BBA

Current Developments in Trustee Pre-Filing Obligations in Preference Actions

DECEMBER 14, 2022

Presented by

David A. Blansky

Section 547 (b) Elements

Section § 547(b) provides the elements of an action to avoid a preferential transfer

(1)to or for the benefit of a creditor;

(2)for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3)made while the debtor was insolvent;

(4)made—**(A)**on or within 90 days before the date of the filing of the petition; or

(B)between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5)that enables such creditor to receive more than such creditor would receive if—
(A)the case were a case under chapter 7 of this title;

(B)the transfer had not been made; and

(C)such creditor received payment of such debt to the extent provided by the provisions of this title

Small Business Reorganization Act (SBRA)

Congress incorporated two important changes into the SBRA that may have broader implications beyond small business reorganizations as applicable to the recovery of "preferential transfers" under Section 547(b) of the Bankruptcy Code.

- First, a debtor or trustee is required to consider a party's statutory defenses "based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses" prior to commencing an action under Section 547(b).
- Second, the small dollar limit contained in 28 U.S.C. § 1409(b) was increased to $25,000.

Historical Context

The amendments were predicated primarily on recommendations made in the report of the American Bankruptcy Institute Commission (the "ABI") to Study the Reform of Chapter 11.

The ABI Commission identified the following "recommended principles" in its report:

1. The trustee's ability to pursue preference claims under Section 547 of the Bankruptcy Code preserves value for the estate and tempers the "run on the debtor" that may occur immediately prior to a bankruptcy filing. The avoiding power in Section 547 may, however, be subject to abuse in certain cases. The Commission analyzed a variety of potential reforms to Section 547, including refining elements of, or shifting the burden of proof for, certain defenses under Section 547(c). After much research and deliberation, the Commission determined that the potential abuses under Section 547 are addressed most effectively through the changes in small preference actions, pleading requirements, and demand requirements described in these principles, and continued judicial oversight in accordance with the Bankruptcy Code.

Historical Context (continued)

2. The 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).

3. The trustee must plead with particularity factual allegations in the complaint that establish a plausible claim for relief under Section 547. In accordance with the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), legal conclusions or speculative allegations should not be sufficient to support a preference complaint.

4. The dollar amount of the defense against preference claims provided in Section 547(c)(9) should be increased to $25,000 in the aggregate. This dollar amount should continue to be increased based on the Consumer Price Index for All Urban Consumers under Section 104(a).

5. The small claims venue provision in 28 U.S.C. § 1409(b) should be amended to (i) clarify that the section applies to preference actions under Section 547 and (ii) increase the dollar limit for debts (excluding consumer debts) against noninsiders to $50,000 in the aggregate. This dollar amount should continue to be increased based on the Consumer Price Index for All Urban Consumers under Section 104(a).

Historical Context (continued)

Congress rejected the ABI's recommendation that a trustee be required to perform "reasonable due diligence" before issuing a demand letter, but adopted the recommendation that such diligence be completed ahead of the filing a complaint.

Congress declined to increase the aggregate amount of the transfers that could not be subject to avoidance as preferential in a non-consumer debtor case from $6,825 to $25,000 under Section 547(c)(9).

However, Congress appears to have seized upon that $25,000 amount for purposes of increasing the "small dollar" venue limitation under 11 U.S.C. § 1409(b), but did not clarify that the small claims venue provision is applicable to preference claims.

Effective Date

Section 5, titled "Effective Date," provides: "This Act and the amendments made by this Act shall take effect 180 days after the date of enactment of this Act." The President signed the Act on August 23, 2019; 180 days after that date is February 19, 2020.

Section 1501 of the 2005 statutory amendments which provides: (a) EFFECTIVE DATE.—Except as otherwise provided in this Act, this Act and the amendments made by this Act shall take effect 180 days after the date of enactment of this Act. (b) APPLICATION OF AMENDMENTS.— (1) IN GENERAL.—Except as otherwise provided in this Act and paragraph (2), the amendments made by this Act shall not apply with respect to cases commenced under title 11, United States Code, before the effective date of this Act. (2) CERTAIN LIMITATIONS APPLICABLE TO DEBTORS.— The amendments made by sections 308, 322, and 330 shall apply with respect to cases commenced under title 11, United States Code, on or after the date of the enactment of this Act.

“Reasonable Due Diligence” Questions

Is “reasonable due diligence” an element of a preference claim?

Does the failure of a trustee to allege reasonable due diligence warrant a 12(b)(6) dismissal?

What conduct constitutes “due diligence”?

Is Rule 11 implicated by the term “due diligence”?

Can a preference defendant seek discovery on whether the due diligence requirement has been met?

