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Preference Due Diligence in the Crypto Winter

This article considers how the due diligence language added to Bankruptcy Code §547(b) might be applied to potential preference claims in a cryptocurrency bankruptcy case.

BY MICHAEL ROSELLA AND DAN MCELHINNEY

Sections 547(b) and 550 of the U.S. Bankruptcy Code allow a debtor to claw back certain payments made to non-insiders in the 90 days prior to the bankruptcy filing and to insiders in the year prior. The Small Business Reorganization Act of 2019 raised the bar on the due diligence needed to pursue such litigation, requiring the debtor assess "known or reasonably knowable affirmative defenses" before moving forward. The following analysis considers how the due diligence language added to §547(b) might be applied to potential preference claims in a cryptocurrency bankruptcy case.

Preference Claim Pleading Standard, Generally

There is lingering disagreement as to the general pleading requirements applied to a complaint alleging a §547(b) preference cause of action. The court in *In re Valley Media*, 288 B.R. 189, 192 (Bankr. D. Del. 2003), applied a "heightened standard" requiring: "(a) an identification of the nature and amount of each antecedent debt and (b) an identification of each alleged preference transfer by (i) date, (ii) name of debtor/transferor, (iii) name of transferee and (iv) the amount of the transfer. Other courts have declined to follow *Valley Media*." See, e.g., *In re The IT Grp.*, 313 B.R. 370, 373 (Bankr. D. Del. 2004) (finding the specific information required by *Valley Media* in the initial pleading "inappropriate and unnecessarily harsh").

After *Valley Media* was decided, the Supreme Court decided *Bell Atl. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), decisions that revised the standard to survive a motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure by requiring the facts alleged in a complaint

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Falling cryptocurrencies (bitcoins, dogecoins, shiba coins, binance coins and other)

be "facially plausible." At least one bankruptcy court interpreted those decisions to revive the heightened pleading requirements of *Valley Media*. See *In re Caremerica*, 409 B.R. 737, 753 n.2 (Bankr. E.D.N.C. 2009). Other courts, however, continue to disagree that a heightened standard is required. See, e.g., *In re Oconee Reg'l Health Sys.*, 621 B.R. 64, 71 (Bankr. M.D. Ga. 2020) ("The heightened pleading standard for preference claims, as adopted by *Caremerica* and its progeny, is inconsistent with the liberal fair

notice pleading standard of Federal Rule of Bankruptcy Procedure … 7008(a)(2), as well as the Supreme Court's assertion that 'a complaint attacked by a Rule 12(b)(6) motion to dismiss does not need detailed factual allegations.'); *TOUSA Homes v. Palm Beach Newspapers (In re TOUSA)*, 442 B.R. 852, 855-56 (Bankr. S.D. Fla. 2010) (same).

Section 547(b) Due Diligence Requirement

In 2019, Congress enacted the Small Business Reorganization Act of 2019, Pub. L. No. 116-54 §3(a), which amended §547(b) to include the following italicized language: "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 …." In applying this new language, courts have come to differing conclusions as to whether new due diligence language constitutes an element of a preference claim, one that must be sufficiently pled in the complaint to avoid dismissal under Rule 12(b)(6).

In *In re ECS Refining*, 625 B.R. 425, 453-58 (Bankr. E.D. Cal. 2021), the court explained: "this condition precedent, i.e., due diligence and consideration of affirmative defenses, is an element of the trustee's prima facie case." The court concluded that the due diligence language requires the trustee to "undertake: (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 458.

Other courts have avoided ruling on whether the due diligence language qualifies as a new element of a preference claim but have nonetheless evaluated the complaint to determine if sufficient information regarding due diligence was pled. For example, in *In re Center City Healthcare*, 2022 WL 2133974, at *6 (Bankr. D. Del. June 13, 2022), the court found the allegations in the complaint regarding due diligence to be sufficient where the complaint stated 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 "the Debtors sent Demand Letters to the Defendants inviting an exchange of information regarding any potential defenses with respect to the Transfers …." Similarly, the court in *In re Insys Therapeutics*, 2021 WL 5016127, at*3 (Bankr. D. Del. Oct. 28, 2021), found the due diligence requirement sufficiently pled based on allegations that "the Trustee sent a letter to [the transferee] … demanding return of the Transfers and inviting [the transferee] 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[.]"

