

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

Article By:

Gregory G. Hesse

Michael R. Horne

In an underreported amendment to the Bankruptcy Code, the Small Business Reorganization Act amended §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.

As background, amended §547(b) of the Bankruptcy Code sets forth the *prima facie* elements of a bankruptcy trustee’s preference action. The section 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—...

11 U.S.C. §547(b) (emphasis added).

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 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 §547(c) affirmative defenses? In what circumstances are §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 §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 §547(c) affirmative defenses before filing suit.

Husted v. Taggart (In re ECS Ref., Inc.)

In *Husted v. Taggart (In re ECS Ref., Inc.)*, 625 B.R. 425 (Bankr. E.D. Cal. 2020) (December 15, 2020), 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 §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.” *Id.* at 454 (internal citations omitted).

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, §547(b) is the sole source of the trustee's substantive rights and defines what a trustee must show for avoidable preferences. Second, §547(c) offers preference defendants an exhaustive list of nine affirmative defenses and, therefore, §547(b)'s new language should not be viewed as a preference defendant's affirmative defense. Third, Congress expressly allocated the burden of proof on the issue of due diligence under §547(b) to the trustee under §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.

11 U.S.C. §547(g) (emphasis added).

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.” *Id.* at 458 (internal citations omitted).

Sommers v. Anixter, Inc. (In re Trailhead Eng'g LLC)

In contrast, in *Sommers v. Anixter, Inc. (In re Trailhead Eng'g LLC)*, No. 18-32414, 2020 WL 7501938 (Bankr. S.D. Tex. Dec. 21, 2020), 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. *Id.* at *7. Nevertheless, the court analyzed the complaint to determine whether the trustee pleaded sufficient factual allegations to meet the “reasonable due diligence” language of §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.” *Ibid.* Based on these allegations, the court concluded the “Trustee's

Complaint contains sufficient information regarding the reasonable due diligence prong of §547(b) to survive dismissal.” *Ibid.*

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 §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.

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)*, No. 18-50214-RLJ-11, 2021 WL 254664 (Bankr. N.D. Tex. June 18, 2021), Lone Star Brokering, LLC moved to dismiss by arguing that §547(b)’s new language added an element that the trustee failed to adequately plead in its complaint. The court observed that “[w]hether 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.” *Id.* at *2.

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. *Id.* at *3. 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.” *Ibid.*

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

Key Considerations

Overall, early cases addressing the SBRA amendments to §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 §547(c). Nevertheless, creditors receiving demand letters in preference actions should consult with counsel early in the dispute to challenge trustee’s counsel to 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 §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 §547(c).

National Law Review, Volume XI, Number 280

Source URL: <https://natlawreview.com/article/courts-begin-interpreting-new-due-diligence-requirements-trustees-filing-preference>