

Due Diligence Is a Virtue, But Does a Preference Plaintiff Have to Prove It?



Bruce Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy & Restructuring Department, and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, a former member of the board of directors of the American Bankruptcy Institute and a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the former co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached at bnathan@lowenstein.com.

Michael Papandrea, Esq., is counsel in Lowenstein Sandler's Bankruptcy & Restructuring Department focused on providing practical solutions for debtors, creditors' committees, individual creditors, and other interested parties involved in bankruptcy and creditors' rights matters. Prior to joining the firm, Mike clerked for multiple bankruptcy judges in the District of New Jersey and Eastern District of Pennsylvania. He can be reached at mpapandrea@lowenstein.com.

A bankruptcy trustee's pursuit of preference claims causes heartburn for trade creditors. It's one thing to be owed a potentially uncollectable receivable from a financially distressed customer that is heading toward or has filed bankruptcy; it's quite another to have to turn over payments that were made in the period leading up to the customer's bankruptcy filing, which the creditor likely spent significant time and effort collecting. While Congress might have intended the Bankruptcy Code's preference statute to promote fairness among creditors (by permitting the bankruptcy estate to recover payments to certain creditors and then redistribute such payments to all similarly situated creditors), the way preference claims are often weaponized in bankruptcy cases is anything but fair. Debtors and trustees have made it a practice to go through the debtor's payment register and assert preference claims *en masse*, and indiscriminately, against virtually every creditor that received a payment during the 90 days before the bankruptcy filing. They often do this without investigating the merits of or defenses to the claims, instead seeking nuisance value settlements

of weak preference claims. Even worse, debtors and trustees often engage in this practice for the purpose of funding the administrative expenses of the case—not for distributions to the unsecured creditors that were targeted.

In 2019, Congress amended the Bankruptcy Code to attempt to curb this widespread abuse of the preference statute. Specifically, Congress amended section 547(b) to add a requirement that a plaintiff must have conducted some diligence of the validity of and defenses to a preference claim prior to commencing a preference action. 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 is unclear whether the amendment imposes any additional burden on plaintiffs as a practical matter.

A recent decision by the Delaware bankruptcy court, in the Chapter 11 cases of *In re Pinktoe Tarantula Limited*, highlights this problem with the due diligence requirement. Although the *Pinktoe* court held that

a plaintiff must plead its performance of due diligence of the merits of and defenses to its preference claim in the complaint seeking recovery of the preference, the court also stated that a simple allegation of plaintiff's performance of the requisite due diligence would suffice. This, combined with the laxity of other courts about imposing any due diligence pleading requirement at all, suggests that a debtor or trustee pursuing a preference claim might not have much of a burden when it comes to satisfying the due diligence requirement.

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 (often a liquidating trustee, as was the case in *Pinktoe*) 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 (such as an outstanding invoice);
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" (as was the case in *Pinktoe*);
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), which sets forth the elements of a preference claim that a plaintiff must prove, to add 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 enactment more than 3 years ago. Defendants have sought to dismiss preference actions by arguing that the due diligence requirement is an additional element of a preference 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. In certain cases, the issue of whether the plaintiff had to specifically allege satisfying the due diligence requirement in its preference complaint was moot since the court held the plaintiff had pled sufficient facts to prove that it had conducted the requisite due diligence in any event. These courts include bankruptcy courts in Delaware (in *In re Insys Therapeutics Inc.* (2021) and *In re Ctr. City Healthcare LLC* (2022)), the Southern District of Texas (in *In re Trailhead Eng'g LLC* (2020)), and the Middle District of North Carolina (in *In re Randolph Hosp., Inc.*, (2022)). The *Ctr. City Healthcare* court noted that there is nothing in section 547 or in SBRA's legislative history specifying

the necessary proof to satisfy the due diligence requirement, and the *Trailhead* court questioned whether a preference plaintiff must include an allegation that it had satisfied the due diligence requirement in its complaint. Other courts have skirted the 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. These courts include the Northern District of Texas bankruptcy court (in *In re Reagor-Dykes Motors LP* (2021)) and the Delaware bankruptcy court (in *In re Art Inst. of Philadelphia LLC* (2022)).

Before *Pinktoe*, only one court had answered the question head-on. In December 2020, the bankruptcy court in the Eastern District of California, in *In re ECS Refining, Inc.*, held that a plaintiff must prove due diligence by alleging in the preference complaint the efforts undertaken to evaluate the merits of and defenses to a preference claim. The court noted that the due diligence requirement is referenced in section 547(b), which sets forth all of the elements of a preference claim that a plaintiff must prove. The court also noted that section 547(g) of the Bankruptcy Code states that a plaintiff "has the burden of proving the avoidability of a transfer under subsection (b)."

