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Recent Developments Regarding Preferential Transfers

Counsel must carefully consider whether complaint is adequately pleaded

By IRVE GOLDMAN

The potential for recovering payments received by a creditor within 90 days of its debtor's bankruptcy filing is a familiar aspect of bankruptcy law.

Familiarity aside, preference law, which has as its rationale equality of distribution among all of a debtor's creditors, is never easily justified to a creditor who is asked to contribute even more to a debtor's bankruptcy cause. Recent developments in preference law, however, can at least give the defending counsel some additional tools to work with in warding off a preference recovery.

Pleading Requirements

In *Ashcroft v. Iqbal,* 129 S. Ct. 1937 (2009), the U.S. Supreme Court ruled that its decision in *Bell Atlantic Corp. v. Twombly,* 550 U.S. 544 (2007), which imposed heightened pleading requirements for an anti-trust complaint, applied to all civil complaints by operation of Federal Rules of Civil Procedure 8(a)(2).

Also according to *Iqbal,* "[t]hreadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice."

As confirmed by recent bankruptcy decisions, the more stringent pleading requirements brought about by *Twombly* and *Iqbal* apply equally to preference complaints brought in bankruptcy court. Such complaints, like any other complaint filed in bankruptcy court, are governed by Rule 8 of Federal Rules of Civil Procedure, which applies to adversary proceedings filed in bankruptcy court pursuant to Rule 7008 of the Federal Rules of Bankruptcy Procedure.

Even before *Twombly* and *Iqbal,* most courts held that to adequately plead a cause of action for a preferential transfer, the complaint must identify each transfer, usually a payment, by date, amount, name of transferor and name of transferee. See, for example, *In re Valley Media, Inc.,* 288 B.R. 189, 192 (Bankr. D. Del. 2003). But after *Twombly* and *Iqbal,* the pleading requirements for preference complaints have become more exacting.

For example, when there is a multi-debtor, jointly administered bankruptcy case or more than one possible transferee defendant, it will not be sufficient to allege that "one or more of the debtors" made a preferential transfer. See *In re Crucible Materials Corp.,* 2011 WL 2669113 at *4 (Bankr. D. Del. July 6, 2011); *In re Tweeter Opco*, 452 B.R. 150, 154-55 (Bankr. D. Del. June 14, 2011), or that "one or more of the defendants" received a preferential transfer. See *In re WBE, LLC,* 2011 WL 2607090, at *3 (Bankr. D. Del. June 30, 2011). The specific transferor and transferee need to be identified.

It is also no longer sufficient to parrot the statutory requirement that a transfer have been "for or on account of an antecedent debt owed by the debtor before such transfer was made." 11 U.S.C. §547(b)(2). An "antecedent debt" is simply a debt of the debtor that existed prior to the challenged transfer. Bankruptcy courts now require that a preference complaint contain factual detail explaining the nature and amount of the "antecedent debt" that was paid by the challenged transfer, such as "any contracts between the parties or [a] description of the goods and services exchanged." *In re Crucible Materials Corp.,* 2011 WL 2669113, at *4 (Bankr. D. Del. July 6, 2011); *In re Tweeter Opco,* 452 B.R. 150, 155 (Bankr. D. Del. June 14, 2011). See also *In re Hydrogen LLC.,* 431 B.R. 337, 355 (Bankr. S.D.N.Y. 2010) (dismissing preference claims because "no allegation has been made that any transfer was made for or on account of a specific and identifiable antecedent debt").


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Transfers to an "insider" of the debtor may also be captured if made between 90 days and one year before a bankruptcy filing, but for these types of transfers, unlike transfers within the 90-day period, the statutory element of insolvency is not presumed. As a result of *Twombly* and *Iqbal,* at least one court has held that for insider transfers, "the trustee must allege facts sufficient to show that such insolvency is plausible." *In re Caremerica.* 409 B.R. 737, 752 (Bankr. E.D.N.C. 2009). In addition, the complaint must set forth a factual basis for the conclusion that the recipient of the transfer is an "insider." *In re Sand Hill Capital Partners III*, 2010 WL 4269622, at*2 (Bankr. N.D. Cal. Oct. 25, 2011); *In re Caremerica Inc.,* 415 B.R. 200, 206 (Bankr. E.D.N.C. 2009).

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While pleading a preference cause of action has become more demanding, courts have been liberal in allowing amendments to the complaint to cure the deficiencies. Whenever an amendment to a complaint is requested after the statute of limitations has expired, however, there is an issue of whether the proposed amendment relates back to the timely filed complaint.

The statute of limitations for bringing a preference action is generally the later of two years after a bankruptcy is filed or, if a trustee is appointed within that two-year period (as in the case of the appointment of a Chapter 11 trustee when the case is originally administered by a debtor-in-possession), one year after the trustee's appointment. In many cases, the plaintiff in a preference action will commence the action shortly before the statute of limitations has expired, so the relation-back issue has a tendency to occur with greater frequency in preference litigation.

The general rule is that a proposed amendment will relate back to the original pleading under FRCP 15(c), made applicable to adversary proceedings by FRBP 7015, if it "spells out the details of the transaction originally alleged…." *In re Austin Driveway Services Inc.,* 179 B.R. 390, 395 (Bankr. D. Conn. 1995). The originally plead transfer in a preference complaint, however must at least be detailed enough on its face to disclose that it is seeking recovery of the same transfer set forth in the proposed amendment. *In re Austin Driveway Services* (quoting *Dworsky v. Alanjay Bias Binding Corp.,* 182 F. 2d 803, 805 (2d Cir. 1950)). Depending on the circumstances, therefore, a proposed amendment to a preference complaint could be barred by the statute of limitations.

Ordinary Course

One of the more common defenses to a preference is that it was made in the "ordinary course of business." 11 U.S.C. §547(c)(2). Prior to the 2005 amendments to the Bankruptcy Code, this defense required proving that the transfer was "ordinary" between the parties themselves as well as "ordinary" according to industry standards. The 2005 amendments made this formerly conjunctive test a disjunctive one.

A significant development under this defense for creditors with a longer-term relationship with the debtor was ushered in by the decision in *In re Archway Cookies,* 435 B.R. 234 (Bankr. D. Del. 2010). There, the bankruptcy court found it relevant to consider the length of the relationship between the debtor and creditor and "a debtor's need to maintain constructive relationships with certain creditors" in determining whether to protect a payment from avoidance. According to the court, a creditor whose relationship with the debtor "has been cemented long before the onset of insolvency," should be given greater leeway in deciding what is "ordinary" between the parties.

Conclusion

Creditors' counsel defending a preference action should now carefully consider whether the complaint adequately pleads the elements of a preference. If the client is an important or long-standing vendor of the debtor, counsel should be aware that this relationship might be a basis for receiving greater leeway in asserting the "ordinary course of business" defense. ■