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Courts Remain Uncertain on How to Apply the New Due Diligence Requirement for Preference Claims

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The Bankruptcy Code and its predecessor statutes have long permitted bankruptcy trustees (or their equivalents) to claw back preferences, which involve transfers made on preexisting debts within 90 days (or 1 year, if made to an insider) before a debtor files for bankruptcy. The trustee's power to avoid preferences is codified in Section 547(b) of the Bankruptcy Code.[1] Significantly, the Bankruptcy Code recognizes that many payments within the preference period do not involve improper partiality for one creditor over others; in fact, making such payments might be necessary for a debtor to stay in business and avoid bankruptcy altogether. As a result, Section 547(c) of the Bankruptcy Code codifies affirmative defenses, including, for example, where a debtor received "new value" in exchange for a transfer or where the transfer was made in the ordinary course of business or was made according to ordinary business terms.[2] As one court recently explained, these affirmative defenses are important to protect "most transfers attacked under § 547," which are made pursuant to "'legitimate . . . established commercial practices.'"[3]

In 2019, Congress passed the Small Business Reorganization Act of 2019, which amended the Bankruptcy Code.[4] Among other provisions, Congress added the following italicized language to Section 547(b): "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."[5] Courts have since been grappling with the practical significance of this added language. In particular, they are divided on whether the 2019 amendment adds an affirmative pleading requirement and, if so, how that pleading requirement can be met. The resolution of this debate could have a tangible impact on the viability of many preference claims.

[1] 11 U.S.C. § 547(b).

[2] *Id.* § 547(c).

[3] *See In re Servicom LLC*, No. 18-31722 (AMN), 2023 WL 2755572, at *8 (Bankr. D. Conn. March 31, 2023) ("Defenses to preferential transfers are designed to rescue from attack in bankruptcy those kinds of transactions, otherwise fitting the definition of a preference, that are essential to commercial reality and do not offend the purposes of preference law, or that benefit the ongoing business by helping to keep the potential bankrupt afloat." (internal quotation marks omitted)).

[4] Pub. L. No. 116-54.

[5] *Id.* § 3(a) (emphasis added).

Background

One reason that courts have been inconsistent in applying the 2019 amendment to Section 547(b) is that there "is no explanation, in the Code or in the legislative history to the amendment, of what is required to meet the new requirement."[6]

While there is no express legislative history illuminating the requirement, it is not hard to trace the impetus for the amendment back to the 2012-2014 Final Report and Recommendation of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 (the "Commission").[7] Among many other recommendations, the Commission proposed modifying Section 547(b) in a manner that was similar—but not identical—to the actual amendment made by Congress in 2019.

In considering aspects of then-existing preference law that "appear[ed] unfair," the Commission noted testimony from public hearings showing that "trustees may pursue preference claims in situations in which a cost-benefit analysis indicates little value for the estate, but significant cost and burden for the targeted creditors."[8] Rather, the testimony suggested, trustees bring such claims merely "to extract a settlement payment."[9]

Balancing these concerns against the reality that a trustee may face challenges at the outset of a bankruptcy proceeding in obtaining the information necessary to state a preference claim, the Commission concluded that a Chapter 11 trustee:

> should be precluded from issuing a demand letter to, or filing a complaint against, any party for an alleged claim under section 547 unless, based on reasonable due diligence, the trustee believes in good faith that a plausible claim for relief exists against such party under section 547, taking into account the party's known or reasonably knowable affirmative defenses under section 547(c).[10]

In an effort to reach a "reasonable compromise" of the different interests involved, the Commission recommended that Congress revise Section 547 to "codify[] a standard that required the trustee to perform reasonable due diligence and to make good faith efforts to evaluate the merits of the preference claim," as well as to plead "with particularity" the facts supporting each element of the preference claim.[11]

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[6] *In re Ctr. City Healthcare, LLC*, 641 B.R. 793, 801 (Bankr. D. Del. 2022); *see also In re Arete Healthcare LLC*, No. 19-52578-CAG, 2022 WL 362924, at *11 (Bankr. W.D. Tex. Feb. 7, 2022) ("The House Report offers no explanation for the amendment.").

[7] American Bankruptcy Institute, *Final Report and Recommendations of the Commission to Study the Reform of Chapter 11* (2014); *see also* H.R. Rep. No. 116-171, at 4 (2019) (noting that the Small Business Reorganization Act of 2019 is "largely derived from the[] recommendations" of the American Bankruptcy Institute and similar organizations).

