MASS PREFERENCE LITIGATION
STRATEGIES AND PITFALLS
(INCLUDING THE USE OF STREAMLINED PROCEDURES AND MEDIATION)

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As preference cases become more and more commoditized, brought in large batches, and with procedures orders entered well before any defendant knows that they have been sued, the potential for abuses increases. Several articles appeared in the ABI Journal bemoaning the lack of oversight and conflicts of interest that arise in mass preference litigation. Those articles call for legislative changes to address the issues. For example, Karen Cordry suggests that the cure for a "blunderbuss" of preference litigation brought with too little investigation is to shift the burden of proof on ordinary course to the estate. Karen Cordry, "*Some Modest Proposals on Preferences*," ABI JOURNAL, June 2008.

Zach Mosner proposes that estates that are administratively insolvent be precluded from bringing preferences and that the Bankruptcy Code be amended to prohibit assignment of preference actions under 363. Zach Mosner, "*'Churn' Noble: Rethinking Preference Suits*," ABI JOURNAL, July/August 2011. Until these legislative suggestions are adopted, the rank and file bankruptcy lawyer will have to create their own solutions to the problem of preference litigation run amok.

This article attempts to highlight where procedures orders, dismissal decisions and mediation orders get it wrong or could be vastly improved. It also suggests creative strategies (some untested) to change the balance of power between plaintiffs and defendants: pre-judgment interest, fee-shifting, jury trial rights, discovery sanctions and similar slings and arrows to favorably move the settlement needle. This article is not a primer on preference elements and defenses as those matters are routinely known or discussed elsewhere.

When faced with a mass preference complaint, a defendant has the choice between attempting to distinguish itself from the hordes to reach an early settlement or to play along like a prisoner in the Bataan Death March, where attrition and time will eventually wear down both plaintiff and defendant making settlement cheaper than going forward. Whether the typical dance of attrition in mass preference actions achieves justice is another matter. Defendants face unnecessary costs in the form of local counsel, travel, and attorneys' fees when the complaint against them was based solely on the fact that a check was written during a 90-day period. Some procedures orders do not require any precision or verification by the plaintiff that a plausible preference claim exists and usually stay discovery "to avoid administrative costs." A review of procedures orders reveals that certain of these provisions are efficient and workable, and others are simply over-reaching, slovenly or both.

PART A--PLAINTIFF ISSUES

Preference litigation can be lucrative for estate counsel, but it also can be unjustifiably expensive for the estate. There is a natural bias against spending too much time investigating claims before they are brought because it is easier to let the defendants identify the weaknesses in the trustee's case. Still, a trustee or estate representative can get caught in a situation where he has brought too many weak cases and the ensuing perception of weakness can embolden both the court and defendants. For both ethical and strategic reasons, the estate representative is well-advised to choose battles that are winnable and to avoid obviously unsupportable cases. Efficiency should not prevail over counsel's goal of reasonable investigation and meritorious pleadings. With respect to winnable cases, the estate is best-served when advancing every

possible avenue of recovery and pleading the case with a full understanding of the facts. We begin with a juxtaposition of various pleading standards and grounds for dismissal.

I. APPLICATION OF THE *TWOMBLY/IQBAL* TO PREFERENCE ACTIONS

The first step in the mass preference march of attrition is the filing of the complaint. Often the preference complaint will be mass produced, sometimes simply using the debtor's check register to identify defendants. The result is a complaint that merely recites the elements of 11 U.S.C. § 547(a) without pleading specific facts as to what was the antecedent debt (or if there was one), whether the transfer was of property of the debtor or someone else, or facts showing that the transfer enabled the creditor to receive more than in a chapter 7 case.

Cases addressing what must be in a preference complaint can be divided into four overlapping constructs: before and after *Twombly/Iqbal* and for or against Judge Walsh's opinion in *Valley Media.* The short explanation of the *Twombly/Iqbal* shift is that these two Supreme Court opinions changed the level of pleading required under FED. R. CIV. P. 8 to withstand a motion to dismiss under FED. R. CIV. P. 12. The old standard was that a complaint should not be dismissed for failure to state a claim unless it appeared "beyond doubt" that the plaintiff could prove *no* set of facts in support of its claims. *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). *Twombly/Iqbal* changed that standard to whether the complaint is "plausible" based on the pleading of "enough factual matter to state a cognizable claim." *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 127 S.Ct. 1955 (2007), and *Ashcroft v. Iqbal*, 129 S.Ct. 1937 (2009). Federal Rules of Civil Procedure 8 and 9 apply to bankruptcy proceedings by operation of Federal Rules of Bankruptcy Procedure 7008 and 7009 with 7008 being applicable to preferences and 7009 also applicable to fraudulent transfers based on actual fraud.[1]

"A claim has facial plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Iqbal*, 129 S.Ct. at 949 (citing *Twombly*, 550 U.S. at 556). "The plausibility standard is not akin to a 'probability requirement,' but it asks for more than a sheer possibility that a defendant has acted unlawfully." *Id.*

A. Rule 12(b)(6) Decisions Pre-*Twombly/Iqbal*

Rule 12(b)(6) decisions on avoidance actions prior to 2007 run the gamut between a very liberal "notice pleading" standard and opinions that presaged the heightened pleading standards in *Twombly/Iqbal*. Judge Walsh's opinion in *In re Valley Media, Inc.*, 288 B.R. 189 (Bankr. D. Del. 2003), set forth the "minimum standard" that preference complaints must contain:

> (a) an identification of the nature and amount of each antecedent debt and (b) an identification of each alleged preference transfer by (i) date, (ii) name of debtor/transferor, (iii) name of transferee and (iv) the amount of the transfer.

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[1] Fraudulent transfer are generally subject to the heightened pleading standard of FED. RULE CIV. PROC. 9, although claims of constructively fraudulent transfers are subject to the FED. RULE CIV. PROC. 8. *See, e.g., In re Saba Enterprises Inc.*, 2009 WL 3049651 at *9 (Bankr. S.D.N.Y.) (Sept. 19, 2009) (citations omitted).

288 B.R. at 192. Given that *Valley Media* was decided before *Twombly/Iqbal,* the decision is notable for its requirement of precision in pleading preferences. *See also, In re Helig-Meyers Co.*, 297 B.R. 46 (Bankr. E.D. Va. 2003) (dismissing fraudulent transfer suit under Rule 8 finding that bare assertion of "less than reasonably equivalent value" was not plausible in light of decisions finding transfers of liens for antecedent debt not fraudulent.) Judge Walsh reiterated this standard in *TWA, Inc. v. Marsh USA, Inc. (In re TWA, Inc. Post Confirmation Estate)*, 305 B.R. 228 (Bankr. D. Del. 2004). However, Judge Walsh's vision of a more perfect preference world was rejected in several intervening decisions in the Delaware courts and elsewhere.

