From: CLA - Business Law Section
To: Mihelic, Kristin T. (USTP)
Subject: ILC e-Bulletin: Small Business Reorganization Act Imposes New Diligence Requirements on Preference Plaintiffs and Modifies Venue Provisions For Proceedings to Recover Less Than $25,000.
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Section Logo

Insolvency Law Committee

December 13, 2019

Dear constituency list members of the Insolvency Law Committee:

On August 23, 2019, President Trump signed the Small Business Reorganization Act of 2019 ("SBRA") into law. The SBRA is scheduled to take effect on February 19, 2020.

Generally, the SBRA does two things. First, it creates a new subchapter within chapter 11 for "small business debtor reorganization" cases. These changes to the Bankruptcy Code are summarized in an ILC e-Bulletin prepared by former ILC Chair Robert Harris. You can read his e-bulletin **here**.

Second, the SBRA amends 11 U.S.C. § 547(b) and 28 U.S.C. § 1409(b) to curb perceived abuses by trustees of their ability to avoid and recover preferential transfers. The amendment to section 547(b) of the Bankruptcy Code forces a trustee (or a debtor in possession, committee, or other person exercising the rights of a trustee) to evaluate the transferee's potential defenses before filing suit. The amendment to section 1409(b) of the Judicial Code – which deals with venue of certain bankruptcy proceedings – purports to force the plaintiff to file the suit in the preference defendant's home district if the plaintiff is seeking to recover less than $25,000. This e-bulletin addresses these two changes.

Genesis of Amendments to 11 U.S.C. § 547(b) and 28 U.S.C. § 1409(b)

The House Judiciary Committee's report on H.R. 3311 states that the SBRA was largely derived from recommendations developed by the National Bankruptcy Conference ("NBC") and the American Bankruptcy Institute ("ABI"). The revisions to 11 U.S.C. § 547(b) and 28 U.S.C. § 1409(b) appear to have derived from a 2014 report of the ABI's Commission to Study the Reform of Chapter 11 (the "ABI Report"). Thus, the ABI Report is helpful to an understanding of the amendments affecting (or purporting to effect) preference claims.

Amendment to 11 U.S.C. § 547(b)

Section 547(b) provides that, except as provided in section 547(c) and (i), "the trustee may avoid any [preferential] transfer of an interest of the debtor in property." A plaintiff has the burden of proving the avoidability of the transfer under section 547(b), and a defendant has the burden of proving the nonavoidability of the transfer under section 547(c). 11 U.S.C. § 547(g).

The ABI Report sought to address concerns that trustees pursue preference actions with little diligence and without regard to the merits of the claims. The Commission rejected several proposals, including one that would have created a presumption in favor of the creditor that the prepetition transfer was made in the ordinary course of business, which the plaintiff could rebut as part of its *prima facie* case. The Commission ultimately determined that codifying a standard that requires plaintiffs to perform reasonable due diligence and make good faith efforts to evaluate the merits of preference claims was a reasonable compromise.

In line with the Commission's recommendation, the SBRA amends section 547(b) to provide 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 [preferential] transfer of an interest of the debtor in property."

Arguably, this language creates two new elements that must be established to prevail on a preference claim. As a matter of statutory construction, the word "and" signifies that the first new element (due diligence) is distinct from the second (consideration of potential affirmative defenses). Otherwise, Congress would have used the word "including" instead of the conjunctive "and."

First, before filing the complaint, the plaintiff must conduct "reasonable due diligence in the

circumstances of the case." It is unclear what this first element entails. For example, can a plaintiff rely on the Statement of Financial Affairs or the debtor's accounting software, or must the plaintiff independently review bank records and copies of checks to confirm the information? Is the plaintiff required to review invoices to confirm that a transfer was made to or for the benefit of a creditor, or for or on account of an antecedent debt?

Second, the plaintiff must take the defendant's affirmative defenses into account. This is the primary purpose of the amendment to section 547(b). Quite simply, the plaintiff must conduct at least some analysis of a transferee's "contemporaneous exchange," "ordinary course" and "new value" defenses (as well as other potential defenses).

Some commentators predict that a plaintiff's due diligence and analysis of defenses will start with a demand letter, requesting either (a) repayment or (b) information and documentation supporting statutory defenses. In this regard, it is noteworthy that the ABI Report contained the following recommendation: "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 . . . ." Thus, at least in the eyes of the ABI Commission, plaintiffs should conduct their due diligence and analysis *before* making any demands.

