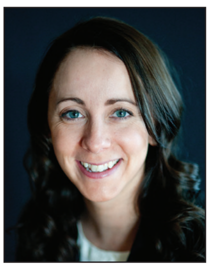
Feature

By Nicholas C. Brown, Bethany J. Rubis and Victoria M. Manfredonia

Amendments to the Preference Statute Under the SBRA and CAA

Nicholas C. Brown
ASK LLP; St. Paul, Minn.



Bethany J. Rubis
ASK LLP; St. Paul, Minn.

Victoria M. Manfredonia
ASK LLP; St. Paul, Minn.

Nicholas Brown is a partner, and Bethany Rubis and Victoria Manfredonia are associates, with ASK LLP in St. Paul, Minn.

Due to recent legislation, practitioners may need to change the way they evaluate and address preference actions. Under the Small Business Reorganization Act (SBRA),[1] enacted in February 2020, Congress amended 11 U.S.C. § 547(b) to now include "reasonable due diligence" language that is arguably part of the preference case in chief. Thus, in addition to proving the five statutory elements of a preference, a trustee could now potentially be required to establish that he/she has exercised reasonable due diligence in the circumstances of the case and evaluated a party's known (or reasonably knowable) affirmative defenses under § 547(c).

In addition, the Consolidated Appropriations Act (CAA),[2] enacted in December 2020, added a new exception to the bankruptcy trustee's avoidance powers under § 547. Section 547(j) precludes a debtor or trustee from avoiding as a preference transfers made in connection with "agreements or arrangements" to "defer or postpone the payment of" amounts (1) for "rent and other periodic charges under a lease of nonresidential real property" or (2) "due under an executory contract for goods or services."[3]

Enforceability Concerns Surrounding the "Reasonable Due Diligence Standard" and Its Interplay with § 547(g)

Upon filing for bankruptcy, the Bankruptcy Code permits a debtor (or trustee) to avoid and recover preferences made during the 90 days prior to its petition date (*i.e.*, the preference period). In order to "avoid" and then recover a preference, a trustee must establish each element of avoidance under § 547(b). In its current form, § 547(b) provides that "[e]xcept as provided in subsections (c), (i) and (j) 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," provided that the five elements of a preference are met.[4] Although requiring a trustee to exercise his/her due diligence when seeking to avoid a preference seems relatively straightforward in theory, complexities arise when trying to reconcile the language of the due diligence standard to the burdens of proof set forth in § 547(g).

Pursuant to § 547(g), the trustee has the burden of proving the avoidability of a transfer under § 547(b), while the creditor with whom avoidance is sought has the burden of proving the nonavoidability of a transfer under § 547(c). In other words, a trustee must prove that a preference exists, while a defendant has the burden of proving that an affirmative defense to an avoidance exists. Congress did not alter the burdens of proof set forth in § 547(g) when it added the due-diligence standard. However, a plain reading of the due-diligence standard, which in part provides that a trustee seeking to avoid a transfer may do so "based on ... taking into account a party's known or reasonably knowable affirmative defenses," arguably begins to shift some of the creditor's burden onto the trustee. The question then arises as to whether the new standard runs in conflict with the allocation of burdens in § 547(g). Conversely, a finding that the standard is in harmony with § 547(g) lends to the burden's "reasonable" threshold, to which many experienced trustees already adhere when deciding which creditors to pursue when commencing a preference action.

Enforceability of the due-diligence standard is further complicated by the nature and surrounding circumstances of the defenses available in preference actions. Like many other areas of the law, affirmative defenses pertaining to preference actions can be messy. One of the most common defenses to a preference action is the subjective prong of the ordinary-course-of-business defense under § 547(c)(2)(A).

The ordinary-course-of-business defense, often asserted by creditors seeking to establish that the transfers at issue were consistent with past dealings, requires a fact-intensive analysis.[5] The defense requires a court to consider a series of factors, including the length of the parties' business relationship, the typical invoice and payment amounts among the parties, the manner in which payments were tendered and the timing of the debtor's payments.[6] Moreover, there can be instances where a debtor's records will look ordinary on their face (*i.e.*, payments were timely and typical in amount),

1 Pub. L. No. 116-54.
2 2021, Pub. L. No. 116-260.
3 11 U.S.C. § 547(j)(1).
4 11 U.S.C. § 547(b) (emphasis added).
5 *See In re Roblin Indus. Inc.*, 78 F.3d 30, 40 (2d Cir. 1996).
6 *In re Hechinger Inv. Co. of Del. Inc.*, 320 B.R. 541, 548 (Bankr. D. Del. 2004).

but a deeper dive into the parties' correspondence, often through the discovery process, shows that the creditor applied pressure and unusual collection tactics to ensure that the debtor continued to make payments.[7]

In addition, even a seemingly more straightforward defense, such as the subsequent new value defense under § 547(c)(4), can be complicated. A trustee may only have electronic data providing the date of an invoice. While that generally is the appropriate date for goods (assuming that the goods were shipped on the invoice date), the appropriate new value date for services is the date that those services were provided.[8] Invoice dates and service dates may vary, meaning that a review of invoice copies in a creditor's possession is often needed.