Relevant Background Regarding the Pinktoe Decision

On February 17, 2018, *Pinktoe Tarantula Limited* and its affiliates filed Chapter 11 bankruptcy petitions. The debtors' Chapter 11 plan of liquidation was confirmed nearly a year later. The confirmed plan provided for the creation of a liquidating trust that was vested with the right to pursue preference claims.

On May 11, 2020, the liquidating trustee filed a complaint against the debtors' founder (who was an insider as a director and officer of the debtors). The trustee sought to recover from the defendant approximately \$450,000 that the debtors had paid to their landlord during the year before the bankruptcy filing. The trustee alleged the defendant had benefitted from the payments because the defendant had guaranteed the debtors' obligations under the lease.

On July 28, 2020, the defendant filed a motion to dismiss the complaint. The defendant argued the trustee had failed to prove its preference claim because the complaint did not include any allegations satisfying the due diligence requirement. The trustee responded that it did not have the burden of proving the due diligence requirement as an element of its preference claim; instead, the defendant had the burden of proving a lack of due diligence as part of the defendant's affirmative defenses. The trustee also asserted that, in any event, it was evident from the facts pled in the complaint that the trustee had conducted the necessary due diligence.

The Bankruptcy Court's Ruling

The bankruptcy court ruled that the due diligence requirement is an element of a preference claim that must be pled in the trustee's complaint. The bankruptcy court was influenced by the *ECS* ruling that, based on a plain reading of section 547, the plaintiff must plead and prove that it had conducted due diligence regarding the merits of plaintiff's preference claim and the defendant's affirmative defenses as part of proving its preference claim. The bankruptcy court relied on three subsections of section 547:

- **Subsection (b)** sets forth the elements of a preference claim that a plaintiff must prove. The inclusion of the due diligence requirement in this subsection suggests that plaintiff must prove that it had conducted due diligence of the viability of the preference claim and defendant's defenses as an element of the plaintiff's preference claim.
- **Subsection (c)** sets forth the affirmative defenses to preference liability. The failure to include the due diligence requirement here shows that it is *not* an affirmative defense.
- **Subsection (g)** states that the plaintiff has the burden of proving a transfer is avoidable under subsection (b), while the defendant has the burden of proving its defenses to a preference claim under subsection (c). This further justifies imposing on plaintiff the burden of proving the due diligence requirement as part of its preference claim.

Against this backdrop, the bankruptcy court dismissed the trustee's preference complaint. The court concluded that the trustee had failed to satisfy all of the elements of section 547(b) since the complaint did not allege that the trustee had performed the requisite due diligence.

The *Pinktoe* decision was a victory for the creditor/defendant, but it may be a hollow one. Although the bankruptcy court dismissed the preference action, it did so without prejudice. The bankruptcy court granted the plaintiff leave to amend the complaint to allege that it had conducted the requisite due diligence. And, notably, the court indicated that a mere "general

Creditors should not ignore preference demands and should respond outlining their preference defenses. A trustee could argue that it satisfied the due diligence requirement by sending a preference demand that the defendant had ignored.

allegation that [due diligence] occurred satisfies [the] pleading requirement" since the due diligence element of the plaintiff's preference claim is a "condition precedent" under the Federal Rules of Civil Procedure.

Conclusion

The *Pinktoe* decision is somewhat of a mixed bag for trade creditors looking to bolster their preference defense toolkit. A Delaware bankruptcy court decision that requires a plaintiff to allege in its complaint that it had conducted due diligence of the merits of plaintiff's preference claim and the creditor/defendant's affirmative defenses is a favorable development. However, as a practical matter, it remains unclear how sharp the teeth added by the due diligence requirement actually are since the *Pinktoe* decision suggests that a plaintiff can satisfy the due diligence requirement by including a simple allegation in its complaint that it had performed the requisite due diligence.

It remains to be seen whether other courts will follow this holding.

If nothing else, the *Pinktoe* decision serves as a great reminder that creditors should leave no weapon unused when defending a preference claim—including the leverage created by a trustee's failure to satisfy section 547(b)'s due diligence requirement. The additional burden and cost of litigating a motion to dismiss or amend a complaint may incentivize a trustee to settle faster and on more favorable terms to the creditor, particularly where the creditor has strong preference defenses.

Another best practice suggestion: creditors should not ignore preference demands and should respond outlining their preference defenses. A trustee could argue that it satisfied the due diligence requirement by sending a preference demand that the defendant had ignored.

**This is reprinted from Business Credit magazine, a publication of the National Association of Credit Management. This article may not be forwarded electronically or reproduced in any way without written permission from the Editor of Business Credit magazine.*