By Brigette McGrath and Eric Steinfeld

Did the SBRA Really Change Much for Preference Litigation?

Editor's Note: *ABI's newly formed Subchapter V Task Force is seeking input from those who have had experience working with subchapter V. To participate in a survey on subchapter V, please visit abi.org/subvsurvey.*

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In an amendment to the Bankruptcy Code, the Small Business Reorganization Act of 2019 (SBRA) amended § 547(b) to add an explicit requirement for a bankruptcy trustee or debtor in possession to conduct "reasonable due diligence" before filing a preference action.[1] Because Congress did not provide legislative history regarding the new language's purpose or application, a host of questions have arisen as to the rule's proper application. Commentators and practitioners have surmised that the new language is intended to curtail certain chapter 7 trustees and chapter 11 liquidating trusts from bringing preference actions against all recipients of transfers without any review of whether such recipients have obvious affirmative defenses under § 547(c) of the Code.[2] However, it is unclear whether the reasonable due diligence requirement is an element of the preference claim or whether it is an affirmative defense. In addition, questions as to what constitutes "reasonable due diligence" under the new rule, and under what circumstances § 547(c) affirmative defenses are not reasonably knowable for a trustee to conduct due diligence, have plagued the courts.

Case Survey

Amended § 547(b) sets forth the *prima facie* elements of a bankruptcy trustee's preference action. Congress amended § 547(b) to include the italicized language:

> Except 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.[3]

While the amended language does not explicitly require trustees to plead due-diligence efforts in the complaint, defense attorneys have sought refuge in the amendment at the motion-to-dismiss stage to argue that preference complaints are insufficiently pled if they fail to explicitly state that the trustee has performed his/her due diligence.[4] Despite these attempts, the majority of courts have been reluctant to weigh in on whether the reasonable due-diligence requirement is an element of the preference claim that must be affirmatively pled.[5] However, at least one court has stated that it is a condition precedent, and thus a new element that the plaintiff must allege and prove.[6]

Apprehension to Finding Due Diligence as a New Element

Courts hesitating to weigh in on whether the reasonable due-diligence requirement is an element of the preference have instead relied on the allegations in the complaint to conclude that the trustee adequately conducted due diligence. In *In re Trailhead Eng'g LLC*,[7] the bankruptcy court denied a motion to dismiss and declined to determine whether the "reasonable due diligence" requirement was an element of a preference action because the complaint

1 *See* Small Bus. Reorganization Act of 2019, Pub. L. No. 116-54 § 3(a), effective Feb. 19, 2020.

2 *See* Gregory G. Hesse & Michael R. Horne, "Courts Begin Interpreting New Due Diligence Requirements for Trustees Before Filing Preference Actions," 18 *Pratt's J. of Bankr. Law* 1(2022); *see also* 5 *Collier on Bankruptcy* ¶ 547.02A (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2020) (presuming amendment's purpose was to combat "preference mills," which are law firms employed on contingent basis who file adversary proceedings for small-dollar actions in districts other than defendant's residence with little or no evaluation of merits, solely to force nuisance value settlements).

3 *See* 11 U.S.C. § 547(b) (emphasis added).

4 *See, e.g., In re Ctr. City Healthcare LLC*, 641 B.R. 793 (Bankr. D. Del. June 13, 2022) (collecting cases); *Miller v. Nelson (In re Art Inst. of Phila. LLC)*, No. 18-11535 (CTG), 20-50627 (CTG), 2022 Bankr. LEXIS 68, at *49 (Bankr. D. Del. Jan. 12, 2022); *Faulkner v. Lone Star Car Brokering LLC (In re Reagor-Dykes Motors LP)*, No. 18-50214-RLJ-11, 2021 WL 2546664 (Bankr. N.D. Tex. 2021); *Sommers v. Anixter Inc. (In re Trailhead Eng'g LLC)*, No. 18-32414, 2020 WL 7501938 (Bankr. S.D. Tex. 2020); *Husted v. Taggart (In re ECS Ref. Inc.)*, 625 B.R. 425 (Bankr. E.D. Cal. Dec. 15, 2020).

