Act of 2019, Pub. L. 116-54, § 1181 et seq., 133 Stat 1079 (2019).

disclosure statement is not required, and there is no absolute priority rule. *NetJets Aviation, Inc. v. RS Air LLC (In re RS Air, LLC)*, 638 B.R. 403, 414 (B.A.P. 9th Cir. 2022). But eligibility for Subchapter V is limited. Among other limitations, the debtor's total noncontingent, liquidated debt may not exceed \$7.5 million. 11 U.S.C. §§ 1182(1)(B)(i), 109(e).

ii. The objecting creditor must prove that the debtor is not eligible for Subchapter V.

The question of whether the debtor is eligible for Subchapter V is a legal question, decided by the court, *RS Air*, 638 B.R. at 408, but in this case the court must ascertain the amount of the debtor's debt, a factual question. Neither the Bankruptcy Code nor the Federal Rules of Bankruptcy Procedure states whether the debtor must prove its eligibility or the creditor must prove the debtor's ineligibility. The case law is unsettled. Some courts have held the debtor must prove it is eligible to proceed under Subchapter V. *See, e.g., RS Air*, 638 B.R. at 413-14; *In re Zhang Med. P.C.*, 655 B.R. 403, 409 (Bankr. S.D.N.Y. 2023). Some courts have held that the creditor must prove that the debtor is not eligible for chapter 13. *See, e.g., In re Body Transit, Inc.*, 613 B.R. 400, 409 & n.15 (Bankr. E.D. Pa. 2020); *In re Serendipity Labs, Inc.*, 620 B.R. 679, 680 n.3 (Bankr. N.D. Ga. 2020). For the reasons stated below, this court adopts the latter approach.

In placing the burden on the debtor, some courts analogize Subchapter V to chapter 12. *RS Air*, 638 B.R. at 413-14 (citing Eighth Circuit chapter 12 precedent). The Ninth Circuit BAP found the similarities of chapter 12 and Subchapter V persuasive because the chapter 12 debtor must be engaged in a farming operation, and Subchapter V debtor must be “engaged in commercial or business activities.” *RS Air*, 638 B.R. at 414.

But Subchapter V is its own subchapter. The Federal Bankruptcy Rules of Procedure provide that a debtor’s attestation that it is a small business debtor — signed under penalty of perjury — must stand until the bankruptcy court makes a contrary finding. Fed. R. Bankr. P. 1020(a). No comparable rule applies to chapter 12 cases. Further, Subchapter V places special emphasis on speed. Extensive eligibility litigation would frustrate this purpose. Much like in chapter 13 cases, *see Scovis v. Henrichsen (In re Scovis)*, 249 F.3d 975, 982 (9th Cir. 2001), courts should presume that the debtor’s eligibility assertion is correct and impose on creditors the burden of refuting it. For these reasons, the court holds that Brighter Smile must prove by a preponderance of evidence that Pearly Whites is not eligible for Subchapter V.

(2) The debtor's future payment obligations under its unexpired lease are not “noncontingent unliquidated” debts for purposes of Subchapter V's eligibility formula.

The court now considers whether future payment obligations under the Lease count toward the Subchapter V debt cap. A Subchapter V debtor may not exceed \$7,500,000 in “noncontingent liquidated” debts as of the petition date. 11 U.S.C. § 1182(1)(A). Generally, a debt is noncontingent when all events creating liability for the debt occurred prior to bankruptcy. *In re Mazzeo*, 131 F.3d 295, 303 (2d Cir. 1997). In assessing a debtor's eligibility for Subchapter V, courts look both to the debtor's schedules and to creditors' proofs of claim in determining the debtor's total noncontingent liquidated debt. *Zhang Med.*, 655 B.R. at 409.

Pursuant to § 365(a), a trustee may (subject to court approval) assume or reject any executory contract or unexpired lease term of the debtor. 11 U.S.C. § 365(a). Since § 1107(a) gives debtors-in-possession most of the rights and powers of a trustee, a debtor-in-possession like Pearly Whites may assume or reject an unexpired lease with court approval. 11 U.S.C. § 1107(a).

