AVOIDANCE ACTION REPORT

A Bi-Annual Report on the Latest Case Law Relating to Avoidance Actions and Other Bankruptcy Issues

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Payments Made Pursuant to A Payment Plan Are Not Ordinary; Forbearing from Filing a Lien is Not Contemporaneous New Value

Dribusch v. Gross Electric (In re New York Light Energy, LLC), 2018 WL 4719007 (Bankr. N.D.N.Y. Sept. 28, 2018)

New York Light Energy ("Light Energy") filed for bankruptcy under Chapter 11 of the Bankruptcy Code. The case later converted to Chapter 7 and Christian Dribusch was appointed as the Chapter 7 trustee. Dribusch sued Gross Electric ("GE") to avoid two transfers made to GE in the 90 days prior to the bankruptcy. The payments were made pursuant to an affidavit in support of judgment by confession under which Light Energy agreed to pay GE $161,283.07 per month for eleven months for past due amounts plus interests. GE argued that the payments were not avoidable because in exchange for the payments GE delayed filing mechanic's liens on the debtor's property, which constituted a contemporaneous exchange for new value under 11 U.S.C. §547(c)(1). GE further argued that the payments were made in the ordinary course of business and are therefore not recoverable under 11 U.S.C. §547(c)(2). The Trustee filed a motion for summary judgment.

The Chapter 7 trustee argued that forbearing from filing the mechanic's liens does not constitute new value under § 547(c)(1). The Chapter 7 trustee further noted that even if GE did file the mechanic's liens, the liens would be primed by the bank's blanket liens and, therefore, the debtor did not receive any value as a result of such forbearance. The Court ruled that it need not determine the validity of either of these arguments as the evidence demonstrated that not only were the forbearance and transfers not contemporaneous, but the parties did not intend for it to be a contemporaneous exchange. Under §547(c)(1)(A), a transfer must not only be contemporaneous, but the parties must also intend for the exchange to be contemporaneous. The Court noted that the payments at issue were made at least two months after GE gave up its right to file its mechanic's liens. Moreover, the Court pointed out that the affidavit in support of judgment by confession contemplated payments being made over 11 months. The Court concluded that the anticipated payments over time combined with the time gap between the payments and when GE allegedly provided the new value (i.e., its forbearance of filing mechanic's liens) demonstrated that the exchange was not contemporaneous and that the parties did not intend for the exchange to be contemporaneous.

Turning to the ordinary course of business defense, the Chapter 7 trust-

ee argued that it was not customary for Light Energy to provide affidavits in support of confessions of judgment and, moreover, such agreements were not customary in the solar power industry. GE argued that the parties' prior dealings indicated that they frequently discussed and agreed upon various payment schedules. However, GE failed to produce any prior agreement that was similar to the payment terms in the affidavit in support of confession of judgment. The Chapter 7 trustee further noted that emails exchanged between Light Energy and GE before the preference period evidenced Light Energy's consistent failure to make payment upon the agreed terms and GE's multiple requests for such payments. Based on the foregoing, the Court noted that the parties' prior dealings consisted of non-payment, late payments, and partial payments, leading for the first time to the affidavit in support of confession of judgment. The Court thus concluded that GE failed to raise a genuine issue of material fact in connection with the ordinary course of business defense. Taking it one step further, the Court found that the collection pressure combined with no prior payment plan under a confession of judgment between the parties evidenced that the payments were not made in the ordinary course of business. Thus, the Court granted the Trustee's motion for summary judgment to avoid the alleged preferential transfers.

COMMENTARY

The Gross Electric decision underscores the difficulties in establishing a contemporaneous exchange defense – as the defendant must demonstrate both parties intended the transfer to be contemporaneous and that the transfer was in fact contemporaneous. In addition, this case highlights that entry to into a special payment arrangement, such as a payment plan, will likely eliminate the possibility of succeeding on an ordinary course of business defense in the absence of a clear prior pattern of similar payment plans.

