Why Creditors Should Beware Of SBRA Due Diligence Defense

By **Eric Chafetz and Lindsay Sklar** (September 6, 2022)

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Preference claims have been a thorn in the side of trade creditors since the promulgation of the U.S. Bankruptcy Code.

One of trade creditors' primary complaints has been the lack of prelawsuit due diligence undertaken by plaintiffs into a defendant's potential preference defenses.

Congress purportedly recognized this concern when it passed the Small Business Reorganization Act of 2019. This act, among other things, included an amendment to Section 547(b) of the Bankruptcy Code, which theoretically required plaintiffs to undertake a heightened level of due diligence before asserting preference claims.

The SBRA amendment became effective Feb. 20, 2020. Given the dearth of legislative history, one interpretation of the SBRA amendment is that its implementation requires plaintiffs to take additional steps to identify and analyze a potential defendant's preference defenses before formally commencing an action.

However, much to the chagrin of trade creditors, courts almost universally have not required a heightened level of diligence into potential defenses, or much additional diligence at all.

The U.S. Bankruptcy Court for the District of Delaware's holding in In re: Center City Healthcare LLC in June[1] is a prime example of courts' reluctance to interpret the SBRA amendment as requiring plaintiffs to undertake any actual additional due diligence.

While courts' analysis of the SBRA amendment's diligence requirement will likely continue to evolve, trade creditors should think long and hard before seeking to dismiss a preference claim on due diligence grounds, unless it is clear that the plaintiff failed to undertake even a modicum of diligence before filing suit, as dismissal is only a distant possibility.

The Due Diligence Requirement

The SBRA amendment modified the preamble of Section 547(b) of the Bankruptcy Code to add the following language:

> (b) 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),[2] avoid any transfer of an interest of the debtor in property.

Neither the legislative history accompanying the SBRA amendment, nor the Bankruptcy Code itself, provide any context or explanation as to what steps a plaintiff must take to satisfy the diligence requirement.

Not surprisingly, courts have reached inconsistent conclusions as to whether the SBRA amendment was intended to add a new prima facie preference element to the Bankruptcy

Code.

One court has held that the SBRA amendment established a new preference element because it created a new condition precedent.[3]

However, the vast majority of courts have not opined on the issue, and instead have focused on other grounds to conclude that the respective plaintiff's pleading of its prefiling diligence efforts was sufficient under the circumstances.

Elements of a Preference Claim

Following the preamble, the unchanged provisions of Section 547(b) require a trustee — or debtor in possession, like here — to satisfy the following elements before recovering a transfer as a preference under Section 550 of the Bankruptcy Code:

- The debtor transferred its property to or for the benefit of a creditor, and the most common type of transfer is the debtor's payment to a creditor.[4]
- The transfer was made on account of antecedent or existing indebtedness — i.e., a payment on credit terms — that the debtor owed to the creditor.[5]
- The transfer was made when the debtor was insolvent.[6]
- The transfer was made within 90 days of the debtor's bankruptcy filing where a noninsider creditor is involved.[7]
- The transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor.[8]

The Center City Case

The courts' hesitance to interpret the SBRA amendment as actually requiring a heightened level of due diligence is illustrated by the Center City case.

In this case, Center City Healthcare and its various affiliates sought Chapter 11 bankruptcy protection in the Delaware bankruptcy court on June 30 and July 1, 2019, respectively.

The debtors retained EisnerAmper LLP to provide certain interim management and operational services. The scope of Eisner's engagement included the review of payments made by the debtors during the 90-day preference period.

During that review, Eisner determined that McKesson Plasma and Biologics LLC and McKesson Medical-Surgical Government Solutions LLC received $790,414 and $62,870 respectively, during the preference period.[9]

On May 7, 2021, and May 26, 2021, the debtors sent two demand letters to the defendants seeking recovery of the transfers.

The demand letters provided an outline of the debtors' claims against the defendants, laid out the defendants' potential preference defenses, provided a settlement offer and requested that the defendants specify the defenses applicable to the claims. For unknown reasons, the defendants never responded to the demand letters.[10]

On June 23, 2021, the debtors filed a complaint against the defendants seeking to avoid and recover the transfers as preferences or fraudulent transfers,[11] and to disallow, under Section 550 of the Bankruptcy Code, any claims that the defendants may have held against the debtors.

The complaint included the following exhibits:

- Exhibit A, or summary of transfers;
- Exhibit B, or detail of transfers to McKesson Plasma; and
- Exhibit C, or detail of transfers to McKesson Medical.

Exhibits B and C each included check numbers, payments, wire or banking Automated Clearing House identifying numbers, payment dates, payment amounts, invoice numbers to which each payment related, and invoice dates and amounts.

The defendants filed a motion to dismiss the complaint Feb. 7. On Feb. 22, the debtors filed a response, and on March 1, the defendants filed a reply.[12]

As described in further detail below, the SBRA amendment's new diligence requirement did not help the defendants' case, and the court denied the motion to dismiss for a variety of reasons.

