The Due Diligence Pleading Requirement in Preference Actions:

Another Quiver in the Preference Defense Toolkit

CREDIT PROFESSIONALS HAVE LONG BEEN FRUSTRATED BY PREFERENCE CLAIMS THAT FEEL MORE LIKE LEVERAGE FOR NUISANCE SETTLEMENTS THAN EFFORTS TO PROMOTE FAIRNESS AMONG CREDITORS, AS CONGRESS INTENDED. THE WAY PREFERENCE CLAIMS ARE OFTEN WEAPONIZED IN BANKRUPTCY CASES IS ANYTHING BUT FAIR.

Debtors, trustees and other estate representatives will often assert preference claims, indiscriminately, against virtually every one of the debtor's prepetition creditors without thoroughly considering the merits of such claims. Adding insult to injury, this scattershot approach to pursuing preference claims is often undertaken to fund payment of secured and administrative expense claims, *not* the general unsecured claims held by the creditors that are the targets of these claims.

About six years ago, Congress amended Section 547(b) of the Bankruptcy Code (the preference statute) to add a *due diligence* requirement. This additional provision was intended to curb indiscriminate, assembly-line preference litigation by requiring plaintiffs to investigate the merits of their claims and a defendant's reasonably knowable defenses before suing. While Congress might have intended this new "due diligence" requirement to impose an extra burden on potential plaintiffs and deter them from asserting specious or weak preference claims, it has been unclear whether any additional burden has been imposed on plaintiffs as a practical matter.

A recent decision by the Delaware bankruptcy court overseeing the *Christmas Tree Shops* bankruptcy is a breath of fresh air for creditors dealing with preference risk. In *Miller v. Prestige Patio*, the Delaware bankruptcy court dismissed a complaint that failed to plead plaintiff's due diligence or consideration of reasonably knowable defenses. Read on to do your diligence on the decision!

PREFERENCE CLAIMS: THE ELEMENTS AND AFFIRMATIVE DEFENSES

Section 547(b) of the Bankruptcy Code establishes a statutory cause of action by a debtor, trustee, or other estate fiduciary in a bankruptcy case to recover, as a "preference," certain transfers by a debtor to a creditor before the bankruptcy filing. A bankruptcy estate fiduciary (in *Christmas Tree Shops*, a Chapter 7 trustee) must prove all of the following to avoid and recover a pre-petition transfer as a "preference":

1. The debtor had transferred property of the debtor's estate (such as a debtor's payment from its bank account);
2. To or for the benefit of a creditor;
3. On account of an antecedent debt (e.g., an outstanding invoice; so cash in advance payments are not preferences!);
4. On or within the 90 days before the bankruptcy filing (or within a year before the filing, if the transfer was to an "insider");
5. While the debtor was insolvent (which is presumed during the 90-day preference period); and
6. The transfer enabled the creditor to recover more than the creditor otherwise would have received in a hypothetical Chapter 7 bankruptcy case.

Section 547(c) of the Bankruptcy Code arms creditors with affirmative defenses they can assert to minimize or eliminate preference liability where the plaintiff has otherwise proven the elements of a preference claim. The primary affirmative defenses—which a creditor has the burden of proving—are the subsequent new value and ordinary course of business defenses. These affirmative defenses are intended to encourage creditors to continue doing business with and extending credit to financially distressed customers.

PREFERENCE CLAIMS: PROVING THE DUE DILIGENCE REQUIREMENT

The Small Business Reorganization Act of 2019 (SBRA), which became effective on Feb. 19, 2020, added a slight wrinkle to the burdens of proof with respect to a preference claim and applicable defenses. **The SBRA amended Section 547(b) to add, as part of plaintiff's**

burden of proof, that a preference claim be based on "reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses."

The impact of this new due diligence requirement has been the subject of a fair amount of litigation since the SBRA's relatively recent enactment. Defendants have sought to dismiss preference actions by arguing that the due diligence requirement is an additional element of the claim, requiring a plaintiff to plead it in its complaint—and ultimately prove—that plaintiff had conducted reasonable due diligence with respect to the viability of the preference claim and the defendant's affirmative defenses.

This approach has had mixed results, as the overwhelming majority of courts presented with this argument have avoided addressing head-on the extent of a plaintiff's burden of proving the due diligence requirement. Numerous courts have found it unnecessary to decide whether a preference plaintiff had to allege satisfying the due diligence requirement in its preference complaint where plaintiff had pled sufficient facts to prove that it had conducted the requisite due diligence in any event. Other courts have skirted this issue by dismissing the preference action on other grounds, negating any need to consider whether the plaintiff had to allege satisfying the due diligence requirement in the complaint.

In 2023, the Delaware bankruptcy court issued an opinion in the Chapter 11 cases of *Pinktoe Tarantula Limited*, in which the court dismissed a preference action for failing to adequately plead the due diligence requirement. However, the court granted the plaintiff leave to amend the complaint to allege that it had conducted the requisite due diligence—and the court also concluded that a mere "general allegation that [due diligence] occurred satisfies [the] pleading requirement."

In a positive development for trade creditors, the Delaware bankruptcy court's recent decision in the *Prestige Patio* case puts some sharper teeth into the due diligence requirement.

IN A POSITIVE DEVELOPMENT FOR TRADE CREDITORS, THE DELAWARE BANKRUPTCY COURT'S RECENT DECISION IN **THE *PRESTIGE PATIO* CASE PUTS SOME SHARPER TEETH INTO THE DUE DILIGENCE REQUIREMENT**.

