

An orange speech bubble with a tail pointing downwards, set against a dark gray background. The bubble contains the text "WAIT WAIT.... DON'T SUE ME!" in white, bold, sans-serif capital letters.

**WAIT WAIT....
DON'T SUE ME!**

Section 547 Preferences & Required Diligence

11 U.S.C. Section 547

The requirement for “reasonable due diligence of the trustee” under Section 547 of the Bankruptcy Code was introduced by the Small Business Reorganization Act of 2019.

This amendment added language to Section 547(b) stating 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, avoid any transfer of an interest of the debtor in property. See Pub. L. No. 116-54 § 3(a).

(b) Except as provided in subsections (c) and (i) of this section, 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—

Preferential Transfers

Generally, payments made within 90 days to fully secured creditors are not preferences. 11 U.S.C. § 547(b)(5); *Goodman v. Triple "C" Marine Salvage, Inc. (In re Gulf Fleet Holdings, Inc.)*, 485 B.R. 329, 334 (Bankr. W.D. La. 2013)

Payments to junior lienholders and undersecured creditors can be subject to clawback as preferences.

The test for purposes of 547(b)(5) is (1) to what claim the payment is applied and (2) from what source the payment comes. *Krafsur v. Scurlock Permian Corp. (In re El Paso Refinery)*, 171 F.3d 249, 256 (5th Cir. 1999).

- (1) The Application Aspect – Is the payment to the unsecured or secured portion of the debt. If no release of collateral, ipso facto application to unsecured portion.
- (2) Source Aspect – Even if payment was applied to unsecured portion of claim, it is not a preference if the source of the payment is the creditor's own collateral.

Creditor Pre-Bankruptcy Preference Planning

- Take a security interest in collateral as part of settlement.
 - certain liens can be avoided as preference.
 - exception is statutory liens.
- Letter of Credit
- Pre-petition Waiver of bankruptcy/chapter 5 rights. *See In re Madison*, 184 B.R. 686 (Bankr. E.D. Pa. 1995) (agreement not to file bankruptcy for certain time period is not binding).
- Include preference defense language in settlement, ex. Contemporaneous exchange (release of a lien).

(c) The trustee may not avoid under this section a transfer—

- (1) to the extent that such transfer was—
- (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
- (B) in fact a substantially contemporaneous exchange;

(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—

- (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
- (B) made according to ordinary business terms;

(3) that creates a security interest in property acquired by the debtor—

- (A) to the extent such security interest secures new value that was—
 - (i) given at or after the signing of a security agreement that contains a description of such property as collateral;
 - (ii) given by or on behalf of the secured party under such agreement;
 - (iii) given to enable the debtor to acquire such property; and
 - (iv) in fact used by the debtor to acquire such property; and
- (B) that is perfected on or before 30 days after the debtor receives possession of such property;

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—

- (A) not secured by an otherwise unavoidable security interest; and
- (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor;

(5) that creates a perfected security interest in inventory or a receivable or the proceeds of either, except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interests for such debt on the later of—

- (A)(i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or
- (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; or
- (B) the date on which new value was first given under the security agreement creating such security interest;

Reasonably Knowable Affirmative Defenses?

In re ECS Refining, Inc.

Court noted that the interpretation of the due diligence language in section 547 has been the subject of some debate

Court concluded that this due diligence requirement constitutes a new element of the trustee's prima facie case for a preference claim.

Court found a failure to plead due diligence on two grounds:

- (1) the trustee's complaint did not meet the general pleading standard, and
- (2) the trustee did not recite the efforts undertaken to evaluate the merits of the action and affirmative defenses.
- *See In re ECS Refining, Inc.*, 625 B.R. 425, 454, 458 (Bankr. E.D. Cal. 2020).

In re Insys Therapeutics, Inc.

- Court stated that the trustee had adequately pled due diligence
- Trustee pleaded that diligence had been adequately conducted through reviewing the debtor's books and records and other available information
- Court found that pleading sufficient to satisfy the due diligence element, to the extent there is one.

See *In re Insys Therapeutics, Inc.*, No. 19-11292, 2021 WL 5016127, at *3 (Bankr. D. Del. Oct. 28, 2021)

In re Trailhead Engineering LLC

- The court did not determine whether reasonable due diligence is an element of any preference claim
- The court did note that a plain reading of the statute references due diligence in the circumstances of the case, implying a level of discretion is involved in determining what constitutes due diligence.
- *See In re Trailhead Engineering LLC*, No. 20-3094, 2020 WL 7501938, at *7 (S.D. Tex. Dec. 21, 2020).

22. The Trustee has completed an analysis of all readily available information of the Debtors, and is seeking to avoid all of the transfers of an interest of the Debtors' property made by the applicable Debtor(s) to Defendant within the Preference Period. The Trustee has performed his own due diligence with respect to the causes of action the subject of the Complaint, including evaluation of the reasonably knowable affirmative defenses available to the Defendant.

24. Based upon the Trustee's review of the available information, the Trustee has determined that the Trustee may avoid some or all of the Transfers even after taking in account the reasonably knowable affirmative defenses available to the Defendant.

