AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Legislative Update

By William A. Brandt, Jr. and Geoffrey L. Berman

ABI Commission Update: Report on Avoiding Powers

William A. Brandt, Jr.
Development Specialists, Inc.
New York

Geoffrey L. Berman
Development Specialists, Inc.
Los Angeles

As ABI members should now be well aware, the ABI Commission to Study the Reform of Chapter 11 ("the Commission") released its Final Report on Dec. 8, 2014. The 400-page report contained more than 240 individual recommendations covering a wide range of topics affecting all facets of the chapter 11 process.[1] This article focuses solely on issues of avoiding powers, which was one of the 13 topic areas that the Commission reviewed.[2]

The Commission heard from the trade creditor community often and received constant feedback from this sector of the insolvency arena throughout its two-plus years of deliberations. Direct meetings with trade creditor representatives included testimony at a field hearing held in conjunction with the 2012 National Association of Credit Managers (NACM) Credit Congress in Las Vegas. As a follow-up to that hearing, written submissions were solicited on topics affecting trade creditors and a further follow-up session was held at NACM's June 2014 Credit Congress. This constant interaction between representatives of trade creditors and the Commission led to a more complete understanding of the trade community's concerns regarding the prosecution of preference claims under § 547 and claims under § 503(b)(9). It was not lost on Commission members that a significant amount of feedback that congressional offices receive about the Bankruptcy Code pertains to the trade creditor body's perception that there is an inherent unfairness in the prosecution of preference actions.[3]

Preferences and Defenses

Specifically, as to actions to recover preferential transfers, the trade creditor community expressed significant concerns regarding the manner in which preference actions are prosecuted and the concomitant burdens placed on trade creditors that are forced to defend such actions. Recognizing these concerns, the Commission analyzed a number of potential reforms regarding preference issues.

The Commission's recommendations included keeping the burden of proof for the defense with respect to recovery actions under § 547, as is currently embodied in the Bankruptcy Code. Simply put, the Commission believed that creditors should continue to have the burden of proving that a transfer (usually a payment) received from a debtor within 90 days of the filing of the commencement of a bankruptcy is either covered by the ordinary course of business defense or the new value defense, or was a contemporaneous exchange for new value.[4] That being said, the Commission did find it appropriate that a trustee, or any other person charged with the authority on behalf of an estate to prosecute preference recovery actions, perform reasonable due diligence and make a good-faith effort to evaluate the merits of any preference claims before making a demand for preference recovery, much less filing suit against a creditor for such recovery. The Commission also expressed its sympathy with those trade creditors who brought up the example of demand letters being sent on behalf of the estate without measurable foundation, often simply after a review of

1 The Final Report and archived video of past hearings are available on the Commission's website at commission.abi.org. An excerpt of the Final Report was featured in the January 2015 issue of the *ABI Journal*.

2 The members of the Avoiding Powers Committee were Prof. **Christopher W. Frost** (University of Kentucky College of Law; Lexington, Ky.), **Debra I. Grassgreen** (Pachulski Stang Ziehl & Jones LLP; San Francisco), Hon. **Stacey G. C. Jernigan** (U.S. Bankruptcy Court (N.D. Tex.); Dallas), **Bruce S. Nathan** (Lowenstein Sandler LLP; New York), **John D. Penn** (Perkins Coie LLP; Dallas), **Ronald R. Peterson** (Jenner & Block LLP; Chicago), Hon. **Steven W. Rhodes** (U.S. Bankruptcy Court (E.D. Mich.); Detroit), Prof. **G. Ray Warner** (St. John's University School of Law/Greenberg Traurig, LLP; Jamaica, N.Y.), **David B. Wheeler** (Moore & Van Allen, PLLC; Charleston, S.C.) and **R. Scott Williams** (Rumberger, Kirk & Caldwell, PA; Birmingham, Ala.).

3 Based on conversations that Mr. Brandt has had with many members of Congress.

4 The defenses are found at 11 U.S.C. § 547(c).

the company's check register for the preceding 90 days. As a result, the Commission found it appropriate that § 547 claims be pled with particularity as to the facts supporting the claim, as is currently required by the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*.[5] A complaint needs to be specific as to the preference allegations involved and not be a mere generalized statement that a creditor received payments during the preference period.

In its report, the Commission also felt that it was appropriate to recommend raising the limits on the amounts of claims being filed under §§ 547(c)(9) and 1409(b) of title 28 of the U.S. Code.[6] These proposed new limits are $25,000 under § 547 and $50,000 under § 1409. Effectively, claims must now reasonably be estimated to be worth more than $25,000 in order to be filed; if under $50,000, such claims must be brought in the district where the creditor resides rather than in the district in which the bankruptcy proceeding is pending.

This recommendation by the Commission still requires a potentially responsible creditor to be prepared to defend a preference claim when a debtor files for bankruptcy, even if the demand or suit is not alleged until near the end of the two-year statute of limitations in which such claims must be brought. However, the debtor/trustee must now have a reasonable basis to bring the claim and will be required to be specific in the bona fides of the claim if an adversary proceeding is to be filed. The Commission examined a number of other issues regarding preference actions and recoveries, but ultimately believed it best to leave the supervision of preference actions to the applicable court.[7]

Reclamation and *In Pari Delicto*

The Commission also gave a great deal of attention to claims of creditors under § 503(b)(9), as well as reclamation claims. The Commission believed that the protections in § 503(b)(9) were an important protection for unsecured creditors. Despite concerns that allowing these claims to remain as administrative expense reimbursement claims can cause a debtor significant issues in conjunction with plan confirmation, the Commission felt that it was important that these claims remain as currently authorized under the Bankruptcy Code. There was significant testimony and discussion about including "drop shipments" under the definition of "goods" under the statute, wherein a vendor sends its product to the debtor's customer(s) on direct delivery rather than to the debtor first. The Commission felt that it was appropriate to recommend that such deliveries as these "drop shipments" be included in the definition of "goods" and therefore made a part of those items potentially allowed under a § 503(b)(9) claim structure.