These examples are just a few of the gray areas surrounding preference defenses under § 547(c). This further lends to the due-diligence standard's enforceability issues, the difficulties that a court will face when evaluating whether a defense was reasonably known to the trustee, and the blurred line of how far a trustee must evaluate a defense whose burden belongs to the creditor.

To further complicate enforceability concerns, a trustee might be forced to rely on imperfect data when assessing preference claims. Given the poor financial state and economic turmoil surrounding many entities during the months leading up to bankruptcy, debtors do not always have the best recordkeeping. Thus, even after spending ample time analyzing a debtor's records and weeding out possible preference targets, there might be discrepancies within the data that can lead to certain defenses being overlooked.

While the courts will parse out many of the questions surrounding § 547(b)'s due-diligence standard in the next few years, given the recency of the enactment, the treatment and effects of the standard are still largely unknown. Of the limited guidance thus far, *In re Trailhead Engineering LLC* is arguably the most informative as to what qualifies as "reasonable due diligence in the circumstances of the case." In this case, the defendant argued that the trustee failed to conduct his pre-filing due diligence given the lack of factual allegations in the complaint, and asserted that this warranted dismissal of the preference claim.[9] Although the court held that it "[n]eed not determine ... whether 'reasonable due diligence' is an element requirement of the preference claim," and therefore did not attempt to clarify the due diligence standard's interplay with § 547(g), the court found that "a plain reading of the statute references due diligence 'in the circumstances of the case,' meaning that a level of discretion is involved."[10] In applying its discretion, the court held that the trustee's review of the creditor's bank and wire records, invoices to the debtor, correspondence between the parties and the contract at issue, all evidenced in the complaint, served as sufficient information to satisfy the reasonable due diligence standard of § 547(b).[11]

Conversely, the court in *In re ECS Ref. Inc.* took a further (and perhaps questionable) view on the statutory implications of the due-diligence standard. Basing its analysis on the Prison Litigation Reform Act, the court held that a trustee's due diligence and consideration of affirmative defenses acts as a condition precedent, and thus is treated as an additional element of the trustee's *prima facie* case under § 547(b).[12] However, this statutory interpretation could be viewed as being in conflict with § 547(g) to the extent that it shifts the burden of establishing § 547(c) defenses onto the trustee. If so, this will almost certainly lead to disputes among the courts. Nevertheless, the court noted that this standard only calls for "reasonable" due diligence, finding that the trustee's *Twombly*-style complaint, which failed to plead necessary facts such as the parties' business relationship along with payment dates and amounts, suggested a "lack of pre-filing due diligence" on the trustee's behalf.[13]

Best Practices Pursuant to § 547(b)'s Due-Diligence Standard

While waiting for the courts to offer further guidance on the effects of the recent legislation, practitioners within the preference field should develop a set of best practices to satisfy § 547(b)'s due-diligence standard, notwithstanding the fact that § 547(c)'s burden remains with the creditor asserting the defense. For starters, if time constraints permit, a trustee should send pre-suit demand letters for the preferential transfers at issue before filing suit, inviting potential defendants to provide evidence of their affirmative defenses in response. This process includes a trustee reviewing plan documents for released parties and other specific concerns, such as creditors with assumed contracts.

Moreover, a trustee should review a creditor's likely new value under § 547(c)(4) to see whether the size of the case warrants filing suit, bearing in mind the jurisdiction's stance on the applicability of the venue statute under 28 U.S.C. § 1409(b). As evidenced by case law, a trustee should also make sure that the complaint clearly recites the facts of the case and the due diligence efforts taken throughout.

The CAA Adds a New Exception to Preference Avoidance

Another recent defendant-friendly addition to the preference statute is new § 547(j). It was enacted to protect landlords and suppliers who agree to defer or postpone the payment of arrearages by debtors struggling because of the COVID-19 pandemic. Normally, landlords and suppliers can reduce or eliminate their preference exposure if they receive payments consistent with past dealings or contemporaneously in exchange for new value.[14]

Under circumstances where the creditor agrees to defer payments to accommodate a debtor's financial hardship, such as through a payment plan, the resulting payments might not qualify as either ordinary or contemporaneous.[15] Section 547(j) mitigates the risk of avoidance inherent in payment plans by rendering certain of those payments immune from clawback.