Judge Case in *Neilson v. Southern (In re Webvan Group, Inc.)*, 2004 W.L. 483580 (Bankr. D. Del. March 9, 2004), rejected Judge Walsh's heightened pleading standard, finding the outcome to be "harsh" on trustees who do not always have access to key facts. In *Family Golf Centers, Inc. v. Acushnet Company (In re Randall's Island Family Golf Centers, Inc.)*, 290 B.R. 55 (S.D.N.Y. 2003), Judge Bernstein stated that the *Conley v. Gibson* standard compelled his ruling that the information identified by *Valley Media* "might ultimately be necessary to adjudicate the preference claims, it does not follow that it must be pleaded on pain of dismissal." 290 B.R. at 65. Judge Bernstein has yet to rule after the new standard emerged in *Twombly/Iqbal.*

Judge Lindsey in *In re The IT Group, Inc.*, 313 B.R. 370 (Bankr. D. Del. 2004) sided with Judges Case and Bernstein in denying defendant's motion to dismiss, noting that if the defendant needs further elaboration, it can be done through the discovery process.[2]

B. Bankruptcy Courts After the Higher *Twombly/Iqbal* Pleading Standard

1. The *Caremerica* Decisions

Several decisions have already applied *Twombly/Iqbal* test to preference complaints. Three of these came from a single judge in North Carolina in the *In re Careamerica, Inc.* converted chapter 11 case. *See Angell v. BER Care Inc. (In re Caremerica Inc.*), 409 B.R. 737 (Bankr. E.D.N.C. 2009) ("*Caremerica I*"); *Angell v. Haveri (In re Caremerica Inc.)*, 409 B.R. 346 (Bankr. E.D.N.C. 2009) ("*Caremerica II*"); *Angell v. Burrell (In re Caremerica Inc.*), 2009 WL 2253225 (Bankr. E.D.N.C. July 28, 2009) ("*Caremerica III*"). In those bankruptcy cases, the trustee filed a groupings of adversary complaints for preferences and fraudulent transfers.

Caremerica I, the bankruptcy court applied *Twombly/Iqbal* to dismiss the trustee's complaint. First, the court found that the trustee failed to plead or show with sufficient factual recitations that the transfers at issue were transfers of the debtor's property. *Caremerica I*, 409 B.R. at 750-51. Specifically, the complaint did not indicate the source of the funds entering the affiliates' accounts or which entity initiated each transfer. *Id.* Accordingly, the court held that the trustee's allegations of transfers of interests of the debtors in property failed to meet the "plausibility" standard imposed post-*Iqbal*.

[2] Ironically, however, many mass preference procedures orders stay discovery until after mediation, leaving all parties flying blind for many months. The author suggests that if discovery is stayed under the procedures order, that Judge Walsh's standard be used or that Rule 26(a) disclosure be reorganized.

The court also dismissed the bare allegation that the transfers were "for, or on account of, an antecedent debt" owed by the debtor to the defendant before such transfer was made. *Id.* Under *Iqbal*, the court ruled, the plausibility requirement for this element requires alleging facts regarding the nature and amount of the antecedent debt at issue, and the payment to which is related. *Id.* Similarly, despite the presumption of insolvency 90 days prior to the petition date under 11 U.S.C. §547(f), transfers to insiders require specific facts showing insolvency for transfers to insiders made between 90 days and one year prior to filing. *Id.* at 752, *citing In re Troll Communications*, 385 B.R. 110, 114 (Bankr. D. Del. 2008).

Although in the context of discussing certain fraudulent transfer claims, the court also dismissed the trustee's lament that he should not be held to a higher pleading standard "because he is a third party with secondhand knowledge and limited access to information at the pleading stage." *Caremerica I*, 409 B.R. at 755. The *Caremerica I* court reasoned that there was no reason for a lesser standard for a trustee, noting that a "trustee is certainly more likely to have access to this information than the antitrust plaintiffs in *Twombly* or the Pakistani detainee in *Iqbal*." Other courts, even after *Iqbal,* have accepted a "give the trustee a break" argument. *e.g., In re Randall's Island Family Golf Center Inc*., 290 B.R. 55, 65 (Bankr. S.D.N.Y. 2003); *In re Chari*, 276 B.R. 206, 214 (Bankr. S.D. Ohio 2002).

Judge Leonard, faced with yet more preference complaints, wrote similar opinions in *Caremerica II* and *Caremerica III*. Here, the judge focused on the summary-style pleading that plagues many preference complaints. Instead of listing a total amount transferred and to what debt those transfers applied, the trustee simply listed a gross amount per defendant. The court ruled that "The total amount of funds transferred and the names of transferees are insufficient, without more, to satisfy the plausibility standard." Judge Leonard found that the specific requirements of *Valley Media* would be adopted, even though that decision occurred prior to *Twombly/Iqbal*. *Id.* at 205.

Closer to home, Judge Isgur adopted the *CareAmerica* standard in his determination that it would be futile to add additional defendants where it could not be shown that the defendant in an amended complaint had any connection with the particular transfer at issue. *In re Juliet Homes, LP*, 2010 WL 5256806 (Bankr. S.D.Tex. Dec. 16, 2010). Without specific facts pleaded connecting the alleged defendant to the transfer at issue, the defendant could not be added. ("A connection between a defendant and another party is not enough to associate that defendant with specific factual allegations pleaded against the other party.")

2. The Anti-*CareAmerica* Decisions

Judge Olson in *In re TOUSA, Inc.*, 442 B.R. 852 (Bankr. S.D. Fla. 2010), rejected the *CareAmerica* line of cases in denying motions to dismiss preference complaints in that massive preference juggernaut. Judge Olson denied that *Twombly/Iqbal* breathed new life into the *Valley Media* enumerated requirements. Rather, as other courts have found, whatever new standard might be imposed by the new plausibility requirement, those standards do not go so far as *Valley Media*. *Id.* at 854, n. 9, *citing*, *In re C.R. Stone Concrete Contractors, Inc.,* 434 B.R. 208 (Bankr. D. Mass. 2010) (finding *Valley Media* specificity not required by *Twombly/Iqbal*); *Gold v. Winget (In re NM Holdings Co., LLC)*, 407 B.R. 232, 256-57 (Bankr. E.D. Mich. 2009) (finding *Valley Media* to be inconsistent with "liberal notice pleading" standards of *Twombly*).