Case Developments

- *Husted v. Tagar (In re ECS Ref., Inc.)*, 625 B.R. 425 (Bankr. E.D. Cal. 2020) (due diligence requirement is now a prima facie element of § 547(b); complaint dismissed with leave to amend in view of pre-*Iqbal/Twombly* notice style pleadings and general allegations)
- *Sommers v. Anixter, Inc. (In re Trailhead Eng'g LLC)*, 2020 WL 7501938 (Bankr. S.D. Tex. Dec. 21, 2020) (some factual allegations should be pled, but due diligence not necessarily an element; recognizing a level of discretion in view of the "circumstances of the case" wording; trustee had examined documents relating to the transactions between the debtor and defendant and included a chart of the relationships between relevant entities)
- *Faulkner v. Lone Star Brokering, LLC (In re Reagor-Dykes Motors, LP)*, 2021 WL 254664 (Bankr. N.D. Tex. June 18, 2021) ("mimicking the language of the statute is not helpful"; complaint contained some allegations relating to defendant's pre-petition relationship with the debtor and transaction details)

Case Developments (continued)

- *Insys Liquidation Trust v. Urquhart (In re Insys Therapeutics, Inc.)*, 2021 WL 5016127 (Bankr. D. Del. Oct. 28, 2021) (no duty to plead around affirmative defenses; trustee had sent defendant a demand letter inviting defendant to advise of defenses; complaint alleged that the trustee had taken into account any presented defenses in conjunction with the review of books and records)
- *Weinman v. Garton (In re Matt Garton & Assoc. LLC)*, 2022 WL 711518 (Bankr. D. Colo. Feb. 14, 2022) ("[a]rguably, the new due diligence requirement is an element of a preference claim"; trustee had reviewed pleadings, conducted an informal interview with defendant, listened to defendant's views on the litigation, conferred with counsel for the debtor's bank, reviewed debtor's books and records, and subpoenaed bank and credit card statements and other materials)
- *Ctr. City Healthcare, LLC v. McKesson Plasma & Biologics LLC (In re Ctr. City Healthcare, LLC)*, 2022 WL 2133974 (Bankr. D. Del. June 13, 2022) ("there is no requirement that the Debtors plead how the affirmative defenses are not available; the Debtors must simply plead that they considered them."; debtors sent pre-suit demand letters inviting settlement or an exchange of information about potential defenses and complaint alleged that debtors had conducted an analysis of the transfers made during the preference period and whether they were protected by any applicable defense)
- *Robichaux v. The Moses H. Cone Memorial Hospital Op. Corp. (In re Randolph Hospital, Inc.)*, 644 B.R. 446 (Bankr. M.D. N.C. 2022) (plaintiff did more than parrot the introductory language and alleged he may avoid the transfers "after reviewing his records" and evaluating the reasonably knowable defenses with due diligence)

Venue Amendment

Venue for an adversary proceeding is generally proper in the District Court in which the bankruptcy case is pending.

28 U.S.C. § 1409(b), as amended by the SBRA, states:

> Except as provided in subsection (d) of this section, a trustee in a case under title 11 may commence a proceeding **arising in** or **related to** such case to recover a money judgment of or property worth less than $1,000 or a consumer debt of less than $15,000, or a debt (excluding a consumer debt) against a noninsider of less than $25,000, only in the district court for the district in which the defendant resides. (emphasis added)

28 U.S.C. § 1409(a) identifies three categories of bankruptcy proceedings and provides:

> Except as otherwise provided in subsections (b) and (c), a proceeding **arising under** title 11 or **arising in** or **related to** a case under title 11 may be commenced in the district court in which such case is pending. (emphasis added)

Venue Amendment (continued)

A Section 547(b) preference claim is a substantive right provided for and only **arising under** title 11. It does not "arise in" and is not "related to" a case under title 11.

As Section 1409(b) identifies only those cases "arising in" and "related to" a bankruptcy case, many Courts have concluded that preference claims are not subject to the "small dollar" venue limitation of 28 U.S.C. § 1409(b). *See Webster v. Republic Nat'l Distrib. Co. LLC* (*In re Tadich Grill of Washington D.C. LLC*), 598 B.R. 65, 67 (Bankr. D.D.C. 2019) (holding that 28 U.S.C. § 1409(b) does not apply to a proceeding "arising under title 11.") *Cf. Creditors' Trust v. Crown Packaging Corp.* (*In re Nukote Int'l, Inc.*), 457 B.R. 668, 684 (Bankr. M.D. Tenn. 2011) (Omission of proceedings "arising under" Title 11 was inadvertent, and that § 1409(b) should apply to such proceedings.)

Accordingly, Section 1409(b), as amended, is likely inapplicable to preference claims absent a technical correction by Congress.

66 West Flagler Street,
Suite 400
Miami, Florida 33130
dblansky@dunnlawpa.com
Phone: (786) 433-3866
Fax: (786) 260-0269

DAVID A. BLANSKY recently joined Dunn Law, P.A. as a senior attorney. David's practice focuses on commercial and bankruptcy litigation, including voidable transactions.