5 *See In re Ctr. City Healthcare LLC*, 641 B.R. at 802 (Bankr. D. Del. June 13, 2022) ("The Court finds it unnecessary to resolve this issue. Even if the amended language of section 547(b) added 'reasonable due diligence' as an element of a claim for an avoidable preference, the Court concludes that the Debtors in this case have adequately pled factual allegations to satisfy that element."); *In re Insys Therapeutics Inc.*, 2021 WL 5016127, at *3 (Bankr. D. Del. Oct. 28, 2021) (concluding that although purpose of reasonable-due-diligence language was susceptible to more than one interpretation, there was no need to rule on interpretative issue because trustee adequately pled due diligence in his complaint); *In re Reagor-Dykes Motors LP*, 2021 WL 2546664 at *5 (explaining that court need not decide whether due-diligence language created additional element, but emphasizing that trustee must exercise certain level of due diligence before bringing preference action); *In re Trailhead Eng'g LLC*, 2020 WL 7501938, at *7 (declining to conclude whether due diligence language created additional element and deciding that court had discretion to apply requirement based on what complaint alleged).

6 *In re ECS Ref. Inc.*, 625 B.R. 425 (Bankr. E.D. Cal. Dec. 15, 2020); *see also Weinman v. Garton (In re Matt Garton & Assocs., LLC)*, Case No. 19-18917 TBM, 2022 WL 711518 (Bankr. D. Colo. Feb. 14, 2022) ("[A]rguably, the new due diligence requirement is an element of a preference claim under Section 547.").

7 *Sommers v. Anixter Inc. (In re Trailhead Eng'g LLC)*, No. 18-32414, 2020 WL 7501938 (Bankr. S.D. Tex. 2020).

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contained sufficient allegations.[8] The complaint specifically alleged that the trustee had examined documents, including the debtor's bank records, invoices between the parties, correspondence and the operative contract.[9] The trustee also included a chart of the relationships among the relevant entities, and had thus demonstrated due diligence, even though the complaint did not plead due diligence as an element. The court emphasized that a plain reading of the statute granted it discretion in applying the requirement, citing to the new "circumstances of the case" language in amended § 547(b).[10]

Although the factual allegations referenced by the court in *In re Trailhead* imply that the trustee sufficiently alleged due diligence regarding the alleged transfers, it remains unclear whether the trustee properly alleged due diligence regarding the defendant's affirmative defenses under § 547(c). Nevertheless, the court's analysis at least suggests that the trustee must plead factual allegations that satisfy the "reasonable due diligence" requirement before filing a complaint, but not necessarily as an independent element of the preference.

The decisions in *In re Reagor-Dykes Motors LP*[11] provide insight into what is and is not an acceptable due-diligence pleading. This case covered three complaints filed against separate defendants, and all three defendants filed motions to dismiss, contending that the trustee failed to allege sufficient facts to carry its burden of "reasonable due diligence." The court acknowledged that the SBRA was intended to deter the filing of abusive lawsuits.[12] It also recognized the lack of clarity regarding the new requirement, stating that it was unclear whether the due-diligence language created an additional pleading requirement.[13] However, the court made it clear that in bringing a preference action, a trustee must exercise due diligence and consider the party's known or reasonably knowable affirmative defenses under § 547(c).[14] As to what constitutes "sufficient due diligence," the court cautioned that it is difficult to assess a trustee's due-diligence efforts at the motion-to-dismiss stage, but the sufficiency of the due diligence depends on the case's circumstances.[15] A mere recital by a trustee that he had exercised sufficient due diligence, thus mimicking the language of the statute, is insufficient.[16]

Ultimately, the court refused to dismiss the complaint against the first defendant despite the minimal factual allegations asserted in the complaint.[17] Because the defendant had not answered the suit, its affirmative defenses were unknown, thus minimal factual allegations about the parties' relationship and the circumstances surrounding the transfers did not reflect an abusive filing.[18]

Taken as a whole, most courts are uniformly requiring trustees to allege facts reflecting their due diligence, but the extent of such due diligence remains unclear and should be determined on a case-by-case basis.

Conversely, the court dismissed the other two complaints[19] because they had failed to provide context as to the transfers and the nature of the parties' relationship.[20] In doing so, the court proffered several questions that provided insight into the type of context that should be included: "What kinds of services or goods did either defendant provide?"[21] "How were the business relationships structured?"[22] "Were the transfers on account of ordinary business practices, simultaneous value, or a cash-on-delivery agreement, or was new value provided for these transfers?"[23] None of these questions could be answered with any certainty, since there was no information in the complaints about the nature of those transfers.[24] Thus, it is important for trustees to provide context as to the transfers and the nature of the parties' relationship in the complaint.