The *TOUSA* decision also found consistency within its own district with Judge Ray's decision in *Feltman v. Keybank, N.A. (In re Levitt and Sons, LLC)*, 2010 WL 1539878, (Bankr. S.D. Fla. Apr. 16, 2010).

C. The Use of Omnibus Complaints and Multiple Defendant Cases

Trustees routinely bring multiple preference claims in a single adversary. Often this is done to decrease the estate's cost, but it dramatically increases defense costs because counsel must attend every hearing in the mass adversary proceeding. The joinder of the defendants in a single adversary proceeding is permitted under Rule 20 of the Federal Rules of Civil Procedure if:

> **(A) any right to relief is asserted against [the defendants] jointly, severally, or in the alternative with respect to or arising out of the same transaction, occurrence, or series of transactions or occurrences; and (B) any question of law or fact common to all defendants will arise in the action.**

FED.R.CIV.P. 20(a)(2); FED. R. BANKR.P. 7020.

Can multiple preference cases be brought in a single adversary proceeding simply because the theory of recovery is the same? Well, it depends. Generally, it is not proper to join multiple defendants in a case if the transactions forming the basis for the claims are not related. *Michaels Building Co. v. Ameritrust Co., N.A.,* 848 F.2d 674 (6th Cir.1988). Joinder requires both the commonality of a particular transaction or occurrence and questions of law or fact. *Intercon Research Associates, Ltd. v. Dresser Industries, Inc.,* 696 F.2d 53 (7th Cir.1982).

Multi-defendant preference suits may have common issues such as insolvency and, to a certain extent, the debtor side of the ordinary course of business. However, each preference claim is itself a discrete "transaction or occurrence" that has to be analyzed independently of any other "transaction or occurrence."

> [K]eep in mind, of course, that there is a continuum between 'interrelated' and 'inextricably intertwined'. There is always an underlying interrelatedness of the claims between the parties in a multiparty civil action; rule 20(a) permits joinder only if the asserted claims for relief by and/or against the various parties are 'in respect of or arising out of the same transaction, occurrence, or series of transactions and occurrences ***and*** if any question of law or fact common to all [plaintiffs or defendants] will arise in the action.'"

Ginett v. Computer Task Group, Inc., 962 F.2d 1085, 1095 (2d Cir.1992) (quoting Fed.R.Civ.P. 20(a)(2)) (emphasis added).

Parties will be misjoined if the claims in a complaint arise out of different transactions or there is a lack of common questions of fact or law. "Therefore, parties are misjoined if the claims asserted against them 'do not arise out of the same transaction or occurrence or do not present some common question of law or fact.' "*Glendora v. Malone,* 917 F.Supp. 224, 227

(S.D.N.Y.1996) (quoting *American Fidelity Fire Insur. Co. v. Construcciones Werl, Inc., 407 F.Supp.,* 164, 190 (D.Va.1975)).

The rule establishes two separate requirements for joinder and both of them must be satisfied for it to be proper. There must be both a common transaction or occurrence giving rise to the defendants' asserted liability *and* a common question of law or fact. *Intercon Research Associates, Ltd. v. Dresser Industries, Inc.,* 696 F.2d at 57; *Mosley v. General Motors Corp.,* 497 F.2d 1330, 1333 (8th Cir.1974); *In re Conners,* 125 B.R. 611, 614 (Bankr.S.D.Cal.1991). What constitutes a common transaction or occurrence is determined on a case by case basis. Courts look to the logical relationship between the events giving rise to the plaintiff's claims, which is interpreted in such a way as to permit all reasonably related claims for relief against different parties to be brought in a single proceeding. *Mosley v. General Motors Corp.,* 497 F.2d at 1333. Nonetheless, it is not so flexible that courts will permit a single proceeding to be brought against multiple defendants simply because they are all liable to the plaintiff under the same theory or similar causes of action. *In re Nuclear Imaging Systems, Inc.,* 277 B.R. 59, 63 (Bankr.E.D.Pa.2002); *Kleven v. Norkus (In re Chochos),* 325 B.R. 780, 783 (Bankr.N.D.Ind.2005).

Under Rule 20 of the Federal Rules of Civil Procedure, the court may issue orders protecting parties from "expense, or other prejudice that arises from including a person against whom the party asserts no claim and who asserts no claim against the party." Fed.R.Civ.P. 20(b); Fed. R. Bankr.P. 7020. Rule 21 provides that the court may "sever any claim against a party." Fed.R.Civ.P. 21; Fed R. Bankr.P. 7021. Thus, if defendants do not win a severance under Rule 21, they should argue for procedures that minimize the expense by restricting the number of settings for hearings in their case and protecting themselves from "law of the case" and other pitfalls of being joined in a single adversary with unrelated cases.

D. Pre-Judgment Interest

Courts may but are not required to award pre-judgment interest on a preference claim from the date of demand until the date of payment. *In re Hechinger Inv. Co. of Del. Inc.*, 489 F.3d 568, 579-80 (3d Cir. 2007); *In re Cybermech, Inc.*, 13 F.3d 818, 822 (4th Cir. 1994); *In re Inv. Bankers, Inc.*, 4 F.3d 1556, 1566 (10th Cir. 1993). The Bankruptcy Code does not specifically provide for the awarding of interest. e.g. *In re Milwaukee Cheese Wis., Inc.*, 112 F.3d 845, 849 (7th Cir. 1997). There are divergent definitions of "discretion" to be used in deciding whether pre-judgment interest should be awarded. In *Milwaukee Cheese*, the Seventh Circuit opined that "prejudgment interest should be awarded unless there is a sound reason not do so," reasoning that, although the bankruptcy court has discretion as to whether to award interest, that discretion must be "according to law." The Eleventh Circuit disagrees with the presumption of awarding interest adopted by the Seventh Circuit in *Milwaukee Cheese*. *In re Glob Mfg. Corp.*, 567 F.3d 1291, 1300 (11th Cir. 2009). There, the circuit court reiterated that the award of interest must be "equitable." *Id., citing Osterneck v. E.T. Barwick Indus., Inc.,* 825 F.2d 1521, 1536 (11th Cir. 1987). Two lessons nonetheless remain; request interest in the demand letter and in the complaint. If you ask, you just might get it.

II. GATEKEEPING ISSUES

Estate counsel should avoid brining claims that will likely fail to the elements test of 11 U.S.C. 547(a). There is no amount of speed or efficiency in bringing claims against targets that are priority claimants or who continued to be employed by the debtor prepetition that can justify glossing over these prevailing defenses. On the other hand, Rule 11 does not require the estate professional to anticipate affirmative defenses. *In re Berger Indus. Inc.* 298 B.R. 37 (Bankr. S.D. N.Y. 2003). Thus, how much new value and the strength of an ordinary course defense are generally for the defendant to plead and prove, and need not be investigated by the estate.