During law school, David experienced a variety of cooperative education opportunities. He clerked at the Massachusetts Superior Court. He assisted in the denaturalization and deportation of Nazi war criminals residing in the United States while serving at the Department of Justice Office of Special Investigations. He litigated numerous criminal cases as a public defender in New Mexico. He also worked on a variety of contract, copyright, trademark, and communications issues at National Public Radio's Office of the General Counsel.

After law school graduation, David worked as an Assistant District Attorney in Nassau County for nearly four years. David prosecuted a variety of petty and felony crimes and often presented evidence before a grand jury. David then worked at the Law Offices of David J. Sutton, P.C., as an associate, where his primary areas of practice were general, commercial and personal injury litigation. David was a partner at LaMonica Herbst & Maniscalco, LLP, located in Nassau County, New York, before he relocated to Florida.

Education

- J.D., Northeastern University School of Law, 1997
- B.A., The American University, 1994

Bar Admissions

- Courts of the States of Florida and New York
- United States District Courts for the Eastern and Southern Districts of New York
- United States District Court for the Southern District of Florida
- United States Courts of Appeals for the Second and Third Circuits
- United States Supreme Court

Honors & Affiliations

- Former Chair of the Bankruptcy Law Committee of the Nassau County Bar Association (2010-2012 term); Former Vice Chair (2009-2010 term)
- Member of the Bankruptcy Law Committee of the New York State Bar Association, Business Law Section
- Focus editor of the July/August 2010 issue of *The Nassau Lawyer*, the journal of the Nassau County Bar Association
- Lecturer on judgment enforcement, litigation practice, voidable transfers, and bankruptcy law

DAVID A. BLANSKY

Professional Associations

- American Bankruptcy Institute
- Nassau County Bar Association
- New York State Bar Association

Recent Reported Cases

- *LaMonica v. Harrah's Atl. City Operating Co. (In re JVJ Pharm. Inc.)*, 2020 Bankr. LEXIS 1948 (Bankr.S.D.N.Y. July 24, 2020), *aff'd and remanded, in part,* 20 Civ. 7009 (JPC) (S.D.N.Y. Juk. 19, 2021)
- *Lynch v. Vaccaro (In re Lynch)*, 795 Fed. Appx. 57 (2d Cir. Feb. 18, 2020)
- *Gould v. LaMonica (In re Gould)*, 790 Fed. Appx. 340 (2d Cir. Jan. 23, 2020)
- *In re Truong v. Mergenthaler (In re Truong)*, 763 Fed. Appx. 150 (3d Cir. 2019)
- *Trovato v. Galaxy Sanitation Servs. of N.Y., et al*, 99 N.Y.S.3d 427, 171 A.D.3d 832 (2d Dept. 2019)
- *In re Gould v. LaMonica*, 2018 U.S. Dist. LEXIS 214470 (S.D.N.Y. Dec. 17, 2018)
- *In re 477 W. 142nd St. Hous. Dev. Fund Corp.*, 346 F. Supp.3d 413 (S.D.N.Y. 2018)
- *Lynch v. Barnard, et al (In re Lynch),* 590 B.R. 30 (E.D.N.Y. 2018)
- *Brown Publ. Co. Liquidating Trust v. Brown*, 2017 U.S. Dist. LEXIS 14775 (E.D.N.Y. Feb. 1, 2017)
- *Barnard v. Town of Huntington (In re Joe's Friendly Serv. & Son, Inc.)*, 533 B.R. 307 (Bankr.E.D.N.Y. 2016)
- *In re Lynn Carol Schneider*, 2015 U.S. Dist. LEXIS 38707, 2015 WL 1412364 (E.D.N.Y. Mar. 26, 2015)
- *In re Collins*, 540 B.R. 54 (Bankr.E.D.N.Y. 2015)
- *Schneider v. Barnard*, 508 B.R. 533 (E.D.N.Y. 2014)
- *Barnard v. Albert (In re Janitorial Close-Out City Corp.)*, 2013 Bankr. LEXIS 523 (Bankr.E.D.N.Y. Feb 8, 2013)
- *Pryor v. Tiffen (In re TC Liquidations LLC)*, 463 B.R. 257 (Bankr.E.D.N.Y. 2011)
- *In re DeMartino*, 448 B.R. 122 (Bankr.E.D.N.Y. 2011) (on the motion)
- *In re Singh*, 434 B.R. 298 (Bankr.E.D.N.Y. 2010)
- *In re DeVanzo*, 2010 WL 1780038 (Bankr.E.D.N.Y. May 03, 2010)
- *U.S. ex rel. Miller Proctor Nickolas, Inc. v. Lumbermens Mut. Cas. Co.*, 2009 WL 962273 (E.D.N.Y. Mar. 31, 2009)

Publications

Same Sex Couples May be able to File Joint Bankruptcy Petitions, co-authored with Rachel P. Corcoran, Esq., THE NASSAU LAWYER (Nov. 2011).

Noteworthy

Since 2011, David has been annually recognized by Avvo.com with a superb rating for his experience, industry recognition and professional conduct.

David is also eligible to serve as a Part 36 receiver in the counties of Nassau and Suffolk, New York.