Until the debtor elects either to assume or to reject an unexpired lease, the amount and nature of its obligations under that lease cannot be determined. *Zhang Med.*, 655 B.R. at 412. If the debtor assumes the unexpired lease, it will be responsible to cure certain

contractual defaults and provide adequate assurance of future performance. *Id.* However, if the debtor rejects the unexpired lease, its obligations will be payable on a prepetition basis, and the landlord's claim is capped. *Id.* Because the amount and nature of the debtor's obligations depend on an uncertain future event — the debtor's election to either assume or reject — any eventual debt is both contingent and unliquidated prior to that election. *Id.* at 412 (citing *Mazzeo*, 131 F.3d at 303); *see also* 11 U.S.C. § 1182(1)(A) (only debts that are noncontingent and liquidated “as of the date of the filing of the petition” are counted toward the Subchapter V debt cap); *In re Parking Mgmt., Inc.*, 620 B.R. 544, 553-54 (Bankr. D. Md. 2020) (holding that postpetition events do not alter the debtor's eligibility for Subchapter V and finding that the unexpired lease at issue was contingent because rejection required court approval).

Brighter Smile argues that Pearly Whites' future payment obligation under its unexpired Lease constituted a noncontingent liquidated debt. Brighter Smile contends that Pearly Whites' liability under the Lease arose prepetition when the Lease was fully executed. Brighter Smile urges us to follow *In re Macedon Consulting, Inc.*, 652 B.R. 480 (Bankr. E.D. Va. 2023). *Macedon Consulting* involved another debtor seeking to use Subchapter V as a remedy to address a burdensome unexpired lease. *Id.* at 482-83. The bankruptcy court ultimately revoked the debtor's Subchapter V status and held that the

debt for future lease obligations was a noncontingent liquidated debt because the only contingency was timing. *Id.* at 485-86. Each month, lease payments come due because they were agreed to prior to the bankruptcy. *Id.* “Absent the end of the world, we know the future date [when rent is due] will occur.” *Id.* Because the parties know the amounts due under the unexpired lease on the petition date, the obligations must be noncontingent. *Id.* Thus, the *Macedon Consulting* court held that no postpetition event, including a rejection of the unexpired lease, can change the prepetition nature of the debt. *Id.*

The court disagrees with this argument. Future obligations under unexpired leases are contingent and unliquidated because the amount and nature of the debtor's obligations depend on an uncertain future event — Pearly Whites’ assumption or rejection of the Lease. *See* 11 U.S.C. § 365(g). The power to assume or reject unexpired leases necessarily arises on the petition date and creates a contingency on the petition date. Section 365 creates an obligation that is distinct from the debtor’s other obligations – one that the debtor can only reduce and recharacterize with court approval. Additionally, any rejection damages claims would be capped by 11 U.S.C. § 362(g) and reduced by the landlord’s duty to mitigate. *See* 11 U.S.C. § 502(b)(1). Here, there is no evidence before the court besides the Lease pertaining to the mitigation issue, so it is not

clear that Westcoast's filed claim reflects the required mitigation of damages. Thus, it is possible that rejection may result in no claim at all. If the rule in *Macedon Consulting* were adopted, small businesses with burdensome unexpired leases would be unable to reorganize in Subchapter V. *Zhang Med.*, 655 B.R. at 411. In summary, because the nature and amount of the landlord's claims cannot be determined as of the petition date, those claims are contingent and unliquidated and are not counted toward the Subchapter V debt cap.

IV. CONCLUSION

Brighter Smile obtained a prepetition \$6,700,000 judgment against Pearly Whites. Pearly Whites also owes \$100,000 in trade debt and \$400,000 in attorney fees to NBS. The \$500,000 lease claim does not count towards the Subchapter V debt cap. Brighter Smile failed to prove by a preponderance of evidence that the lease obligation is a noncontingent liquidated debt. Pearly Whites' noncontingent liquidated debts as of the petition date do not exceed the \$7,500,000 debt limit set forth in § 1182(1)(A). The motion to dismiss Pearly Whites' petition for relief under Subchapter V is DENIED.