RELEVANT BACKGROUND REGARDING THE *PRESTIGE PATIO* DECISION

The well-known retailer Christmas Tree Shops, LLC and its affiliates filed their Chapter 11 bankruptcy cases in May 2023, initially planning to close certain underperforming stores and restructure their debt. However, when their restructuring efforts proved unsuccessful, the Debtors shifted to a full liquidation process. Their Chapter 11 cases were ultimately converted to Chapter 7, and a Chapter 7 trustee was appointed to administer the Debtors' estates and pursue potential sources of recovery, such as preference claims.

On May 5, 2025, the Chapter 7 trustee filed an adversary proceeding against Prestige Patio Co. Ltd. seeking to avoid and recover $736,820.85 in payments made by the Debtors to Prestige Patio during the 90 days before the bankruptcy filing as preferential transfers. Prestige Patio moved to dismiss the complaint, arguing that the trustee had failed to plead compliance with Section 547(b)'s due diligence requirement. The trustee opposed the motion and, in the alternative, requested leave to amend the complaint if the court found the pleading deficient.

THE BANKRUPTCY COURT'S RULING

The court dismissed the complaint (without prejudice), holding the due diligence language in Section 547(b) requires the plaintiff to at least generally allege it had conducted reasonable due diligence and took into account the defendant's known or reasonably knowable affirmative defenses. The trustee's complaint did neither. It merely stated that the defendant might assert affirmative defenses (such as the subsequent new value and ordinary course of business defenses) and bears the burden of proving them—a truism insufficient to satisfy the condition precedent.

In explaining what would suffice to satisfy the due diligence requirement, the court contrasted the trustee's boilerplate allegations in the complaint with the more detailed allegations deemed adequate in other cases. For example, in another Delaware bankruptcy case, *Pack Liquidating*, the plaintiff alleged it had reviewed the debtor's books and records, evaluated potential subsequent new value, and concluded plaintiff could avoid some or all transfers even after considering reasonably knowable defenses. In the *Randoph Hospital* bankruptcy case filed in the Middle District of North Carolina, the court concluded that "[t]he Plaintiff has done more than recite the introductory sentence of § 547(b) and alleges that he has determined he may avoid the subject transfers 'after reviewing his records' and evaluating the reasonably knowable affirmative defenses with due diligence."

In *Prestige Patio*, the Delaware bankruptcy court explained:

> The trustee here has made no such allegations in the complaint. While the court does not suggest that any magic words are required to establish this condition precedent, the complaint here does not use the term "due diligence" or any other language with similar meaning. It contains no language that

plausibly could be understood as alleging that the trustee made any inquiry at all into whether there were "known or reasonably knowable affirmative defenses." Accordingly, the complaint must be dismissed.

That being said, the story of the *Prestige Patio* preference action may not be over, as the trustee has moved for leave to amend the complaint. Prestige Patio has opposed the motion, and the motion awaits a ruling by the bankruptcy court.

CONCLUSION

The *Prestige Patio* decision gives some leverage to potential preference targets. Coming from one of the most prominent bankruptcy courts in the country, it reinforces that preference plaintiffs must adequately plead the due diligence requirement with sufficient factual assertions or risk dismissal of their complaints. Credit professionals should respond to pre-suit demands by documenting ordinary course and subsequent new value defenses so they are "known or reasonably knowable"—strengthening their motion to dismiss if the complaint ignores them. Even where the plaintiff may amend the complaint to satisfy the due diligence requirement, the added cost and delay can drive more favorable and faster resolutions for well-prepared defendants. BC

BRUCE NATHAN, *Partner, Lowenstein Sandler LLP's Bankruptcy & Restructuring Department, bnathan@lowenstein.com. With approximately 45 years of experience in the bankruptcy and insolvency field, Bruce is a recognized nationwide leader in trade creditor rights and the representation of trade creditors. Bruce has represented trade and other unsecured creditors, unsecured creditors' committees, secured creditors, and other interested parties in many of the larger Chapter 11 cases that have been filed.*

MICHAEL PAPANDREA, *Partner, Lowenstein Sandler LLP's Bankruptcy & Restructuring Department, mpapandrea@lowenstein.com. Mike provides counsel to debtors, creditors' committees, trade creditors, liquidating trustees and other interested parties with respect to corporate bankruptcy and creditors' rights matters, including bankruptcy-related litigation. As a seasoned creditors' rights advocate, Mike works tirelessly to understand clients' needs and provide practical solutions that are reasonable, balanced and favorable to the clients he serves.*

IN MEMORIAM

Bill Dearhammer

It is with sadness that we share with you that Bill Dearhammer passed away on January 29, 2026. Bill served as President of the Chicago-Midwest Credit Management Association (CMCMA—now known as NACM Connect) for 11 years. In 2018, he received a Lifetime Achievement Award from NACM Connect. Following CMCMA were 24 years as an Accounts Receivable Specialist with Paladin and the Chicago office of Thompson Coburn LLP, the latter a law firm headquartered in St. Louis. Bill's career was spent in the business-to-business credit field, including 31 years with The First National Bank of Chicago.

Bill served as a member and Chairman of the Board of Directors of the Kenneth Young Center, a community mental health organization, a member and Director of the National Association of Credit Management, and a member and Chairman of the Board of the Chicago Chapter of Robert Morris Associates (RMA), a national association of bank loan and credit officers. In 1992, he was the recipient of the Byron O'Connor Memorial Award "in recognition of his achievements in advancing the state of the art of commercial banking through years of service to RMA." Bill was a frequent speaker and author on credit-related topics, including three monographs published by RMA.

Other activities included a number of years' service as Executive Secretary for the Business Executives Association (BEA) and Secretary-Treasurer of the Association of Credit Executives (ACE), a position he held until his retirement in 2018.

Bill graduated from DePaul Academy in 1952, DePaul University in 1958 and received an MBA, also from DePaul, in 1975. BC