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What Satisfies the Due Diligence Requirement for Bringing a Preference Action?

The Small Business Reorganization Act ("SBRA") was enacted August 23, 2019, and went into effect in February 2020, to assist small-businesses with a simpler alternative bankruptcy option, Subchapter V of Chapter 11 ("Subchapter V").[1] In addition to streamlining the chapter 11 process for eligible debtors and their creditors, the SBRA made amendments to the statutory provisions governing preference actions under Section 547 of the Bankruptcy Code, primarily relating to venue and due diligence. This article focuses on the due diligence requirement imposed by the SBRA, and what is required when attempting to recover from transferees. Also, we will refer to a "trustee" for ease of reference, but we mean any party seeking to recover a preferential transfer.

Initially, the Bankruptcy Code did not explicitly require a trustee to conduct due diligence prior to commencing an action under Section 547(b). But the SBRA amended the Bankruptcy Code to now require a trustee to conduct "reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonable knowable affirmative defenses" prior to commencing an action under Section 547. This amendment is meaningful because it may provide a defense to parties sued under section 547 in the event due diligence is not undertaken prior to commencing an action.

Defendants in preference actions have moved to dismiss complaints for failure to adequately allege sufficient facts to state a claim for a preference action, because it did not establish that the trustee exercised reasonable due diligence.

To date, there have been three court decisions analyzing the due diligence requirement (two unreported), which may be instructive for other Circuits: (1) *In re ECS Refining, Inc.,* 625 B.R. 425 (Bankr. E.D. Cal. 2020); (2) *In re Trailhead Engineering LLC,* 18-32414, 20-3094, 2020 WL 7501938 (Bankr. S.D. Tex. Dec. 21, 2020); and (3) *In re Reagor-Dykes Motors, LP,* 18-50214 (Jointly Administered), 20-05028, 2021 WL 254664 (Bankr. N.D. Tex. June 21, 2021). Those three decisions considered, among other things, two issues: (a) whether the due diligence requirement is a condition precedent to a preference action, and must it be pleaded in the complaint; and (b) whether the allegations in the complaints filed were sufficient to demonstrate that due diligence was conducted, and then survive a motion to dismiss.

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1 Under the SBRA, qualifying small business debtors can retain control over their business operations while reorganizing and not be subject to the more costly requirements under Chapter 11.

Is the due diligence requirement a condition precedent to a preference action, and must it be pleaded in the complaint? First, these decisions considered whether the due diligence requirement was an element of a preference action that had to be expressly pleaded. The Bankruptcy Court for the Eastern District of California held that the due diligence requirement is a condition precedent, which is an element of the trustee's prima facie case. *In re ECS Refining, Inc.,* 625 B.R. at 453-54. The Bankruptcy Court for the Southern District of Texas did not determine whether reasonable due diligence is an element of or condition precedent to a preference claim, but held that a plain reading of the statute references due diligence "in the circumstances of the case," meaning that a level of discretion is involved when determining whether due diligence was conducted. *In re: Trailhead Engineering LLC,* 2020 WL 7501938, at *7. The Bankruptcy Court for the Northern District of Texas held that it is unclear whether the due diligence language creates an additional pleading requirement, but it is required in bringing a preference action. *In re Reagor-Dykes Motors, LP*, 2021 WL 2546664, at *2.

Were the allegations sufficient to demonstrate that due diligence was performed and would the complaints then survive dismissal? Second, these decisions considered whether the allegations in the complaints were sufficient to demonstrate that the trustee conducted due diligence and, therefore, would survive dismissal.
All of the decisions noted that the circumstances of the particular case had to be analyzed to determine whether sufficient due diligence was undertaken. *In ECS Refining*, the Bankruptcy Court for the Eastern District of California held that the use of notice style pleadings and the general nature of the allegations suggested a lack of pre-filing due diligence. *In re ECS Refining, Inc.,* 625 B.R. at 458. It did not appear to the court that the trustee had considered whether the debt was antecedent, whether those transfers improved defendant's position, or the inapplicability of all affirmative defenses, known or reasonably knowable. *In Trailhead Engineering LLC,* the Bankruptcy Court for the Southern District of Texas held the trustee's complaint contained sufficient information to infer that reasonable due diligence was conducted to survive dismissal, because the complaint demonstrated that the trustee reviewed the debtor's bank and wire records, invoices relating to the alleged transfer, correspondence, the relevant contract, and mapped out the structure of the parties' relationships. *In re: Trailhead Engineering LLC,* 2020 WL 7501938, at *7. In Reagor-Dykes Motors, LP, the Bankruptcy Court for the Northern District of Texas did not dismiss the preference claim against one defendant, even though it lacked the allegations regarding due diligence contained in the complaint in *Trailhead Engineering* which satisfied the requirement, and noted that whether the trustee's due diligence is sufficient depends on the circumstances of the case. *In re Reagor-Dykes Motors, LP*, 2021 WL 2546664, at *2. It was clear though, that a mere recitation of the statute is inadequate. Id.

Conclusion

At this point, it remains unclear what exactly constitutes "reasonable due diligence" sufficient to satisfy the new requirement in Bankruptcy Code Section 547(b). We do know from these three decisions that due diligence is an element that must be pleaded based on the circumstances of the case, and if courts follow these decisions, then simply reciting the statute will not be sufficient.

In addition, prior to bringing preference actions, trustees and their professionals should undertake reasonable due diligence in determining the known or reasonably known affirmative defenses of transferees, and plead supporting facts in the complaint that will demonstrate such effort. Last, defendants in preference actions (and their professionals) should carefully review a preference complaint and confirm that the plaintiff even attempted to reasonably satisfy the due diligence requirement.

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