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New Bankruptcy Amendments Lower the Burdens of Preference Actions on Defendants

By David S. Forsh, Jonathan S. Hawkins, John C. Allerding, and Scott E. Prince*

The authors of this article discuss a new bankruptcy bill, the Small Business Reorganization Act of 2019, that facilitates the Chapter 11 bankruptcy process for small businesses and includes amendments to lower the burden on non-debtors in defending against any preference claims brought by trustees or debtors in bankruptcy.

Three bankruptcy bills were recently enacted into law: the Family Farmer Relief Act of 2019 (H.R. 2336), the Honoring American Veterans in Extreme Need Act of 2019 (H.R. 2938), and the Small Business Reorganization Act of 2019 (H.R. 3311, the "SBRA"). These bills bring several welcome reforms to the Bankruptcy Code, such as increasing the amount of debt that may be addressed by farmers in a Chapter 12 bankruptcy case, protecting disability benefits for veterans in a Chapter 7 bankruptcy case, and facilitating the Chapter 11 bankruptcy process for small businesses. In addition to these reforms, the SBRA includes amendments to lower the burden on non-debtors in defending against any preference claims brought by trustees or debtors in bankruptcy. As such claims are at issue in almost every bankruptcy case, all creditors should be aware of these developments.

BACKGROUND

The Bankruptcy Code aims to maximize (or at least preserve) the value of a troubled entity for the benefit of creditors and to provide equal treatment

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among creditors. However, distressed companies often attempt to deal with liquidity constraints by selectively paying creditors, which can result in creditors with similar legal rights receiving different recoveries on their claims if the recovery efforts are not successful and a bankruptcy case is commenced. To remedy this, the Bankruptcy Code provides for the avoidance and recovery of such transfers (commonly referred to as "preferential transfers" or simply as "preferences"). In particular, subject to certain exceptions, the Bankruptcy Code empowers the trustee or debtor in possession to avoid and recover any transfer of money or other property made to or for the benefit of a creditor by a debtor in the 90 days before bankruptcy (one year for transfers to insiders) on account of an existing debt that enables such creditor to receive more than it would in a liquidation under Chapter 7 of the Bankruptcy Code.[1]

While this power to avoid and recover prebankruptcy payments promotes the goal of creditor equality generally, it is often highly disruptive to the recipient and the process is heavily weighted in favor of the plaintiff in many key respects. Because the elements of a preference are so broad, a claim can be asserted with minimal effort and cost, and it is not unusual for trustees in bankruptcy or debtors in possession to file preference actions against every entity that received any payment from the debtor during the applicable period before bankruptcy (other than for entities who are critical vendors or counterparties to assumed contracts, as the claims of such entities would be otherwise satisfied). Frequently, less-diligent debtors and trustees file complaints that do little more than parrot the statutory elements in reference to an attached list of payments,[2] are mass filed on or just prior to the expiry of the statute of limitations for such claims,[3] and seek to disallow any pending claims for other

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[1] 11 U.S.C. §§ 547(b)–(c), 550.

[2] The standard federal court pleading standards apply to bankruptcy actions, including preference claims. *See, e.g., Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 555 (2007) (a complaint "requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do."); *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949, 173 L. Ed. 2d 868 (2009) ("Threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice" to overcome a motion to dismiss for failure to state a claim). These standards are increasingly being applied to preference complaints. *See, e.g., In re Tribune Co. Fraudulent Conveyance Litig.*, 2019 U.S. Dist. LEXIS 10983 at *70–71 (S.D.N.Y. Jan. 23, 2019) (dismissing preference for failure to adequately plead claim); *In re Liquid Holdings Grp.*, 2018 Bankr. LEXIS 3589, at *10 (Bankr. D. Del. Nov. 14, 2018) (same). Despite such rulings, formulaic complaints remain common.

[3] Generally, this period expires two years after the commencement of the bankruptcy case. 11 U.S.C. § 546(a).

amounts filed by the recipient.[4] While the Bankruptcy Code provides for various defenses against preference claims, including with respect to transfers from a debtor made in a contemporaneous exchange of new value, in the ordinary course of business, or for which the creditor subsequently provided new value, these defenses are often highly fact intensive and can be difficult or costly to assert.[5] Accordingly, while these defenses impact the value of the asserted claim and any potential settlement, creditors generally cannot rely on these defenses to dispose of the preference action prior to discovery and summary judgment.[6]

The discrepancy in costs and burdens for plaintiffs and defendants in a preference action is further exacerbated by the applicable venue provisions, which usually provide for venue of such cases in the bankruptcy court where the debtor's case is pending.[7] This is often inconvenient for the creditor in terms of distance and cost and provides a "home field" advantage for the debtor. In addition, it has become increasingly common for plaintiffs to seek and obtain, sometimes before commencing the subject adversary proceedings or otherwise on little notice to defendants, mandatory case procedures governing all preference claims (and other avoidance actions) that have further advantages for the plaintiff over the defendant, such as requiring the defendant to participate in mandatory mediation proceedings in the plaintiff's chosen venue and extending the plaintiff's time to respond to any dispositive motion from the defendant until after conclusion of the mediation.

Overall, the extensive procedural advantages held by the plaintiff in a

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[4] The Bankruptcy Code provides for the disallowance of the claims of any person who has received a transfer that is avoidable or recoverable but has not returned such transfer to the debtor or its estate. 11 U.S.C. § 502(d).