[8] American Bankruptcy Institute, *Final Report and Recommendations of the Commission to Study the Reform of Chapter 11*, at 149-50 (2014).

[9] *Id.* at 150.

[10] *Id.* at 148.

[11] *Id.* at 150-51.

What Congress ultimately codified in the new Section 547(b) omitted any good faith or particularity requirement but embraced the remaining requirements recommended by the Commission that necessitate "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)."

Collier on Bankruptcy has suggested that this amendment was passed to curtail the practice of bringing preference claims against every creditor identified in the debtor's statement of financial affairs as having received payment within the preference window, whether or not these payments meet the definition of a preference or are subject to any other defenses.[12]

As another commentator noted, "[i]t has long been said that preference plaintiffs file large numbers of claims without first taking into account applicable defenses" in order to "extort[] small settlements from trade creditors."[13] Given the expense of litigation, it often makes little economic sense to litigate these suits, even where a defendant had a viable defense and the resulting settlements did "little to enhance the value of the estate, . . . instead serv[ing] primarily to enrich estate professionals."[14] Accordingly, it appears that Congress revised Section 547(b) to "rebalance the playing field in favor of preference defendants."[15] Courts have acknowledged a similar purpose in amending Section 547(b).[16]

Recent Case Law Interpreting the Revised Section 547(B)

Because Congress was not explicit in what the due diligence requirement entails, courts have been left to decipher the intent of the amendment. Against this backdrop, courts have taken divergent approaches—some expressly treat it as an affirmative pleading requirement while others equivocate. In addition, courts thus far have been inconsistent in defining what allegations might meet the requirements of the new language.

A. Did Congress Create a New Pleading Requirement in Section 547(b)?

While the judicial landscape remains far from unified, several courts have interpreted Section 547(b)'s new language as imposing an affirmative pleading requirement. For example, in *In re ECS Refining, Inc.*—one of the first cases to interpret the revised statute in a published decision—the bankruptcy court held that reasonable due diligence is a condition precedent to bringing a preference claim.[17] As the court articulated, "this condition precedent has three discrete subparts": "(1) reasonable due diligence under 'the circumstances of the case'; (2) consideration as to whether a prima facie case for a preference action may

[12] 5 Collier on Bankruptcy ¶ 547.02A (16th ed. 2020).

[13] Kara J. Bruce, *Bankruptcy's Uneven Response to Nuisance Claims*, 41 Bankruptcy Law Letter 4 (April 2021).

[14] *Id.*

[15] *Id.*

[16] *See, e.g.*, *In re Reagor-Dykes Motors, LP*, No. 18-50214-RLJ-11, 2021 WL 2546664, at *2 (Bankr. N.D. Tex. June 21, 2021) ("The language added to § 547(b) under the Small Business Reorganization Act of 2019 is meant to deter the filing of abusive preferential transfer suits.").

[17] *In re ECS Refining, Inc.*, 625 B.R. 425, 453 (Bankr. E.D. Cal. 2020) ("Section 547(b) now requires that the trustee satisfy a condition precedent, i.e., reasonable due diligence and consideration of known or knowable affirmative defenses.").

be stated; and (3) review of the known or 'reasonably knowable' affirmative defenses that the prospective defendant may interpose."[18]

A recent case from the Bankruptcy Court for the District of Delaware, *In re Pinktoe Tarantula Ltd.*, expressly adopted the *ECS Refining* court's discussion of the "structure of the statute itself and its delineated subsections" and concluded that "the due diligence requirement is an element of a preference claim, not an affirmative defense."[19] The *Pinktoe Tarantula* court focused on the placement of the due diligence requirement in subsection (b) of Section 547, which sets out the claim, rather than in subsection (c), which sets out the affirmative defenses.[20]

Other courts have been less direct. For example, one court acknowledged a split between courts that have determined that due diligence is a pleading requirement and others that express less certainty.[21] Ultimately, that court implicitly acknowledged due diligence as an affirmative pleading requirement by holding that "the Plaintiff has adequately pleaded reasonable due diligence."[22] Many other courts have avoided the question of whether an affirmative pleading requirement exists by holding any such requirement, if there is one, was satisfied.[23]

Finally, at least one court has expressly questioned whether there is a new pleading requirement. One week after the *In re ECS Refining* decision, *In re Trailhead Engineering LLC* noted that the defendant did "not cite to any authority actually stating that the failure to affirmatively allege diligence leads to dismissal, beyond a reference to COLLIER which states that 'it is unclear whether the "reasonable due diligence" requirement is an element of the preference claim.'"[24] The *Trailhead Engineering* court also cited the amended language of Section 547(b), noting that the inclusion of the words "in the circumstances of the case" suggested "that a level of discretion is involved" in the assessment of due diligence.[25]

B. Courts Apply Varying Standards in Discussing What Satisfies New Section 547(b)

Just as courts have not adopted a uniform approach to whether Section 547(b) creates a new pleading requirement, they also have had varied responses on whether any such requirement, if it exists, has been

[18] *Id.* at 454 (quoting 11 U.S.C. § 547(b)).