An 8-Day Deviation In Average Days to Payment Can Be "Ordinary"

Yoo v. Zeta Interactive (In re Blue Glob., LLC), 591 B.R. 433 (Bankr. C.D. Cal. 2018)

Blue Global, LLC, a failed internet-based financial services business, filed for bankruptcy under Chapter 7 of the Bankruptcy Code on January 25, 2017. The Chapter 7 trustee sought to avoid transfers totaling $601,723.52 made by Blue Global to Zeta Interactive, an affiliate-marketing company. Zeta Interactive moved for summary judgment, arguing that the payments in question were made in the ordinary course of business of Blue Global and Zeta Interactive and that the payments were made according to ordinary business terms within the affiliate-marketing industry. The trustee opposed the summary judgment motion, arguing, among other things, that Zeta Interactive used the wrong pre-preference time period for establishing the parties' baseline course of dealing.

The payments made during the preference period were paid, on average, 46 days after the invoice date. Zeta Interactive demonstrated that the historical transfers from June 30, 2015 to January 31, 2017 averaged 43.95 days to payment. Thus, Zeta Interactive argued that the payments in the preference period were ordinary. The trustee asserted that the historical baseline should not include any payments made subsequent to March 17, 2016, when Blue Global entered into a consent order for a payment plan with the New York Department of Financial Services, because, after such time, Blue Global was in financial distress. The trustee noted that prior to the consent decree, Blue Global took an average of 37.75 days to pay Zeta Interactive, which rose to 47.55 days after the consent decree. Thus, the trustee argued that the baseline days to payment should be 37.75, not 43.95, and therefore, the preference payments at 46 days to payment were not ordinary.

The Court disagreed with the trustee's position that there is a genuine dispute as to the appropriate baseline period. The Court noted that it was dealing with a relatively small pre-preference period data set and that dividing the pre-preference period into segments prior to and subsequent to the entry of the consent decree renders the data set even smaller, making it difficult to identify a general trend from a descriptive sta-

tistic such as an average. Nevertheless, the Court concluded that the eight-day difference between the post-consent decree period and the pre-consent decree period did not result in a genuine dispute in connection with determining the appropriate historical baseline because either way, the payments at 46 days would be ordinary. Therefore, the Court held that Zeta Interactive is entitled to summary judgment finding that the preference period transfers were made within the ordinary course of business and are exempt from avoidance pursuant to § 547(c)(2)(A) and § 547(c)(2)(B).

COMMENTARY

Zeta Interactive serves as a reminder that the ordinary course defense is highly fact specific and a relatively small shift in payment terms, without more, may not be sufficient to defeat this affirmative defense.

Debtor's Prior Counsel May Represent Defendants Of Debtor's Preference Actions

Peterson v. Sanches (In re Mack Indus., Ltd), 606 B.R. 313 (Bankr. N.D. Ill. 2019)

After filing for bankruptcy under Chapter 11 of the Bankruptcy Code, Mack Industries, Ltd. ("Mack") hired attorney David Lloyd to assist Mack and its original bankruptcy counsel with the bankruptcy process. Soon thereafter, Mack consented to the appointment of Ronald Peterson as the Chapter 11 trustee in the case. Peterson moved to convert Mack's Chapter 11 case to Chapter 7, which the court granted. Peterson was appointed as Chapter 7 trustee and filed 440 preference actions. Upon finding out that Lloyd represented defendants in 52 of the adversary proceedings, the Chapter 7 trustee filed motions to disqualify Lloyd.

The Chapter 7 trustee argued, without any supporting case law, that Lloyd owed (i) a statutory duty to cooperate with the trustee, and (ii) a duty of loyalty to the bankruptcy estate. The trustee further argued that by representing defendants in the adversary proceedings, Lloyd breached both duties. The Court noted that the Bankruptcy Code did not impose a statutory duty to cooperate with a chapter 7 trustee on a debtor's counsel. The Court further noted that Lloyd did not owe any statutory duties to the estate. Lloyd only owed his client, the debtor, the standard fiduciary duties, which are governed by the court's rules of professional conduct.