There are some preferences that should almost never be brought. The following is a list of the types of payment recipients that will not be liable because of the chapter 7 test in section 547 or other elemental reasons that the claim will fail. *See, e.g. In re Brook Mays Music Co.*, 2007 Bankr. LEXIS 2902 (Bankr. N.D. Tex. Aug. 1, 2007) (enumerating types of preferences that should not be brought). In general, if a trustee brings these types of claims *en masse*, the chances are good that no serious gatekeeping occurred at the pleading stage.

A. Payments to Priority Tax or Other Priority Creditors.

"A debtor's payment to a creditor with a priority claim would not constitute a preference if the creditor would have received the same distribution in a chapter 7 liquidation case." *In re Rocor Intern., Inc.*, 352 B.R. 319, 330 (Bankr. W.D. Okla. 2006) (*citing In re Castletons, Inc.*, 990 F.2d 551, 554 (10th Cir. 1993)); *see also In re Ozcelik*, 267 B.R. 485, 489 n8 (Bankr. D. Mass. 2001) ("if Dubinsky is correct that its claim would enjoy priority over all other claims in the case, any attempt to avoid its lien as a voidable preference would likely fail. See 11 U.S.C. § 547 (b)(5) and 547(c)(6).").

B. Statutory Liens or Construction Trusts

"Contractor's liens are not avoidable as a preference." *In re Rainbow Trust*, 216 B.R. 77, 80 (B.A.P. 2nd Cir. 1997); see also at 86 ("mechanic's liens qualify as statutory liens … and cannot be avoided as a preferential transfer"). Similarly, transfer to subcontractors are frequently from a "construction trust" and are not transfers of the debtor's property. *N.S. Flash Foundation, Inc.*, 2008 WL 4763328 (5th Cir. October 31, 2008) (payments to subcontractor from self-executing construction trust funds under Texas Prop. Code 162.001 not subject to avoidance).

C. Payments for Employee Wages

Generally, it is both harsh and un-winnable to sue rank-and-file employees. *In re Labrum & Doak, LLP*, 227 B.R. 383, 387 (Bankr. E.D. Pa. 1998) ("We know of no case holding that salaries paid to employees as work is performed, as these payments were in substance, are transfers subject to avoidance as preferences. In addition, viable affirmative defenses appear to lie under 11 U.S.C. § 547(c)(1) and (c)(2*)."); Jones Truck Lines, Inc. v. Central States, Southeast and Southwest Area Pension Fund (In re Jones Truck Lines, Inc.,* 130 F.3d 323, 328 (8th Cir. 1997) (employees provide value equal to wages paid).

D. Payments for Rent.

Even where a trustee has established that rent payments satisfy the elements of a preference under section 547(b), "courts that have addressed this issue have held that "new value" is created by the debtor's right to continue a leasehold estate in exchange for the rental payment. *In re General Time Corp*., 328 B.R. 243, 246 (Bankr. N.D. Ga. 2005); *see also e.g., Brown v. Morton (In re Workboats Northwest, Inc.)*, 201 B.R. 563 (Bankr W.D. Wash. 1996); In re Coco, 67 B.R. 365 (S.D. N.Y. 1986); *Armstrong v. General Growth Development Corp. (In re Clothes, Inc.)*, 35 B.R. 489, 491 (Bankr. N.D. 1983); *Carmack v. Zell (In re Mindy's Inc.)*, 17 B.R. 177, 178-9 (Bankr. S.D. Ohio 1982)." In re JS & RB, Inc., 446 B.R. 350, 355-56 (Bankr. W.D. Mo. 2011).

"The rationale is that an unexpired lease on real property is treated as an executory contract under 11 U.S.C. § 365, and therefore as each month comes up under the lease the lessee becomes obligated anew for that individual month's rent. *See Clothes, Inc*., 35 B.R. at 491. In return, the lessor becomes obligated to provide the lessee with the leasehold for that month. Id. Therefore, the payment of current rent is premised upon current consideration and is therefore an exchange of "new value" between the parties. *Id., see also In re Mindy's Inc.,* 17 B.R. at 178-9. Thus, most cases hold that a landlord provides "new value" as a result of the tenant's payment of required rent." *In re JS & RB, Inc.*, 446 B.R. at 356.

E. Payments on Account of Assumed Contracts.

A preference action is not viable where the debtor assumes an executory contract or unexpired lease under which the alleged preferential transfer was made. In *re Superior Toy & Mfg. Co., Inc.*, 78 F.3d 1169 (7th Cir. 1996); *In re LCO Enterprises*, 12 F.3d 938, 941 (9th Cir. 1993). For example, *in Superior Toy & Mfg. Co., Inc*., the Chapter 7 trustee brought a preference suit to recover payments made to a creditor. The payments were monies due the creditor under the terms of a licensing agreement with the debtor. The licensing agreement was assumed by the debtor during the initial Chapter 11 proceedings, prior to conversion of the case to Chapter 7. The appellate court determined that, as a matter of law, the debtor's assumption of the licensing agreement under § 365 precluded a finding that the pre-petition payments were preferential under § 547(b)(5). 78 F.3d at 1171. *See also In re Teligent, Inc*., 326 B.R. 219, 223 (S.D.N.Y. 2005) (noting "well-settled" doctrine that a preference action may not be maintained for payments made in connection with an assumed executory contract); *In re Vision Metals, Inc*., 325 B.R. 138, 142 (Bankr. D. Del. 2005) (finding that prepetition payments made to parties to eventually assumed contracts are not recoverable as preferences.); *In re MMR Holding Corp.*, 203 B.R. 605, 613 (Bankr. M.D. La. 1996) (". . . it can be said without qualification that the act of assumption precludes the application of section 547(b)(5)").

F. Payments to Fully Secured Creditors.

The Seventh Circuit in *In re Prescott*, 805 F.2d 719 (7th Cir. 1986) clarified a test to determine whether payments made to a secured creditor during the preference period should be considered preferences. In *Prescott*, the bank had a lien against certain inventory, accounts receivable, and accounts/deposits with the bank. *In re Prescott*, 51 B.R. 751, 753 (Bankr. W.D. Wis. 1985). In the 90 days preceding the debtor's bankruptcy filing, the bank applied certain

deposits toward the debtor's outstanding balance. *Prescott*, 51 B.R. at 753-54. The bank then argued that because it was a secured creditor the transfers were not preferential.

