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PERSPECTIVE

Section 547 amendments' impact on bankruptcy trustees

By Nancy Simons and Jeremy Faith

The Small Business Reorganization Act of 2019, which went into effect in February, brought significant changes to the United States Bankruptcy Code. As its name suggests, the focus of the SBRA was the addition of a new Chapter 11 sub-section designed to provide certain small businesses with a more stream-lined and affordable route to reorganization. Lost in the glare of this shiny new subsection were less heralded amendments to the Bankruptcy Code's preferential transfer statute in Section 547 and related venue rules found in 28 U.S.C. Section 1409(b). For practitioners, these changes are worthy of discussion, lest you or your client find yourself on the receiving end of a demand letter or adversary proceeding that seeks recovery of the infamous "preferential transfer."

The Avoidable Preferential Transfer

One of the underlying goals of the Bankruptcy Code is to treat similarly situated unsecured creditors equally — such that when distributions are made from a bankruptcy estate, they are done on a pro rata basis. To further this noble endeavor, the Bankruptcy Code allows the representative of the bankruptcy estate to avoid and recover certain payments a debtor makes to creditors within the 90-day period before a bankruptcy petition is filed, and within one year for creditors who are considered "insiders" of the debtor. The rationale for having to give back an otherwise legitimate payment is that when a debtor is on the verge of bankruptcy (90 days prior to filing), they will "prefer" payment to certain creditors over others. Thus, by recovering such payments made in the 90 days pre-petition, the bankruptcy estate is able to equalize treatment by distributing the funds pro rata to all creditors.

A Brief Overview of Section 547 Amendments

The changes to the venue rules found in Section 1409(b) of Title 28 for preference actions are merely increases to the statutory minimums governing whether such actions can be filed in the court where the bankruptcy case is pending, or if they need to be filed in a district court where the defendant is located. However, the additions to Section 547 lack such arithmetical clarity. Under the SBRA, Section 547(b) was amended to require that "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."

Raising Questions Without Clear Answers

Among the many questions the amendment raises for trustees is: What is considered "reasonable due diligence in the circumstances of the case"? As a term of art, "reasonable due diligence" is a unique term not previously defined by the Bankruptcy Code or case law.

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In addition, the new statute gives no guidance as to the consequences of a trustee's failure to perform the undefined "reasonable due diligence." Needless to say, the lack of both definitional and consequential clarity will invite litigation, as parties seek to clarify the borders of these currently ambiguous statutory boundaries.

How subjective will the analysis be? What hoops must a trustee jump through, or what boxes must they check, to reasonably satisfy the due diligence requirement? Once reasonable due diligence is performed, what is a trustee's obligation beyond that? And what are the consequences of a trustee's failure to meet this new standard?

Without guiding statutory definitions, the natural next place to look for answers is in case law interpreting similar language in other statutes that include a "reasonable due diligence" standard. However, the absence of such standard anywhere in the Bankruptcy Code means that there is little to be gleaned from a review of the case law. Possible places to look for general definitions of reasonableness and due diligence would be case law that addresses the allowance of late-filed claims in bankruptcy. Ultimately, defining both the terms and consequences of this new legislation will come down to smart lawyering to help craft judicial interpretation.

Proceed with Caution and Best Practices

Without a crystal ball to reveal the impacts of the amended statutes, trustees will want to minimize the risks and costs of

future litigation by following certain best practices. When analyzing the reasonableness of a trustee's due diligence, a court will likely start by looking at the resources available to the trustee at the time that such examination is performed. For example, a trustee administering an estate with no liquid cash or assets will likely be held to a lower standard of reasonableness than a trustee who has sufficient funds to perform a more detailed examination of a debtor's books and records, or to conduct pre-litigation discovery.

Some trustees are addressing the issue by sending pre-litigation demand letters to all defendants, and affirmatively requesting that the defendants disclose and provide back-up for any affirmative defenses they may assert. The question remains, however, whether such letters alone will satisfy the due diligence requirement, especially if the defendant does not respond. Are there more steps that the trustee must reasonably take to determine if the defendant has affirmative defenses? The answers are likely to be found on a case-by-case basis, with the specific facts of the matter used as a gauge of what constitutes "reasonableness."

Moving on from the pre-litigation phase, a plaintiff needs to ascertain what level of detail should be added to preference complaints going forward. Is it sufficient to provide a brief description of the trustee's due diligence, or must it have greater detail? Most practitioners would agree that it is better practice to provide more detailed information when trying to satisfy a new statutory due diligence requirement. Such details could include how the books and records were reviewed, the demand letters that were sent, as well as any additional efforts.

Timing will also be a critical factor evidencing reasonable due diligence efforts. Taking action in the earlier stages of the bankruptcy case will demonstrate a trustee's good faith efforts to uncover affirmative defenses. Trustees who wait until the eve of the statute of limitations to file a preference action, without first contacting the defendant about possible affirmative defenses, may find it difficult to explain to the court that the trustee's due diligence efforts were "reasonable." In light of the new language, the better practice would be to proactively engage with defendants prior to filing any complaints.

Let's assume the trustee failed to conduct reasonable due diligence into the existence of a defendant's affirmative defenses. Now what? Or rather, so what? The new language in Section 547 imposes a new duty, but does not provide any consequences for failing to perform such duty. What remedies are available to defendants who are able to establish a trustee has failed to perform "reasonable due diligence"? Motions to dismiss will likely be one of the first tactics litigants may employ to challenge the trustee's efforts to investigate the defendant's potential affirmative defenses. Given the novelty and vagaries of the new law, it is also likely that judges will grant trustees the ability to amend their complaints. However, if a trustee fails to conduct *any* due diligence prior to the filing of a complaint, one could imagine such motions would result in dismissals without prejudice — a dangerous proposition for trustees filing complaints immediately prior to the tolling of a statute of limitations.

Conclusion

As a general concept, the Section 547 amendments' goal of requiring trustees to give greater scrutiny to preference claims before initiating litigation has merit. Though such goal is conceptually sound, achieving it through legislation is more difficult than merely imposing a new standard of "reasonable due diligence." This term has no defined meaning within the four corners of the Bankruptcy Code. Thus, it is not up to trustees and defendants to test the boundaries of interpretation until the case law develops and illuminates how best to proceed in each case. ■

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