7 *See In re Sierra Concrete Design Inc.*, 463 B.R. 302, 306 (Bankr. D. Del. 2012).
8 *In re U.S. Interactive Inc.*, 321 B.R. 388, 394 (Bankr. D. Del. 2005).
9 *In re Trailhead Eng'g LLC*, No. 18-32414, 2020 WL 7501938, at *7 (Bankr. S.D. Tex. Dec. 21, 2020).
10 *Id.*
11 *Id.*
12 *In re ECS Ref. Inc.*, No. 18-22453-A-7, 2020 WL 7383655, at *18-22 (Bankr. E.D. Cal. Dec. 15, 2020).
13 *Id.*
14 11 U.S.C. § 547(c)(1)-(2), (4).

continued on page 61

Limitations to the New Exception

The application of § 547(j) will depend on meeting certain criteria. The arrearages at issue must be owed under a lease for nonresidential real property (for landlords) or an executory contract (for suppliers). Because § 547(j) was designed specifically with the COVID-19 pandemic in mind, the exception applies only to leases and executory contracts in place *before* March 13, 2020, and for which the parties formalize an agreement *after* March 13, 2020, to address arrearages. The exception is not available in bankruptcy cases filed prior to March 13, 2020, and contains a sunset provision discontinuing the defense for bankruptcy cases filed after Dec. 27, 2022. The exception remains in effect for adversary proceedings filed after that date, so long as the underlying case was filed prior to Dec. 27, 2022.

In addition to these temporal limitations, the new exception does not apply to payments for fees and other charges that do not appear in the underlying contract. Section 547(j)(1)(A)(iii) excludes from coverage "fees, penalties, or interest in an amount greater than the amount of fees, penalties or interest that the debtor would owe if the debtor had made every payment due under the [lease or executory contract] ... on time and in full before March 13, 2020." The exception is not meant to reward creditors seeking to benefit from the debtor's financial hardship. Thus, if the payment plan includes fees, penalties or interest in excess of what is scheduled under the original contract, those payments are not protected.[16]

Prospects for Future Litigation

Due to ambiguities in the language, certain provisions of § 547(j) appear destined for litigation. For example, it is not clear how payments that combine contractual arrearages with extra-contractual fees will be treated. If a landlord charges a fee for deferring payments, do the deferred payments lose protection, or just the amount of the fee? If the landlord and tenant agree as part of a payment plan to retroactively increase the monthly rent, such that the payments exceed what was owed under the original lease, will courts bifurcate the payments into avoidable and nonavoidable portions or deem them avoidable in full?

Another aspect of § 547(j) that gives rise to uncertainty is the requirement that supplier arrearage payments be due under an executory contract. Executory contracts have been famously defined:

> An agreement is executory if at the time of the bankruptcy filing, the failure of either party to complete performance would constitute a material breach of the contract, thereby excusing the performance of the other party.[17]

Most suppliers and debtors rely on purchase orders and invoices to formalize their transactions, but in many instances, the parties also operate under a master services agreement. Courts undergoing a § 547(j) analysis will need to pinpoint the specific contract under which the arrearages are due, and may require a Countryman analysis to determine whether the contract is executory.[18]

Finally, the new exception is silent as to the holder of the burden of proof, and Congress failed to amend § 547(g) to specify who carries the burden of proof under § 547(j). Absent an amendment by Congress, it is unclear how courts will allocate the burden of proof.

Conclusion

Moving forward, whether a trustee meets his/her due diligence under § 547(b) is largely circumstantial and within a court's discretion. However, as the due-diligence standard begins to receive more attention, best practices such as those identified herein will provide trustees with the best chance of avoiding potential tussles with the courts. Meanwhile, § 547(j) offers an alternative to landlords and suppliers who cannot take advantage of ordinary course or new value defenses, at least for the next few years. abi

15 *In re Bender Shipbuilding & Repair Co. Inc.*, 479 B.R. 899 (Bankr. S.D. Ala. 2012); *In re Forklift LP Corp.*, 2006 WL 2042979 (D. Del. July 20, 2006); *In re Gangarams Inc.*, 219 B.R. 2 (Bankr. D.R.I. 1998).
16 11 U.S.C. § 547(j)(1)(A)(iii)(I), (B)(iii)(I).