The first step was to determine the status of the creditor. *Prescott*, 51 B.R. at 754, aff'd, 805 F.2d at 726; *see also In re El Paso Refinery, L.P.*, 178 B.R. 426, 433 (Bankr. W.D. Tex. 1995) The court must look at the actual status of the creditor on the date of filing. The *Prescott* bankruptcy judge recognized that fully secured creditors cannot be preferenced. *Prescott*, 51 B.R. at 754-55. However, the creditor must have been fully secured at the time immediately preceding the initial contested transfer. *Prescott*, 51 B.R. at 755 ("To determine whether a creditor is fully secured, the court looks at the creditor's status immediately before the contested transfers occurred"). Subsequently, the Seventh Circuit then held that "to meet his burden [that a secured creditor has been preferenced], the trustee must establish that the value of [the creditor's] collateral on . . . the date before the first alleged preferential transfer took place . . . was less than the amount owed by [the Debtor] to [the creditor] on that date." *Prescott*, 805 F.2d at 726. Therefore, if a creditor is fully secured at the time of the potentially preferential payment, the payment simply releases the same amount of collateral back to the estate, and is not considered a preference.

See also In re Missionary Baptist Found. Of Am., Inc., 796 F.2d 752, 759 (5th Cir. 1986) (noting that is it "commonplace that preference law exempts fully secured creditors from its grasp"); *In re Schwinn Bicycle Co.*, 200 B.R. 980, 988 (Bankr. N.D. Ill. 1996) ("However, a creditor that receives payment attributable to a secured claim is not usually "preferred" because secured creditors generally receive 100% of the value of their collateral upon distribution in a Chapter 7 case. Transfers to a secured creditor within 90 days of bankruptcy do not ordinarily exceed the value of the collateral, and thus do not deplete the debtor's estate or deprive similarly situated creditors of their fair share of the creditor's collateral, because the secured creditor has an identifiable property interest in its collateral or the proceeds derived from the sale of it.") (internal citations omitted); *In re Erin Food Servs., Inc.*, 980 F.2d 792, 803 (1st Cir. 1992) ("Transfers to a fully-secured creditor, for example, are not avoidable as preferences, since the secured claim would be satisfied in full in a chapter 7 liquidation.").

G. Judge Jernigan's List

In *In re Brook Mays Music Co.*, 06-32816-sgj7 (Bankr. N.D. Tex. July 30, 2007), Judge Jernigan, upon conversion of a large chapter 11 case, granted the trustee permission to pursue preference actions but also fashioned a list of the types of cases she did not want to see in the minute entry on the docket sheet. That list is:

(a) no defendant who received aggregate payments of $10,000 or less may be sued; (b) no defendant may be sued in respect of a payment that would, had it not been paid, given rise to a Section 503(b)(9) claim; (c) no party may be sued on a chapter 5 cause of action unless the Trustee has, at least 45 prior to suit, served a demand letter giving party 20 days to provide information regarding possible defenses (with a contact person with whom to communicate identified in letter); and (d) no school or non-profit organization may be sued on a chapter 5 cause of action without a further report to and order from the court.

III. ETHICS

A. Sanctions and Ethical Considerations

Each attorney has the obligation to insure that all "representations to the court" either to "have evidentiary support" or to be "likely to have evidentiary support after a reasonable opportunity for further investigation." Fed. R. Bankr.P. 9011(b)(3). *See also*, ABA Model Rules 3.1 (meritorious claims and contentions) and 3.3 (candor towards tribunal). Sanctions generally require that the position be unsupported at the time of filing, rather than the position be proven unsupported at a later time. *See Turner v. Sungard Bus. Sys.,* 91 F.3d 1418, 1420, 1422 (11th Cir.1996) (lawyer explicitly "told the court that he had evidence to support" plaintiff's only claim even though he "knew from the moment he began representing Plaintiff that his claim was meritless"); *Young v. Corbin,* 889 F.Supp. 582, 586 (N.D.N.Y.1995) (plaintiff "defaulted on his obligation under Rule 11 by submitting to the court a frivolous lawsuit"). Various attempts to apply Rule 11 sanctions to trustees and counsel in connection with avoidance actions have not withstood appellate scrutiny, however. *In re Southern Textile Knitters, Inc.,* 2000 WL 33709686, at *8 (Bankr.D.S.C., Aug 18, 2000), the bankruptcy court sanctioned the trustee for failing to withdraw a fraudulent transfer complaint. The district court reversed. The bankruptcy court noted that the only affirmative representation made by the trustee was that: The only [claim] that's left [to be litigated], as far as I know, as far as Old Fort, is the accounting." And the only claim against Old Fort listed in Trustee's Pre-Trial Order was a request for an accounting. Trustee's Jan. 12, 2000 Pre-Trial Order at 6-13, *In re Southern Textile Knitters, Inc.,* No. 98-07203-W (Bankr.D.S.C.2000).

Thus, the claims were neither improper when filed nor affirmatively reiterated once their lack of evidentiary support became clear. Rather, the sanctions were levied because Defendants "fail[ed] to withdraw the allegations despite a knowledge of a lack of evidentiary support." *In re Southern Textile Knitters,* 2000 WL 33709686, at *10. "Presenting to the court" is carefully defined in the rule; it includes "signing, filing, submitting, or later advocating" a meritless position. FED. R. BANKR.P. 9011(b). It does not include failing to formally withdraw a meritless position. On the basis that the rule did not support the sanctions, the district court reversed.

Further, sanctions should not be awarded for failing to anticipate the result of an affirmative defense. Clearly, the burden of Rule 11 is to set forth a prima facie case after reasonable investigation, not to rule out every possible defense that can only prevail if it is advanced. This is particularly true of an ordinary course defense that is inherently fact intensive. *E.g. In re Excello Press, Inc.*, 967 F.2d 1109, 1112 (7th Cir. 1992) (reasonable inquiry not required of affirmative defenses or matters that needed factual development); *In re Berger Indus., Inc.*, 298 B.R. 37 (Bankr. S.D.N.Y. 2003) (reasonable inquiry does not include ruling out affirmative defense of ordinary course).