[19] *In re Pinktoe Tarantula Ltd.*, No. 18-10344 (LSS), 2023 WL 2960894, at *5 (Bankr. D. Del. April 14, 2023).

[20] *Id.*

[21] *In re Randolph Hosp., Inc.*, 644 B.R. 446, 462 (Bankr. M.D.N.C. 2022).

[22] *Id.*

[23] The *Pinktoe Tarantula* court perhaps expressed it best: "Most courts that have confronted the issue of whether the due diligence requirement is an element of a preference cause of action or an affirmative defense have skillfully avoided the determination." *In re Pinktoe Tarantula Ltd.*, 2023 WL 2960894, at *4 & n.24 (collecting cases); *see also In re: Servicom LLC*, No. 18-31722 (AMN), 2023 WL 2755572, at *11 (Bankr. D. Conn. March 31, 2023) ("The court need not decide whether the relatively new due diligence provision of § 547(b) is a separate element that may be dispositive of an otherwise established preference claim. Here, the court is unpersuaded there was a lack of reasonable due diligence.").

[24] *In re Trailhead Eng'g LLC*, No. 18-32414, 2020 WL 7501938, at *7 (Bankr. S.D. Tex. Dec. 21, 2020) (quoting 5 Collier on Bankruptcy ¶ 547.02A (16th ed. 2020)).

[25] *Id.*

met. At the threshold, a few courts have observed some tension between the ordinary pleading requirements under the Federal Rules of Civil Procedure—which do not contemplate dismissal of a complaint at the pleading stage based on the existence of an affirmative defense—and the possibility that Section 547(b) imposes a pleading requirement that a trustee "tak[e] into account a party's known or reasonably knowable affirmative defenses."[26]

On one end of the spectrum of how to apply this pleading standard is *In re ECS Refining*, which found that the trustee failed to satisfy her pleading burden because she "d[id] not expressly recite the efforts she undertook to evaluate the merits of a prima facie case or reasonably knowable affirmative defenses."[27]

Similarly, although the court in *In re Arete Healthcare LLC*, dismissed the preference claim on other grounds, it also noted with regard to the due diligence issue that "merely paraphrasing the element will not satisfy Rule 8," and, "[a]ssuming due diligence is an element, what the Trustee plead is insufficient," because it "merely stated that it had performed 'reasonable due diligence', 'investigat[ed] into the circumstances of the case' and '[took] into account the Defendant's reasonably knowable affirmative defenses under 11 U.S.C. § 547(c).'"[28]

Other courts have found either that the pleading standard was met or that, if it existed, would be met based on allegations that seem to require less of a trustee than what the court required in *In re ECS Refining*. Common efforts by trustees to meet the pleading requirement include reviewing relevant records and sending a pre-complaint demand letter to the potential defendant. For example, courts have found the pleading standard (if it exists) satisfied by alleging:

- An exercise of due diligence by, "among other things, attaching wire and check records of the alleged transfers made to the Defendants," including the relevant contract, and "describing the contractual relationship" it created.[29]

[26] *See, e.g.*, *In re Art Inst. of Philadelphia LLC*, No. 18-11535 (CTG), 2022 WL 18401591, at *19-20 (Bankr. D. Del. Jan. 12, 2022) ("But even where a defendant's affirmative defense is obviously available, nothing in the federal rules by their terms bars a plaintiff from filing suit—the traditional theory being that defendants bear the burden of proving an affirmative defense, and a plaintiff that is able to establish its *prima facie* case is therefore entitled to hold the defendant to its burden of pleading and proving such a defense . . . . The 2019 amendment to section 547 appears to be a response to that practice, imposing an obligation on trustees (not typically borne by plaintiffs) to assess the availability of an affirmative defense before filing suit."); *In re Insys Therapeutics, Inc.*, No. 19-11292 (JTD), 2021 WL 5016127, at *3 (Bankr. D. Del. Oct. 28, 2021) (noting that, "there is no requirement that a plaintiff plead around potential affirmative defenses" under the ordinary federal pleading standard but holding that Section 547 pleading requirement was met if it exists).