The Parties' Arguments About the Due Diligence Requirement

The defendants argued that the SBRA amendment added a new affirmative diligence requirement that a plaintiff needed to satisfy as part of their prima facie case.[13]

They asserted that the complaint's threadbare contention that the debtors undertook an inquiry into the defendants' relevant defenses was insufficient to satisfy this new requirement.[14]

Instead, according to the defendants, the debtors were required to plead, in painstaking detail, the specific due diligence efforts that they undertook and then also to analyze the defendants' affirmative defenses.[15]

The defendants also argued that the demand letters lacked specificity and did not include any analysis of the defendants' known or reasonably knowable affirmative defenses, despite the debtors' access to defense information from the debtors' books and records.[16]

In opposition, the debtors argued that the SBRA amendment did not create a new affirmative preference element, and that even if the diligence requirement was treated as a new element, the debtors were not obligated to refute the defendants' affirmative defenses in the context of a motion to dismiss.[17]

This is irrespective of how the complaint did not specifically detail the level of diligence undertaken by Eisner, or include copies of the demand letters.

Instead, according to the debtors, even after passage of the SBRA amendment, the only pleading requirement was that the complaint reflected that the debtors undertook reasonable diligence concerning the preference claims and any potential defenses.

To that end, the debtors argued that they had satisfied this requirement by merely referencing the demand letters and Eisner's diligence efforts in the complaint.[18]

The Court's Holding

Like most prior courts, the court declined to decide whether the SBRA amendment added a new affirmative diligence requirement that the debtors needed to satisfy, in addition to satisfying the existing prima facie elements in Section 547(b) of the Bankruptcy Code.

Nevertheless, the court held that even if the SBRA amendment did create a new diligence requirement, the debtors had adequately pled facts to satisfy this requirement.

Specifically, the court held that the complaint:

- Demonstrated that the debtors sufficiently analyzed the transfers as well as the defendants' available defenses to the avoidance of the transfers;

- Illustrated the debtors' diligence by referencing how the demand letters were sent; and

- Referenced Eisner's efforts and due diligence on behalf of the debtors.

Accordingly, the court held that the debtors sufficiently considered the defendants' affirmative defenses, and that dismissal of the complaint was not warranted at the motion to dismiss stage.[19]

Conclusion

Congress may have intended for the SBRA amendment to create an additional due diligence hurdle that plaintiffs must clear prior to pursuing a preference action.

However, as shown by the Center City case and the case law upon which it relied, this requirement is generally not interpreted in a manner that a defendant would prefer.

Even after the passage of the SBRA amendment, to survive the motion to dismiss, the debtors were only required to plead that they considered the defendants' affirmative defenses, rather than to disprove the defenses.

More significantly, the court did not require the debtors to reduce the gross amount sought in the complaint to account for the impact of any potential defenses — i.e., quantifying the ordinary course of business, new value or contemporaneous exchange for new value defenses — which would have placed an additional burden on the debtors.

One interesting question not answered by the court's decision was whether the holding would have been different if the defendants had responded to the demand letters and provided a detailed defense analysis that the debtors just completely ignored.

While hypothetical, this leads to many potential questions:

- Was the defendants' failure to respond to the demand letters material to the court's reasoning and ultimate holding?

- Would the court have interpreted the diligence requirement differently had the debtors still sought to recover the full amount of the transfers after receiving a detailed analysis in response to the demand letters?

- Would the category of defense asserted in the response to a demand letter be material, i.e., would an ordinary course of business, new value, contemporaneous exchange for new value be treated differently than a cash in advance or contract assumption defense?

While the court in the Center City case did not address these questions or interpret the SBRA amendment as creating a new hurdle, it will be interesting to monitor whether future courts do eventually interpret the SBRA amendment as an additional affirmative diligence requirement that a plaintiff must satisfy to prove its prima facie case.

Until then, trade creditors will continue to have to decide whether asserting a defense based on due diligence grounds through a motion to dismiss is a beneficial use of their limited resources, or just a waste of time.

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[1] In re Center City Healthcare, LLC, No. 19-11466 (MFW), 2022 WL 2133974 (Bankr. D. Del. June 13, 2022).

[2] A defendant's available affirmative defenses include, but are not limited to, the ordinary course of business defense, the subsequent new value defense, and the contemporaneous exchange for new value defense.

[3] See Husted v. Taggart (In re ECS Refining, Inc.), 625 B.R. 425, 453 (Bankr. E.D. Cal. 2020).

[4] § 547(b)(1).

[5] § 547(b)(2).

[6] § 547(b)(3); unlike a fraudulent transfer claim, insolvency is presumed, which makes it easier for a trustee or debtor to prove.

[7] § 547(b)(4).

[8] § 547(b)(5).

[9] In re Center City Healthcare, LLC at *1.

[10] Id. at *1.

[11] The fraudulent transfer claim will not be discussed in this article, but it was dismissed by the Court due to the Debtors' failure to adequately plead solvency.

[12] Id. at *1.

[13] The Court initially disposed of the Defendants' first two non-diligence related arguments. First, the Court held that the allegations in the Complaint were not boilerplate and included sufficient factual information about the Transfers by pointing to, and relying upon, the detailed information included in the Exhibits. Second, the Court held that the Complaint sufficiently alleged that the Defendants receipt of the Transfers resulted in them having received more than they otherwise would have received in a chapter 7 case, as unsecured creditors were not being paid in full under the liquidating plan.

[14] Id. at *4.

[15] Id.

[16] Id.

[17] Id.

[18] Id. at *5.

[19] Id. at *6.