Despite the lack of conformity in determining what constitutes "reasonable due diligence," two recent decisions seem to indicate a baseline for satisfying the requirement, whether it is an element or not. Both *In re Insys Therapeutics Inc*.[25] and *In re Ctr. City Healthcare LLC*[26] declined to rule on whether the revisions to the statute created a new element, but determined that if it was an element, it was met by the trustee and debtors, respectively.[27] In both cases, the trustee and debtors conducted an analysis of the pre-petition payments during the avoidance period for goods and services provided by the transferees, and analyzed whether those transfers were protected from avoidance by any knowable defenses.[28] They then sent letters prior to initiating suit and invited the defendants to advise them of their defenses, and to the extent any defenses were presented, they took them into account.[29] Both courts held that they conducted reasonable due diligence despite not

8 *Id.* at *7.
9 *Id.*
10 *Id.*
11 *In re Reagor-Dykes Motors LP*, No. 18-50214-RLJ-11, 2021 WL 2546664 (Bankr. N.D. Tex. June 21, 2021).
12 *Id.* at *2.
13 *Id.*
14 *Id.*
15 *Id.*
16 *Id. See also Arete Creditors Litig. Trust v. TriCounty Fam. Med. Care Grp. LLC (In re Arete Healthcare LLC)*, No. 19-52578-CAG, 2022 WL 362924, at *11 (Bankr. W.D. Tex. Feb. 7, 2022) ("If due diligence is an element, merely paraphrasing the element will not satisfy Rule 8.").
17 *Id.* at *3.
18 *Id.*
19 The trustee was granted leave to amend the complaints.
20 *Id.* at *6.
21 *Id.* at *5.
22 *Id.*
23 *Id.*
24 *Id.*
25 *Insys*, 2021 WL 5016127 at *3.
26 *Ctr. City*, 641 B.R. at 802.
27 *Insys*, 2021 WL 5016127 at *3 (declining to conclude that amended language added new element but finding that trustee had adequately pled due diligence.); *Ctr. City*, 641 B.R. at 802 ("Even if the amended language of section 547(b) added 'reasonable due diligence' as an element ... the Debtors in this case have adequately pled factual allegations to satisfy that element.").
28 *See id.*
29 *Id.*

pleading how the affirmative defenses were not available:[30] "There is no requirement that the debtors plead how the affirmative defenses are not available, the debtors must simply plead that they considered them."[31]

Minority View: "Reasonable Due Diligence" Is an Element of § 547(b)

Although most courts have side-stepped the issue by relying on the complaint's factual allegations, the *In re ECS Ref. Inc.* court concluded that the new language inserted into § 547(b) created a condition precedent to a preference claim, requiring that the trustee's due-diligence efforts be set forth in the complaint to state a *prima facie* claim.[32] The court analyzed the condition precedent as having three prongs that a trustee must undertake before commencing a preference action: "(1) reasonable due diligence under 'the circumstances of the case'; (2) consideration as to whether a *prima facie* case for a preference action may be stated; and (3) review of the known or 'reasonably knowable' affirmative defenses that the prospective defendant may interpose."[33] In concluding that "reasonable due diligence" is an element of the trustee's preference action and not an affirmative defense, the court focused on three features of the statute.

First, § 547(b) is the sole source of the trustee's substantive rights and defines what a trustee must show for avoidable preferences.[34] Second, § 547(c) offers preference defendants an exhaustive list of nine affirmative defenses, therefore § 547(b)'s new language should not be viewed as a preference defendant's affirmative defense.[35] Third, Congress expressly allocated the burden of proof on the issue of due diligence under § 547(b) to the trustee under § 547(g).[36] Despite finding that reasonable due diligence was a new element of the preference claim, the court noted that reasonable due diligence was already required under Rule 9011 of the Federal Rules of Bankruptcy Procedure.[37] Thus, in practice, all that has changed is that trustees now have to plead their due diligence efforts in their complaints.

Practice Tip

Taken as a whole, most courts are uniformly requiring trustees to allege facts reflecting their due diligence, but the extent of such due diligence remains unclear and should be determined on a case-by-case basis. In particular, very fact-specific defenses, such as the ordinary-course-of-business defense, can be very difficult to assess until discovery. At a minimum, trustees should send pre-suit demands with a net of new-value calculation and request information to support any other affirmative defenses. Trustees should also describe these efforts in their complaints to ensure protection from any motions-to-dismiss. abi

30 *Id.*
31 *Ctr. City*, 641 B.R. at 802.
32 *Husted v. Taggart (In re ECS Ref. Inc.)*, 625 B.R. 425, 454 (Bankr. E.D. Cal. Dec. 15, 2020).
33 *Id.*
34 *Id.* at 456.
35 *Id.*
36 *Id.*
37 *Id.* at 457.