B. Risk/Reward Analysis – Benefit to Unsecureds

Counsel for the estate must, in some cases, file a fee application for representing the trustee or debtor in possession in connection with bringing preference claims. Obviously, some

objectors will raise a *Pro Snax*[3] objection to the fee application if the benefits of litigation are exceeded by the costs. Although each preference case may not result in benefit exceeding the cost, most would agree that in the aggregate, the recoveries should greatly exceed the costs of prosecution. Many estate counsel bring cases in an assembly line fashion attempting to realize economies of scale and may not account for each case separately. This fee-saving technique should not give way to excessive time-keeping on a case by case basis that will actually cost the estate more through unavoidable double billing. For example, if counsel drafts one form demand letter for a group of 10 defendants, bills half an hour, and has a secretary fill in the names, dates and amounts based on a chart, the letter cost the estate less than if the lawyer bills for drafting 10 separate demand letters and bills the estate .1 hour for each case against each defendant.

It is also possible for counsel for one defendant in a group to require more litigating than others with larger preferences. If the publicized fee application standard becomes one of evaluating time spent on avoidance cases on singular basis only, defense counsel on a smaller case would be well advised to multiply the issues to attempt to force estate counsel to abandon the claim or risk disallowance of fees. That said, many courts and commentators rightfully lament the potential for abuse or benign waste that occurs if the recoveries do not greatly exceed the cost. Many mass preference cases of late employ contingency fee counsel such that litigation costs are right-sized to the amount of the recovery.

Absent a contingency fee arrangement, many post-confirmation entities, be they trusts or disbursing agents, will have extricated themselves from the fee application process. In those situations, the opportunities for meaningful oversight evaporate, and there is little in the way of transparent checks and balances. Many post-confirmation entities have boards or other governing mechanisms, but rarely do those boards publish litigation results versus costs, or otherwise answer to the creditor body.

PART B--DEFENDANT STRATEGIES

I. COUNTERCLAIMS AND JURY TRIALS AFTER *STERN V. MARSHALL*

A. When Can Counterclaims be Asserted?

It is uncommon, but not impossible, to assert counterclaims as a preference defendant. A preference defendant may assert a general unsecured claim under 11 U.S.C. § 502(h) for any damages arising from the avoidance of the transfer. It is rare for a counterclaim to be asserted as such because in order to be viable the counterclaim must have arisen during the course of the administration of the bankruptcy case so as to not be barred by the automatic stay or the claims bar date or there must be some other circumstance that gives the counterclaim priority or setoff status.

1. Recoupment as a Defense or Counterclaim

One counterclaim or affirmative defenses discussed in the case law is recoupment. Recoupment is the theory that claims arising out of a single, integrated transaction are available as a defense to a claim. Because recoupment is not barred by the automatic stay, a sale free and

[3] *In re Pro Snax Distributors, Inc.* 157 F.3d 414, 419-20 (5th Cir. 1998).

clear or a discharge, recoupment should be ever-present in creditors' counsel's mind, but it is narrowly construed. Moreover, the theory seems to conflict with the Code's classification of claims arising out of avoidance actions as general unsecured claims under section 502(h). *Ralar Distribs., Inc. v. Rubbermaid, Inc. (In re Ralar Distribs., Inc.),* 4 F.3d 62, 66 n. 2 (1st Cir.1993) (stating, "[f]inally, arguably no 'unjust' enrichment would result were [transferor-debtor] to recover from [transferee]. If [transferee] were required to disgorge, it could file a proof of claim for the amount of the avoided transfer ... which would be entitled to a pro rata distribution from the [transferor-debtor] estate."); *Verco Indus. v. Spartan Plastics (In re Verco Indus.),* 704 F.2d 1134, 1138 (9th Cir.1983) (stating, "[a]lthough we acknowledge that [transferor-debtor] has a valid claim for the unpaid amount of the note from Spartan, we also believe that [transferee] would have a claim against [transferor-debtor] for the loss it suffered when the transfer was set aside. [We have] stated that even where the transferee is responsible for the transfer being invalidated as fraudulent, that factor does not prevent the transferee from asserting a claim against the transferor ... [a]ccordingly, [transferee] has a claim against the estate which may be set-off against [transferor-debtor's] recovery on the note .... [transferee] concedes that [transferor-debtor] is entitled to invalidate the transfer and retain the property for the benefit of its creditors.") (citations omitted); *Cohen v. Eiler (In re Cohen),* 305 B.R. 886, 898 (9th Cir. BAP 2004)(stating, "[n]or does recovery from a transferee under avoiding powers unfairly deprive the transferee of rights against the estate. Upon recovery, the transferee has a claim that is treated as a prepetition claim. 11 U.S.C. § 502(h).

Not surprisingly, different courts have come to opposite conclusions as to whether recoupment may be asserted as a defense or counterclaim to a preference. *Compare Raleigh v. Mid American Nat'l Bank & Trust Co. (In re Stoecker*), 131 B.R. 979, 983 (Bankr.N.D.Ill.1991) (recoupment not a viable defense on merits of preference avoidance action as it is not an enumerated defense in § 547(c)(1)-(7)), *with Visiting Nurse Ass'n of Tampa Bay, Inc. v. Sullivan (In re Visiting Nurse Assoc. of Tampa Bay, Inc.*), 121 B.R. 114, 121 n. 4 (Bankr.M.D. Fla.1990) (recoupment "well recognized" defense to preference avoidance).

2. Counterclaims

Defendants assert counterclaims in a variety of ways. In *Jack Greenberg Inc. v. Grant Thornton LLP*, 1997 WL 860673 (Dec. 12, 1997), the preference defendant asserted common law and contractual indemnification as a counterclaim to the trustee's preference complaint. The bankruptcy allowed the contractual indemnity claim to go forward even though it may have only unsecured status if successful. The court dismissed the common law indemnity as being inapplicable between two parties who are suing each other.

In *The Official Committee of Unsecured Creditors v. Martin (In re Enron Creditors Recovery Corp.)*, 376 B.R. 442 (Bankr. S.D.N.Y. 2007), the defendant, a former executive of Azurix Corp. an Enron subsidiary not in bankruptcy, received a $2.7 million severance payment from Enron seventeen (17) days prior to the petition date in connection with a Severance Agreement negotiated upon her departure from the company. In response to the preference complaint, the executive asserted counterclaims and third-party claims against the debtor and affiliated debtors for breach of contract and fraud as well as a claim for the balance of her contractual severance payment. However, the executive did not file a proof of claim for the remaining balance due under the Separation Agreement.

The bankruptcy court held that the right to seek damages for breach of the Separation Agreement was preserved by section 502(h), but was not preserved for the unpaid portion for which the executive failed to file a proof of claim. Further, the court reasoned, the preference liability did not arise from the Separation Agreement, but from the Bankruptcy Code. In the same vein, then, setoff of the two liabilities was foreclosed by operation of section 553 (requiring mutuality of right or capacity), and recoupment rendered unavailable (because the preference liability did not arise from the same transaction). The third-party claim against Azurix's non-bankrupt successor survived summary judgment as not being barred by any of the bankruptcy issues.