However, after ruling on the duty issue, the Court then turned to whether Lloyd's current representations of the debtor in its Chapter 7 bankruptcy as well as 52 defendants in adversary proceedings was permissible under the Court's rules of professional conduct, which adopted the ABA Model Rules of Professional Responsibility ("ABA Model Rules"). The Court concluded that while Lloyd did not have a statutory duty to cooperate with trustee, he did have a duty to assist the debtor in attempting to comply with the Chapter 7 trustee's requests during the course of the adversary proceedings, which could be adverse to the interests of the defendants in the adversary proceedings and would thus violate Rule 1.7 of ABA Model Rules. Rule 1.7 of ABA Model Rules states that "a lawyer shall not represent a client if the representation involves a concurrent conflict of interest." The Chapter 7 trustee contended that even if Lloyd withdrew as a counsel to the debtor, he could not still represent defendants in the adversary proceedings because the issues were substantially related to his representation of the debtor. Under Rule 1.9 of the ABA Model Rules "[a] lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interest of the former client unless the former client gives informed consent, confirmed in writing." The Court, however, concluded that this rule did not apply to Lloyd because the Chapter 7 trustee brought avoidance actions as trustee for the benefit of the Chapter 7 estate, not on behalf of the debtor, who was Lloyd's actual client. Thus, the Court ruled that if Lloyd withdrew as counsel to the debtor, he could continue representing defendants in the case.

COMMENTARY

While the Mack court ultimately ruled that counsel to a debtor may represent avoidance action defendants in the debtor's chapter 7 case, the decision should still serve as a cautionary tale to practitioners. At a minimum, counsel should first obtain consent from their original client to withdraw from the representation before moving forward with new engagements to avoid potential disqualification disputes.

The Small Business Reorganization Act and Its Effect on Preference Actions in Bankruptcy Cases

Small Business Reorganization Act of 2019

The Small Business Reorganization Act ("SBRA" or the "Act") was enacted after being signed by the President on August 23, 2019 and becomes effective 180 days after enactment. The Act provides small businesses with less than $2.5 million in debt with an opportunity to resolve outstanding liabilities and reorganize through a streamlined and cost-effective Chapter 11 process.

Tucked towards the end of the SBRA, however, is a section that could have a substantial effect on avoidance actions in bankruptcy cases of all sizes. The SBRA amended Section 547(b) of title 11 by inserting that a 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 transfers of property of the debtor. This addition seemingly places a pre-filing burden on the trustee to examine a defendant's affirmative defenses. Section 547(g), however, remains unchanged by the act, and explicitly places the burden of proof for Section 547(c) defenses on the defendant. Also, Section 1409(b) of title 28 is amended by striking $10,000 [currently $13,650 when adjusted for inflation] and inserting "$25,000." This is a substantial increase that nearly doubles the current venue dollar threshold. These two amendments raise several questions for attorneys practicing in the area of avoidance actions.

First, it is not clear whether these amendments are retroactive and will affect avoidance actions filed before the effective date of the Act. Retroactivity is generally not the norm and has to be explicitly provided for in the statute. However, section 104(c) of the Bankruptcy Code clearly states that the periodic dollar adjustments do not apply to cases filed before the effective date of the adjustment. This suggests that Congress, when it so wishes, explicitly limits the application of amendments to adversary proceedings filed after the amendment becomes effective. It could therefore be argued that because Congress did not insert this limitation here, it intended for the amendments to apply to adversary proceedings in bankruptcy cases filed before the SBRA's effective date.

Second, it is unclear what effect, if any, the new due diligence language will have on trustees' pre-filing duties. At first glance, Congress seems to place the burden on the plaintiff to analyze the defendant's defenses and give it credit for them. On the other hand, Congress could have changed the language of Section 547(g), which places the burden on defendant, but it chose not to. This suggests that while there may be some perfunctory minimal pre-filing due diligence requirement, Congress still intended for the defendant to bear the ultimate burden on its defenses.

Finally, if the "reasonable due diligence" becomes a pleading requirement, the language "in the circumstances of the case" and "reasonably knowable" are subject to interpretation.

COMMENTARY

The latest amendments raise a lot of questions for attorneys and, probably, open doors to litigation on retroactivity, respective burdens of proof applicable to a plaintiff or defendant and the level of diligence required prior to commencement of litigation.