[27] *In re ECS Refining, Inc.*, 625 B.R. at 458.

[28] *In re Arete Healthcare LLC*, 2022 WL 362924, at *11 ("The Court will not reach the issue of whether due diligence is an element because the Amended Complaint fails to survive Rule 8 on other elements.").

[29] *In re Randolph Hosp., Inc.*, 644 B.R. at 457-58, 462 (holding that plaintiff had "adequately pleaded" the diligence element by doing "more than recit[ing] the introductory sentence of § 547(b)," including by attaching the underlying contract and describing the contractual relationship).

- Acts the trustee took as part of due diligence, including informal telephone interviews with representatives of the debtor and others, reviewing bank statements, and conducting his own investigation into the claims and allegations.[30]

- The sending of "a letter to [defendant] demanding return of the Transfers and inviting [defendant] to advise the Trustee of its defenses, and further alleging that to the extent any defenses were presented, they have been taken into account by the Trustee, in conjunction with the Trustee's review of the Debtors' books and records."[31]

- That the debtors "conducted an analysis of the Transfers made to the Defendants during the Avoidance Period and whether they were protected from avoidance by any applicable defense" and "sent Demand Letters to the Defendants inviting an exchange of information regarding any potential defenses with respect to the Transfers and received no responses."[32]

- A review of the debtor's "books and records and other available information."[33]

Ironically, on the far end of the spectrum from *In re ECS Refining* is the case that adopted its reasoning on the existence of the pleading requirement, *Pinktoe Tarantula*, which reasoned that the "new due diligence requirement is a condition precedent [so] Federal Rule of Civil Procedure 9(c), not Federal Rule of Civil Procedure 8, therefore applies."[34] Rule 9(c) provides that in "pleading conditions precedent, it suffices to allege generally that all conditions precedent have occurred or been performed. But when denying that a condition precedent has occurred or been performed, a party must do so with particularity."[35] The *Pinktoe Tarantula* court dismissed the complaint because there was "no allegation, general or otherwise, that Plaintiff performed due diligence."[36]

Advice Going Forward

Bankruptcy courts continue to grapple with how to interpret the due diligence requirement and what burden it imposes on plaintiffs bringing preference claims, and no district court, much less federal court of appeals, has yet to weigh in. Although there is no consensus on whether there is in fact a pleading requirement, some courts have expressed doubt that a complaint's reliance on recitation of the statutory language or other generalities about diligence is sufficient, and a number have held that the requirement

[30] *In re Matt Garton & Assocs., LLC*, No. AP 21-1215 TBM, 2022 WL 711518, at *12 (Bankr. D. Colo. Feb. 14, 2022).

[31] *In re Insys Therapeutics, Inc.*, 2021 WL 5016127, at *3 n.9. Cases like *Insys Therapeutics* that credit the use of a demand letter as a valid part of a trustee's due diligence are difficult to reconcile with the Commission's recommendation that due diligence be completed before a demand letter is sent. *See supra*, pp. 2-3 & n.10. However, this recommendation by the Commission was not codified in the statute. *See id.*

[32] *In re Ctr. City Healthcare, LLC*, 641 B.R. at 802.

[33] *In re Flywheel Sports Parent, Inc.*, No. 20-12157 (JPM), 2023 WL 2245382, at *4 (Bankr. S.D.N.Y. Feb. 27, 2023).

[34] *In re Pinktoe Tarantula Ltd.*, 2023 WL 2960894, at *5.

[35] Fed. R. Civ. P. 9(c).

[36] *In re Pinktoe Tarantula Ltd.*, 2023 WL 2960894, at *5.

can be satisfied if the complaint pleads specific actions, such as reviewing relevant documents and making a pre-complaint demand inviting the potential defendant to explain any defenses.

Given this continued uncertainty, we advise that defendants faced with a preference claim under Section 547(b) consider moving to dismiss any complaint that fails to allege in detail the trustee's consideration of affirmative defenses, especially if the complaint fails to allege any specific effort or merely recites the statutory language. Although it is difficult to predict what level of diligence will suffice, we think this course of action represents the most effective use of one tool in the defendant's toolbox against preference claims. It is also, in our view, the path most faithful to resolving the concerns Congress sought to address through its amendment of Section 547(b).

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