In *In re Amp'd Mobile, Inc.*, 404 B.R. 118 (Bankr. D. Del. 2009), the chapter 11 debtor brought an avoidance action against its former CEO seeking to avoid severance and stock redemption payments received less than one month before the petition date. As part of the severance agreement, the CEO had executed broad settlement and release agreements covering both the debtor and its officers, directors and employees. In response to the preference complaint, the CEO filed third party complaints against the board members who had approved his severance package, counterclaimed for contractual indemnification and breach of contract in connection with the severance agreement. Applying *Twombly/Iqbal* against the CEO's counterclaims, the court held that the CEO failed to establish that the release of the officers and directors was ineffective. Importantly, the fact that the severance payment was being avoided as a preference did not render the release unenforceable for failure of consideration. The court reasoned that the CEO would retain "sufficient consideration under the release agreement to be enforceable and bar any contribution or subrogation claim against" the third party defendants.

As to claims against the debtor itself, the court determined that any rescission or breach of contract allegations were properly asserted as claims under section 502(h). Relying on the *Enron* decision, the *Amp'd Mobile* court decided that to the extent that the avoidance of payments on a contract gave rise to a counterclaim for breach of contract, the claims were properly considered only under § 502(h).

B. Jurisdiction and Jury Trial Rights after *Stern v. Marshall*

As established by *Langenkamp v. Culp* 499 U.S. 42 (1990), discussed *infra*, preferences are inherently legal rather than equitable. Thus, for purposes of the right to trial for jury under the Seventh Amendment, and requiring an Article III Judge under Article III. Accordingly, "a creditor's right to a jury trial on a bankruptcy trustee's preference claim depends upon whether the creditor has submitted a claim against the estate." Id., at 58, *Granfinanciera, S.A. v. Nordberg* 109 S.Ct. 2782 (1989), relying on *Katchen v. Landry*, 383 U.S. 323 (1966). If a party does *not* submit a claim against the bankruptcy estate, the trustee can recover allegedly preferential transfers only by filing what amounts to a legal action to recover a monetary transfer. In those circumstances the preference defendant is entitled to a jury trial. 492 U.S. at 58-59, 109 S.Ct. at 2799. If the defendant has not filed a proof of claim, then the defendant has a right to a jury trial that the bankruptcy court is not authorized to conduct absent consent of all the parties to the action. 28 U.S.C. § 157(e).

Langenkamp considered whether a creditor who had filed a proof of claim was entitled to a jury trial on a preference claim brought by the trustee. In concluding that there is no Seventh

Amendment right to a jury trial in such cases, the Supreme Court reasoned that the filing of the claim by the creditor triggers the process of allowing and disallowing claims, thereby subjecting the creditor to the bankruptcy court's equitable power. "In other words, the creditor's claim and the ensuing preference action by the trustee become integral to the restructuring of the debtor creditor relationship through the bankruptcy court's *equity jurisdiction.*"

In both *Katchen* and *Langenkamp,* the preference actions and counterclaims would necessarily be resolved in ruling on the claims objections. The straightforward calculus of these decisions is file a claim, waive jury trial rights and Article III judge rights; don't file a claim and preserve jury trial and Article III judge rights. In 2011, however, the Supreme Court issued its ruling in *Stern v. Marshall*, 131 S.Ct. 2594 (2011), holding that the bankruptcy court lacked jurisdiction to hear the debtor's counterclaim despite the fact that Pierce filed a proof of claim in the bankruptcy case. The Supreme Court's decision in *Stern v. Marshall* invokes the spectre that not all Article III rights are waivable by private litigants because the balance of power is not the individual's right to waive. The opinion thus raises the additional question of whether the bankruptcy court as an Article I court has jurisdiction to hear any suit at common law. Thus, when *Langenkamp* does not apply to a preference, i.e. the defendant did not file a claim, some commentators suggest that the Article I court lacks jurisdiction.

Decisions on avoidance actions after *Stern* have not recognized a total lack of jurisdiction over causes of action that derive from the Bankruptcy Code itself. First, the Supreme Court in *Stern* distinguished both *Katchen* and *Langenkamp,* because the trustee's right of recovery is created by federal bankruptcy law. "Vickie's claim, in contrast, [was] in no way derived from or dependent upon bankruptcy law; it [was] a state court action that exist[ed] without regard to any bankruptcy proceeding."

In *In re Salander O'Reilly Galleries,* 453 B.R. 106 (Bankr. S.D.N.Y. 2011), the losing party in a section 544 dispute sought to lift the stay to reassert its lien in Jersey (not New) against a piece of art. The creditor argued that using section 544 to avoid its unperfected consignment interest in the art was beyond the bankruptcy court's jurisdiction, rendering the confirmation order avoiding the lien invalid as to that claim based on *Stern*. The bankruptcy court rejected the argument reasoning that *Stern* does not oust the bankruptcy court of jurisdiction over causes of action that arise under the Bankruptcy Code itself.

In re Safety Harbor Resort and Spa, 2011 WL 3849639 (M.D. Fla. Aug. 30, 2011) considered a challenge by the chapter 11 debtor to an order resolving a secured creditors objection to confirmation (essentially a channeling injunction and lock up provision protecting guarantors for four years rather than a blanket release requested by the debtor). That court similarly rejected the debtors *Stern* argument that the bankruptcy court was bereft of jurisdiction to impose the stay and lock up. The *Safety Harbor* rejected a broad application of Stern, quoting from the limitations in the case itself. The bankruptcy court explained that the only result of *Stern* is that it "requires a court to distinguish between proceedings that 'may have *some* bearing on a bankruptcy case,' such as Vickie's tortious interference claim whose only effect on the bankruptcy case is that it would "augment the bankruptcy estate," and those that either (1) stem from the bankruptcy itself, or (2) would necessarily be resolved in the claims allowance process." *Id.* at *8. In this respect, *Stern* should not have a huge effect on the garden variety

preference and in reaffirming *Langenkamp, Stern* has already made that clear as to claim-filing defendants.