Courts have also highlighted the discretion inherent in the due diligence standard, suggesting that differing levels of diligence may be sufficient depending on available information in each case. See, e.g., *In re Reagor-Dykes Motors L.P.*, 2021 WL 2546664, at *2 (Bankr. N.D. Tex. June 21, 2021) ("Whether, as here, the trustee's due diligence is sufficient depends on the circumstances of the case.") (citing *In re Trailhead Engineering*, 2020 WL 7501938, at *7 (Bankr. S.D. Tex. Dec. 21, 2020)).

Due Diligence in a Cryptocurrency Case

A key factor in satisfying the due diligence requirement of §547(b) in a cryptocurrency case will be access to demographic and transaction data necessary to assess affirmative defenses. Given the opaqueness of certain cryptocurrency transactions, it is unclear what level of due diligence may be achieved in each case.

In general, to conduct a data analysis assessing the three most common affirmative defenses asserted by transferees, i.e., contemporaneous exchange of new value defense (§547(c)(1)), subjective ordinary course of business defense (§547(c)(2)(A)), and subsequent new value (§547(c)(4)), the following data is needed: name of transferee; name of debtor-transferor; payment date, type and amount; paid and unpaid invoice date and amount. Understanding the nature of the transferor-transferee relationship is important but not typically required to perform a data analysis. However, where the relationship is not one where invoices are typically issued, an understanding of the underlying relationship and/or agreement would be needed to assess when the obligation satisfied by the payment was due.

Information relating to cash transfers typical of any company (i.e., vendor payments) should be accessible from a company's accounting system. In addition, such transfers should be reflected in bank statements and canceled checks, information that can be obtained from the company or the bank consensually or via subpoena. By contrast, transfers by an unregulated debtor of cryptocurrency (i.e., Bitcoin; Ether) to the independent digital wallet of a customer or counterparty (i.e., customer withdrawal) may complicate completion of due diligence and assessment of affirmative defenses due to the potential anonymity of the transferee. Indeed, to secure name and address information of the transferee in this scenario, the debtor may need to track the digital wallet to a cryptocurrency exchange, at which point the debtor can attempt to compel the exchange to provide demographic information related to that digital wallet (assuming they are required to obtain "know your customer" information). Still, where the debtor is a regulated entity and required to perform customer verification processes, it may have sufficient information regarding the cryptocurrency transferee. If successful in obtaining customer information, the debtor could then prepare and send demand letters, inviting the transferees to respond and present their affirmative defenses, which the debtor would then be in a position to consider. This approach was sufficient to satisfy the due diligence requirements outside the crypto context in *In re Insys Therapeutics*, where the pre-complaint assessment of affirmative defenses was limited to only those that were asserted by defendants in response to a demand letter.

Key Takeaways

There is considerable case law suggesting that a court would accept less than would be required under the *Valley Media* heightened pleading standard when assessing the general sufficiency of allegations contained in a preference complaint. Consistent with this approach, the newly added due diligence language of §547(b) explicitly requires courts to apply a standard that accounts for the underlying circumstances in a given case when considering the sufficiency of the due diligence performed. This is good news for cryptocurrency debtors, as the ability to conduct due diligence and obtain necessary information to assess affirmative defenses may be impaired by the nature of the debtor's business. Nonetheless, the debtor in a cryptocurrency case should include in the complaint a recitation of those efforts—including efforts to obtain information needed information to consider affirmative defenses, as well as reference to demand letters sent inviting the transferee to assert such defenses—to minimize any dismissal risk.

Michael Rosella *is senior associate at Katten Muchin Rosenman.* **Dan McElhinney** *is managing director at Stretto.*