It also is important to note that the new elements appear in section 547(b). This means that they must be (a) adequately pled and (b) proven at trial. What happens if a plaintiff files a slam-dunk preference claim to which the defendant has no legitimate defense, but the court determines that the plaintiff failed to perform reasonable due diligence and/or attempt to determine ahead of time whether a defense existed? Arguably, the plaintiff should lose.

Another dilemma exists because preference claims, and potential defenses, are often evaluated by the plaintiff's attorneys and accountants. Will the analyses and advice given by attorneys and accountants to the plaintiff be discoverable? Further, will the submission of evidence regarding the plaintiff's due diligence and analysis of defenses waive privilege regarding such matters?

Amendment to 28 U.S.C. § 1409(b)

Section 1334(b) of title 28 provides that district courts have original, non-exclusive jurisdiction over bankruptcy proceedings. That section divides bankruptcy proceedings into three categories: (1) proceedings "arising under" the Bankruptcy Code, (2) proceedings "arising in" cases under the Bankruptcy Code, and (3) proceedings "related to" cases under the Bankruptcy Code.

Section 1409 of title 28 dictates where these three types of bankruptcy proceedings may be filed.

Section 1409(a) sets forth the general rule: Except as provided elsewhere in the statute, "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." Thus, the general rule applies to all three categories of proceedings.

Section 1409(b) establishes some exceptions:

> 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 $1,375 or a consumer debt of less than $20,450, or a debt (*excluding a consumer debt*) against a noninsider of less than $13,650, only in the district court for the district

> in which the defendant resides.

This exception applies only to two of the three categories of proceedings. Proceedings "arising under" the Bankruptcy Code are *not* included within section 1409(b).

BAPCPA's legislative history strongly suggests that the $13,650 threshold (which was originally $10,000 but adjusts upward every three years) was intended to apply to preference actions. Commentators recognized at the time that Congress was trying to stop the practice of filing small preference actions against defendants who have no connection to the district in which the bankruptcy case is pending.

Many courts and commentators also pointed out that Congress made a mistake when it added the phrase italicized above. Preference actions fall within the first category of proceedings listed in section 1409(a) – those "arising under" the Bankruptcy Code. But the exceptions in 1409(b) apply only to the other two categories of proceedings. Therefore, Congress tried to impose a $10,000 threshold on preference actions by inserting language into a statute that does not actually apply to preference actions.

Even if section 1409(b) applied to proceedings "arising under" the Bankruptcy Code, it still is not clear that the threshold would apply to preference actions. Section 547(b) allows a trustee to avoid a transfer. Section 550 allows the trustee to recover the property transferred or the value thereof. Arguably, an action to avoid a transfer and recover property (or its value) is not an action "to recover . . . a [non-consumer] debt."

This problem has persisted for over 13 years. In fact, just this year the ILC published an e-bulletin discussing *Klein v. ODS Technologies, LP* (*In re J & J Chemical, Inc.*), Adv. No. 18-08029-JDP (Bankr. D. Idaho Jan. 11, 2019), in which the bankruptcy court reiterated that section 1409(b) does not apply to claims "arising under" the Bankruptcy Code.

The ABI Report recognized the problem. The Commission recommended that section 1409(b) be amended to (i) clarify that the small claims venue provision applies to preference actions, and (ii) increase the threshold to $50,000.

The SBRA provided Congress a perfect opportunity to fix its prior mistake. Congress could have created a new section 1409(f) to deal specifically with preference actions. Or it could have revised section 1409(b) to provide that all of the exceptions in that subsection apply to proceedings "arising under" the Bankruptcy Code. Or Congress could have revised section 1409(b) to expressly say that it covers preference actions (but no other "arising under" actions).

The SBRA does none of these things. It simply increases the current $13,650 threshold to $25,000 (subject to periodic increases based on the Consumer Price Index).

It is unclear why Congress did not follow the ABI Commission's recommendation to clarify that the non-consumer debt threshold in section 1409(b) applies to preference actions. What *is* clear is that Congress *thinks* that the provision already applies to preference actions. This is reflected by the House Judiciary Committee's report:

> The bill also includes two provisions . . . pertaining to preferential transfers. . . . 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.

As a result, even after the SBRA, courts still will be required to make a choice. Follow the plain language of the statute? Or read the statute consistent with the clear intent of Congress?

These materials were written by former ILC Chair John N. Tedford, IV, of Danning, Gill, Israel & Krasnoff, LLP, in Los Angeles, California (jtedford@DanningGill.com). Editorial contributions were provided by Robert G. Harris, a partner in the Silicon Valley bankruptcy law firm Binder & Malter, LLP (rob@bindermalter.com).

Thank you for your continued support of the Committee.

Best regards,
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