However, the Commission did not feel that it was appropriate to further expand the definition of an allowed § 503(b)(9) claim to include the concept of "services" rather than "goods." The Commission also felt that it was important that creditors be required to file a claim for recovery of such § 503(b)(9) claims as they may exist. Rather than assuming that these claims are valid per the debtor's records, the Final Report recommends that creditors be required to file a claim, by the applicable claims bar date as set by the court, to qualify for administrative expense claim treatment and be advised that such proofs of claim need to be specific as to the shipments included in the asserted claim, as well as a break-out of the amount of drop shipments vs. direct delivery.

Not surprisingly, the Commission also found, in conducting its research in the trade creditor arena, that creditors rarely pursued their state law reclamation rights and any rights that they might have under § 546(c) after a debtor has filed for bankruptcy. The general thinking on this appears to be that the § 503(b)(9) remedies have largely trumped reclamation claims remedies, such that the § 503(b)(9) claim structure now appears to be the primary mode of recovery for most creditors. Therefore, the Commission believed that when a creditor files a claim under § 503(b)(9), it should give up any state law reclamation right(s).[8] Further, the Commission felt that preserving the trade creditors' § 503(b)(9) rights should also replace any "critical vendor" designation or treatment by the debtor.

Also included in the Commission's deliberations were the implications of the *in pari delicto* defense. This defense to claims brought by a trustee "generally bars the pursuit of a cause of action by a plaintiff who allegedly acted in concert with the defendants or was otherwise involved in the wrongful conduct underlying the plaintiff's complaint."[9] The underlying premise in this interpretation is that a court should not "lend their good offices to mediating a dispute among wrongdoers."[10] The cause of action brought by a trustee is typically based on the pre-petition conduct of the debtor's principals and/or its professionals, and this cause of action belongs to the estate under § 41 as property of the debtor.

As most professionals may know, present law precludes recovery because of a debtor's wrongdoing (subject to various exceptions).[11] The Ninth

Bill Brandt is president and CEO of Development Specialists, Inc. in New York and a member of the ABI Commission to Study the Reform of Chapter 11. He is also chair of the Illinois Finance Authority. Geoff Berman is senior vice president of Development Specialists, Inc. in Los Angeles and a former ABI President. He formed the Commission during his presidential year (2011-12) and served as an ex-officio *member of the Commission.*

5 *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007); *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

6 This is the small claims venue provision.

7 For example, testimony that was submitted to the Commission included instances where creditors felt that the preference action process was being abused by the trustee, as well as the potential of shifting the burden of proof in these cases to the trustee. For more information on these issues, *see* the Commission's Final Report at p. 150.

8 For a more detailed look at the recommendations related to § 503(b)(9) and reclamation claims, *see* the Final Report, beginning at p. 169.

9 Final Report at p. 186.

10 *See Mosier v. Callister, Nebeker & McCullough PC*, 546 F3d. 1271, 1275 (10th Cir. 2008), and the Final Report at p. 186.

11 For more information on the *in pari delicto* defense, *see* Gregory W. Fox, "Limits of Expansive Protection of New York's *In Pari Delicto* Defense," XXXIII *ABI Journal* 9, 20-21, 76-77, September 2014; Allan B. Diamond and J. Maxwell Beatty, "*In Pari Delicto*: The Inequitable Application of an Equitable Doctrine," XXX *ABI Journal* 4, 36-37, 78-79, May 2011; Emily Stone and Emily Horowitz, "*In Pari Delicto*: 'At Equal Fault' Defense Explained," XXX *ABI Journal* 5, 54-55, 69, June 2011; Catherine E. Vance, "*In Pari Delicto*, Reconsidered," XXVIII *ABI Journal* 9, 40-41,78, November 2009. These articles are available at www.abi.org/abi-journal/archived-issues.

Circuit Court of Appeals is the only circuit court yet to rule on the issue; every other circuit court to examine the proposition has found that the *in pari delicto* doctrine bars a trustee's claims when the doctrine would also bar the debtor from bringing these types of claims. This situation relates only to those claims that are property of the debtor's estate under § 541 and does not apply to a trustee's recovery rights under other Bankruptcy Code sections, such as §§ 544 and 547 or the bringing of fraudulent transfer claims under §§ 548 and 550.

The issues facing the Commission in dealing with the *in pari delicto* doctrine included the fact that the claims brought by the trustee, if successful, would often not benefit the wrongdoers, but rather the creditors who have lost money because of the bankruptcy being filed. The Commission was unable to reach a consensus on its recommendations as to the application of the *in pari delicto* defense except in cases where the cause of action is brought by any *trustee appointed in the case*. In those instances and under those circumstances, the Commission recommended that the *in pari delicto* defense not be applicable. However, a trustee was not defined to include a post-confirmation trustee, such as the trustee of a liquidation or litigation trust.[12]

Conclusion

The Commission listened carefully to the everyday issues that trade creditors deal with and then tried to balance the trade creditors' needs with other imperatives of the Bankruptcy Code. Like every other aspect of the Commission's deliberations, extensive time was spent looking at the needs of trade creditors and the potential recoveries by unsecured creditors in bankruptcy cases and working to ensure that its recommendations were balanced and represented an improvement over the current application of the existing provisions of the Bankruptcy Code. abi

Reprinted with permission from the ABI Journal, Vol. XXXIV, No. 2, February 2015.

12 For more information on this area of the Commission's study, *see* the Final Report, beginning at p. 188.