[5] *See generally* 11 U.S.C. § 547(c). For example, the ordinary course defense is available only for transfers made by the debtor in payment of a debt incurred in the ordinary course and where such payment was made either in the ordinary course between the debtor and that creditor or according to ordinary business terms within the industry. 11 U.S.C. § 547(c)(2). Such fact-specific issues generally will not be considered on a motion to dismiss or for judgment on the pleadings.

[6] *See, e.g., In re Magnesium Corp. of Am.*, 460 B.R. 360, 366 (Bankr. S.D.N.Y. 2011) (denying plaintiff's motion for summary judgment on a preference claim when opposed by an ordinary course defense, noting that "[h]ere, as in the great majority of cases in which it is raised, [the defense] should be decided only after trial."); *cf., e.g., In re Crucible Materials Corp.*, 2012 Bankr. LEXIS 5102, at *12–14 (Bankr. D. Del. Oct. 31, 2012) (granting defendant's motion to dismiss on the ordinary course defense based on the complaint's allegations regarding a 25 year payment history between the defendant and debtor).

[7] Generally, matters related to a pending bankruptcy case may be brought in the same court where the bankruptcy case is pending. 28 U.S.C. § 1409(a).

preference action will often compel the defendant to settle a preference claim on less favorable terms than otherwise warranted by the merits of the underlying claim. The SBRA amendments to preference claims will lessen the procedural burdens on defendants in such actions and may significantly impact preference litigation and valuation in practice.

DISCUSSION

The SBRA impacts potential preference actions by requiring, effective as of February 19, 2020, that the plaintiff account for the recipient's defenses before asserting the preference claim and by requiring that certain bankruptcy actions with less than $25,000 at issue be commenced in the district where the defendant resides.[8]

First, the SBRA amends Section 547(b) of the Bankruptcy Code to explicitly condition the assertion of a preference claim by the plaintiff "on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses" under Section 547(c) of the Bankruptcy Code. As an initial matter, this new requirement is likely to result in fewer preference claims being brought overall, and may even curb the practice of filing preference actions against every entity receiving any prebankruptcy transfer. More importantly, with reasonable due diligence and accounting for defenses as a statutory prerequisite for the assertion of a preference claim, we expect that plaintiffs will need to include detailed statements regarding the due diligence undertaken and defenses accounted for. This should assist creditors in defending such claims (and facilitate discovery) but should also require bankruptcy courts to consider the applicability of the preference defenses under Section 547(c) of the Bankruptcy Code on motions by defendants for dismissal under Rule 12(b)(6) or for judgment on the pleadings under Rule 12(c).[9] Accordingly, while each preference claim and defense will remain highly fact intensive, this amendment should be significantly favorable for preference defendants.

Second, the SBRA amends Section 1409(b) of Title 28 to require that any proceeding arising in or related to a bankruptcy case against a non-insider to recover a non-consumer debt of less than $25,000 (an increase from $13,650

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[8] SBRA § 3.

[9] Pursuant to Federal Rule of Bankruptcy Procedure 7012(b), Rule 12(b)–(i) of the Federal Rules of Civil Procedure are applicable to all adversary proceedings in bankruptcy court, including preference actions.

currently) be commenced in the district where the defendant resides.[10] While there is some dispute among bankruptcy courts (and no binding authority in any jurisdiction) whether Section 1409(b) applies to preference actions,[11] the SBRA legislative history is clear that the section 1409(b) amendment was specifically intended to apply to preference actions.[12] If so applied, this would shift the venue and cost advantages from the plaintiff to the defendant for the subject preference actions, and would also procedurally benefit defendants by preventing such actions from being subject to any mandatory case management procedures imposed by the debtor's bankruptcy court.

CONCLUSION

The SBRA amendments are likely to significantly reduce some key procedural disadvantages for defendants to preference claims and are likely to substantially impact the early stages of preference litigation. All creditors should consider the impact of these amendments when evaluating preference exposure and potential litigation.

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[10] This amount will be subject to periodic adjustment. 11 U.S.C. § 104(b).

[11] *Compare, e.g., In re Excel Storage Prods., L.P.*, 458 B.R. 175, 183 (Bankr. M.D. Pa. 2011) (holding that Section 1409(b) does not apply to preference actions); *In re Tadich Grill of Wash. DC LLC*, 598 B.R. 65, 67 (Bankr. D.D.C. 2019) (same), *with In re DynAmerica Mfg., LLC*, 2010 Bankr. LEXIS 1384 (Bankr. D. Del. May 10, 2010) (Section 1409(b) does apply to preference actions).

[12] H.R. Rep. No. 116-171 at 4 (2019) ("The second provision concerns the venue where such preferential transfer actions may be commenced. Current law requires this type of action to be commenced in the district where the defendant resides if the amount sought to be recovered by the action is less than $13,650. H.R. 3311 would increase this monetary limit to $25,000.") (footnote omitted). In contrast, the prior version of Section 1409(b) was enacted as part of the BAPCPA amendments in 2005 with final legislative history omitting mention of preference actions, which omission has been relied on by some bankruptcy courts. *See, e.g., Excel Storage*, 458 B.R. at 183 (discussing BAPCPA legislative history and noting "[g]one is any reference to preferential transfers as existed in the previous House Reports.") (citing H.R. Rep. No. 109-31(I) (2005)). Accordingly, while the SBRA does not resolve the statutory language issues that have led some courts to conclude that Section 1409(b) does not apply to preference actions, this legislative history may prompt courts to view the issue more favorably to defendants.