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Courts Begin Interpreting New Due Diligence Requirements for Trustees Before Filing Preference Actions

By Gregory G. Hesse and Michael R. Horne*

The authors explain that, before filing preference actions, bankruptcy trustees now may have to review available documents and other evidence that may readily reveal viable defenses for potential defendants.

In an underreported amendment to the Bankruptcy Code, the Small Business Reorganization Act ("SBRA") amended Section 547(b) of the Code to add an explicit requirement for the bankruptcy trustee or debtor in possession to conduct "reasonable due diligence" before filing a preference action. The apparent goal of this amendment to the Bankruptcy Code is to reduce the number of frivolous preference lawsuits pursued by trustees.

In view of these new explicit due diligence requirements, creditors should reconsider their initial response strategy by impressing upon trustees the risk of filing a preference lawsuit before reviewing available documents and other evidence that may readily reveal viable defenses for potential defendants.

THE NEW PREFERENCE SECTION

As background, amended Section 547(b) of the Bankruptcy Code sets forth the prima facie elements of a bankruptcy trustee's preference action. Section 547(b) now provides:

> (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)*, avoid any transfer of an interest of the debtor in property—. . .[1]

The new language raises a host of questions:

- Must the trustee conduct reasonable due diligence regarding the transfer(s) and affirmative defenses before filing suit?
- Is the trustee's due diligence requirement an element it must prove in

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[1] 11 U.S.C. § 547(b) (emphasis added).

addition to the other elements of a preference claim or an affirmative defense a defendant must assert against the trustee?

- What constitutes "reasonable due diligence" when taking into account a defendant's Section 547(c) affirmative defenses?
- In what circumstances are Section 547(c) affirmative defenses not reasonably knowable for a trustee to conduct due diligence?

Congress has not provided any legislative history regarding the purpose or application of this new language. Commentators and practitioners alike surmise that this language may be intended to curtail the abusive practice of certain Chapter 7 trustees and Chapter 11 liquidating trusts bringing preference actions against all recipients of transfers without regard to whether such recipients have affirmative defenses under Section 547(c) of the Bankruptcy Code.

Although courts have yet to address many of these questions, as discussed below, initial decisions lean toward requiring the trustee to perform reasonable due diligence of both the prima facie elements of a preference action and a potential defendant's Section 547(c) affirmative defenses before filing suit.

HUSTED V. TAGGART (IN RE ECS REF., INC.)

In *Husted v. Taggart (In re ECS Ref., Inc.)*,[2] a bankruptcy court in the U.S. District Court for the Eastern District of California dismissed a preference action with leave to amend by finding that the due diligence requirement is a prima facie element of a Section 547(b) preference claim.

Specifically, the court concluded that "the trustee must engage in prefiling diligence that encompasses the following: (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."

In concluding the new language is an element of the trustee's preference action and not an affirmative defense, the court focused on three features of the statute.

First, Section 547(b) is the sole source of the trustee's substantive rights and defines what a trustee must show for avoidable preferences.

Second, Section 547(c) offers preference defendants an exhaustive list of nine affirmative defenses and, therefore, Section 547(b)'s new language should not be viewed as a preference defendant's affirmative defense.

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[2] *Husted v. Taggart (In re ECS Ref., Inc.)*, 625 B.R. 425 (Bankr. E.D. Cal. 2020).

Third, Congress expressly allocated the burden of proof on the issue of due diligence under Section 547(b) to the trustee under Section 547(g):

> (g) For the purposes of this section, *the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section*, and the creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subsection (c) of this section.

Turning to the allegations of the complaint, the court concluded that "[r]easonable inferences do not suggest that trustee Husted considered whether the debt was antecedent; whether those transfers improved defendant's position; nor the inapplicability of all affirmative defenses, known or reasonably knowable."

SOMMERS V. ANIXTER, INC. (IN RE TRAILHEAD ENG'G LLC)

In contrast, in *Sommers v. Anixter, Inc. (In re Trailhead Eng'g LLC)*,[3] the bankruptcy court denied a motion to dismiss and declined to determine whether the "reasonable due diligence" requirement is an element of a preference action. Nevertheless, the court analyzed the complaint to determine whether the trustee pleaded sufficient factual allegations to meet the "reasonable due diligence" language of Section 547(b).

The court found "the Complaint demonstrates that Trustee reviewed Trailhead's bank and wire records, invoices relating to the Anixter Transfer, correspondence, and the contract between Targa and Trailhead. Additionally, Trustee mapped out the alleged structure of the parties' relationships in the Complaint."

Based on these allegations, the court concluded the "Trustee's Complaint contains sufficient information regarding the reasonable due diligence prong of [Section 547(b)] to survive dismissal."

Although the factual allegations referenced by the court in *Sommers* imply 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 Section 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.

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[3] *Sommers v. Anixter, Inc. (In re Trailhead Eng'g LLC)*, No. 18-32414 (Bankr. S.D. Tex. Dec. 21, 2020).

FAULKNER V. LONE STAR BROKERING, LLC (IN RE REAGOR-DYKES MOTORS, LP)

In *Faulkner v. Lone Star Brokering, LLC (In re Reagor-Dykes Motors, LP)*,[4] Lone Star Brokering, LLC moved to dismiss by arguing that Section 547(b)'s new language added an element that the trustee failed to adequately plead in its complaint. The court observed that:

> Whether the new due diligence language creates an additional *pleading* requirement remains unclear. But a trustee (or debtor-in-possession) must, in bringing a preference action, exercise due diligence and consider the party's "known or reasonably knowable affirmative defenses under subsection (c)." Whether, as here, the trustee's due diligence is sufficient depends on the circumstances of the case. Assessing a trustee's due-diligence efforts at the motion-to-dismiss stage is difficult. A recital by a *litigation trustee* that he exercised sufficient diligence, thus mimicking the language of the statute, is not helpful.

In addressing Lone Star's motion to dismiss, the court observed the complaint asserted "minimal factual allegations" about the relationship between the debtors and the defendant and the circumstances of the relevant transfers. Nevertheless, the court still denied dismissal of the preference claim, finding that "[a]t this stage, allegations—or lack thereof—do not reflect an abusive filing. Lone Star has not answered the suit; its affirmative defenses are unknown."

Interestingly, the *Faulkner* decision seems to ignore that a trustee presumably knows the applicable affirmative defenses available to potential defendants under Section 547(c) before filing suit, much less before a defendant files an answer.

KEY CONSIDERATIONS

Overall, early cases addressing the SBRA amendments to Section 547(b) preference actions provide limited clarity regarding the level of reasonable due diligence the trustee must perform before filing a preference action on not only the transfers at issue, but also the nine affirmative defenses set forth in Section 547(c).

Nevertheless, creditors receiving demand letters in preference actions should consult with counsel early in the dispute to challenge trustee's counsel to

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[4] *Faulkner v. Lone Star Brokering, LLC (In re Reagor-Dykes Motors, LP)*, No. 18-50214-RLJ-11 (Bankr. N.D. Tex. June 18, 2021).

provide proof of any due diligence conducted regarding the evaluation of the creditor's contemporaneous exchange of value, ordinary course of business, subsequent new value and other affirmative defenses under Section 547(c).

Further, creditors should utilize the response to a demand letter to put the trustee on notice of viable defenses to impress upon the trustee the risk of filing a preference lawsuit in the face of viable defenses.

If a complaint has already been filed, creditors should consider revisiting the availability of a Rule 12(b)(6) motion to dismiss, especially for complaints that only allege the statutory elements with an attached list of payments or fail to include allegations regarding the due diligence for any of the nine affirmative defenses under Section 547(c).