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LIMERICKS!

A lack of candor to the court will draw ire,
Truthful disclosures to the judge are required,
But you must tell the court
Because failure to report
Will most certainly get an attorney...

...FIRED!

While striving for confirmation and the case to close,
Balancing trust and what the law will impose,
With privilege in mind
And the court's rules aligned
Attorneys navigate what they must...

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...DISCLOSE!

While it can be hard to balance attorney-client relations,

Learning about their assets requires lots of patience,

We must properly disclose

All the assets we know

Because filing false schedules may bring...

...SANCTIONS!

IS THE DEBT NON-
DISCHARGEABLE
UNDER EITHER
SECTIONS
523(A)(2); (4); OR
(6)

2·4·6?

11 U.S.C. Sections 523(a)(2); (4); (6)

(a) A discharge ... of this title does not discharge an individual debtor from any debt—

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by— (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition; (B) use of a statement in writing— (i) that is materially false; (ii) respecting the debtor's or an insider's financial condition; (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and (iv) that the debtor caused to be made or published with intent to deceive; ...;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

Rapid Fire on Local Rules

Ch. 13
Consumer
Cases

Complex
Ch. 11
Cases

Subchapter
V Cases

LR 1004

■ : “[I]f a bankruptcy petition is filed on a debtor’s behalf by the holder of a power of attorney, proposed guardian ad litem, or proposed next friend (the “Filing Party”), a motion shall be filed with the petition requesting that the Court appoint the Filing Party to be the debtor’s representative. The motion shall attach either (1) a copy of the power of attorney that the Filing Party asserts grants the authority to act on the debtor’s behalf in the bankruptcy proceeding or (2) a declaration executed by the Filing Party under penalty of perjury that details why a representative should be appointed for the debtor entity.”

LR 1017-1(E)

- “(1) Failure of the debtor to timely file a plan (including all extensions of time granted under L. Rule 3015-1(a)) or use the local form plan; (2) Failure of the debtor to timely file schedules, statements, and other documents required under 11 U.S.C. § 521(a) (including all extensions of time granted under L. Rule 1007-1(d)); (3) Unexcused failure of the debtor to appear at the Meeting of Creditors as required by 11 U.S.C. § 341; (4) Delinquency of the debtor of 60 or more days on payments under a proposed or confirmed plan; and (5) Failure of the debtor to comply with a prior Order of the Court that allows for such dismissal.”

LR 3015-1(G)(2)

- “If the trustee, creditor, or other party in interest objects to confirmation, the debtor shall file a response to pending objections to confirmation no later than three business days prior to the confirmation hearing. If the response indicates the debtor will address an issue in the future, the response should specifically indicate when and how the issues will be addressed. If no response is timely filed, the Court may elect to deny confirmation by default.”

LR 6004-1(B)

- “(4) Based on reasonable inquiry, all entities known or believed to hold legal or equitable interests in the property to be sold or leased;
- (5) Whether the offer is subject to higher and better bids, along with other material terms
- and conditions of the offer; (6) The debtor’s opinion of the value of the property and the basis therefor; and (7) Whether the sale is free and clear of liens, claims, or interests.”

LR 7015-1(A)

- LR 7015-1(a) to require a complete, redline copy of the amended or supplemental pleading the movant proposes to file. Also, lawyers sometimes forget that they need leave of court to amend pleadings, so the LRC added LR 7015-1(c) to provide “If leave is required to file an amended pleading, the Court may on its own initiative, strike any amended pleading filed without an order granting such leave.”

Complex Chapter 11 Cases

WHO?

- **Practitioners who file complex Chapter 11 cases filed in any Division of the Western District of Texas Bankruptcy Court must follow the “Complex Case Procedures.”**
- **Brand new complex chapter 11 case procedures! Come on, pay attention!**

WHAT?

- **No your client cannot sell assets in a 363 sale without disclosing basically everything. Review the Complex Case procedures for a complete list of information needed to properly get approval of a 363 sale.**

Complex Chapter 11 Cases (Cont'd)

WHERE AND WHEN?

- Yes, you have to use the forms in the Appendix after a certain date in the Western District.
- When? The final day for submission of comments was October 8, 2024, so get ready for some changes!

HOW?

- The format of the hearing depends on the *type* of hearing. For example, first-day hearings are conducted as virtual hearings!
- However, if you are a non-party to the proceeding, you must attend this hearing in person (yes, inside the Courtroom) unless you have Court permission.

SUBCHAPTER V LOCAL RULES

- These rules are brand new – so listen up!
- Local Rule 1020.2-1 – Subchapter V of chapter 11 was added to the Code effective February 19, 2020, by the Small Business Reorganization Act of 2019.
 - This new local rule incorporates appendix L-1020.2-1, which provides procedures and mandatory forms – including a subchapter V form plan – for the administration of subchapter V cases filed in the Western District of Texas.
 - This is a substantial addition to the local rules that should be carefully read by all bankruptcy practitioners.

Thanks for joining us for this episode of....

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