This leaves the question of whether to proceed on a non-claim filing preference case before the bankruptcy court by consent. First, each court to have considered it conclude that parties may still waive their Article III and jury trial rights after *Stern*. *See, e.g., In re GB Herndon and Associates, Inc,* 2011 WL 4628805 (Bankr. D. Colo October 04, 2011); *In re Olde Prairie Block Owner, LLC, 2011 WL 3792406,* at *7–8 (Bankr.N.D.Ill. Aug. 25, 2011); *Pro–Pac, Inc. v. Chapes (In re Pro–Pac, Inc.),* 2011 WL 4469973, at *2 (Bankr.E.D.Wis. Sept. 27, 2011); *Robinson v. Questex Media Group, LLC (In re Oxford Expo., LLC),* 2011 WL 4074028, at *6–9 (Bankr.N.D.Miss. Sept. 13, 2011); *In re Safety Harbor Resort and Spa,* 2011 WL 3849639, *11–12 (Bankr.M.D.Fla. Aug. 30, 2011). It is only when that consent upsets the balance of power between the legislative and judicial branches that consent may not be enough.

One can imagine that getting a district court judge or a jury to undertake the mental gymnastics of a new value defense in a multi-transfer preference case may not lead to a better result. But if the defendant asserts a less technical defense, that might be a better choice. And given that a preference case arises under the Bankruptcy Code, *Stern*'s balance of power concerns are not implicated such that consent is effective. Preferences againt non-claim filing defendants will likely see some upheaval and jurisdictional ping-pong, particularly where the amount in controversy is high.

II. FEE SHIFTING STRATEGIES

Under what is known as the American Rule, parties involved in litigation are normally required to bear their own costs for legal fees and cannot have them assessed against the losing party. *Alyeska Pipeline Service Co. v. Wilderness Society,* 421 U.S. 240, 247 (1975). The Rule is "founded on the egalitarian concept of providing relatively easy access to the courts to all citizens and reducing the threat of liability for litigation expenses as an obstacle to the commencement of a lawsuit or the assertion of a defense that might have some merit." *In re Paoli R.R. Yard PCB Litig.,* 221 F.3d 449, 457 (3rd Cir. 2000).

However, the American Rule may, and often is, abrogated by statute, contract, or other specific rule of common law authorizing an award of attorneys' fees. *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.,* 549 U.S. 443, 127 S.Ct. 1199, 1203–04, 167 L.Ed.2d 178 (2007). State fee shifting statutes are a common example. Where the parties' agreement and/or applicable law so allows, bankruptcy law will recognize a party's right to recover legal fees. *Id*. *See, e.g.,* 11 U.S.C. § 506(b) (allowing legal fees as part of a claim for oversecured creditors); 11 U.S.C. § 1322(e) (providing that the amount necessary to cure a default, "shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.").

Additionally, legal fees may also be awarded to a party in the form of a sanction. *In re American Telecom Corp.,* 319 B.R. 857, 866 (Bankr.N.D.Ill.2004). The power of a bankruptcy court to award legal fees as a sanction generally arises from two sources: (1) Bankruptcy Rule 9011; and (2) the inherent authority of the Court to sanction parties for their misconduct. *In Re Kujawa,* 270 F.3d 578, 582 (8th Cir. 2001

A. Contractual Attorneys Fees under State Law

The Supreme Court's decision in *Travelers* leaves the door open for asserting attorneys' fees as a preference defendant if attorneys' fees are otherwise available under state law. Overruling the so-called *Fobian* rule, the *Traveler's* Court nixed the theory that attorneys' fees were never available to a creditor litigating purely bankruptcy issues. Contractual attorneys' fees are of limited leverage value in most cases. Contractual attorneys' fees would only be allowable as an unsecured, prepetition claim based on a pre-petition contract. The math becomes more important when the dividend to unsecured creditors goes up, but not so high to make the preference claim not worth bringing because of the resulting claim under § 502(h). There may be some circumstances where preserving the right to assert attorneys' fees in the proof of claim may provide some leverage in responding to a preference claim.

In diversity cases, federal courts apply state substantive law in both awarding (if) and assessing (how much) attorneys' fees to allow. *E.g. Camacho v. Texas Workforce Comm'n,* 445 F.3d 1286 (5th Cir. 2006), *cert. denied,* 127 S. Ct. 349 (2006) (finding only fee shifting statutes that depend on a party prevailing are substantive for purposes of *Erie* doctrine). Under TEX. CIV. PRAC. & REM. CODE 38.001, and in many contracts, the availability of attorneys' fees does depend on the party prevailing in the litigation. Under the *Travelers'* rubric, then, neither the fact that the issue is one of pure federal bankruptcy law, nor the limitation of the substantive moniker to those statutes contingent on winning prevents the award of attorneys' fees to a preference defendant with an underlying contract.

Consider the result when creditor under a commercial loan agreement unsuccessfully challenged a debtor's discharge. The Eleventh Circuit held that the debtor could recover attorneys' fees where state law would the contractual right to fees. *In re Martinez*, 416 F.3d 1286 (11th Cir. 2005). Like *Travelers,* the *Martinez* court found it to be of no moment that the fees were incurred litigating a purely federal bankruptcy issue.

Again, contractual fee shifting is not likely to create significant claims because of the pre- versus post-petition nature of the two parties' remedies. What if there was a state law statute that shifted attorneys' fees not under a contract, but based on a rejected offer of compromise? Would that post-petition event create a post-petition claim against the estate that could be offset against the preference claim? And some cases make attorney's fees available as an administrative claim.

B. Texas Fee Shifting Statute

The Texas legislature amended the Texas Settlement Statute codified under Tex. Civ. Prac. & Rem. Code 42.004, effective September 1, 2011. In that amendment, a defendant can offset its attorneys' fees up to the full amount of the award if the defendant made an offer of compromise that was significantly higher than the ultimate result. A increased limits under the rule follows:

Limits on litigation costs.

> (1) In cases filed before September 1, 2011, The litigation costs that may be awarded under this rule must not exceed the following amount:
>
> (a) the sum of the noneconomic damages, the exemplary or additional damages, and one-half of the economic damages to be awarded to the claimant in the judgment; minus
>
> (b) the amount of any statutory or contractual liens in connection with the occurrences or incidents giving rise to the claim.
>
> (2) In cases filed on or after September 1 2011, the litigation costs that may be awarded to any party under this rule must not exceed the total amount that the claimant recovers or would recover before adding an award of litigation costs under this rule in favor of the claimant or subtracting as an offset an award of litigation costs under this rule in favor of the defendant.

The statute is under the same codification as 38.001 that has been routinely enforced in federal court. *E.g., Smith v. United Nat'l Bank-Denton,* 966 F.2d 973, 978 (5th Cir.1992). Further, if the award of attorneys' fees arises from the trustee's actions in a case, they potentially should be treated on equal footing with the trustee's preference claim.

C. Attorney's Fees As Administrative Claims

Fee shifting may be available but of little consequence, however, unless the fees awarded can be accorded administrative priority. In some cases, courts have awarded fees as an administrative priority for litigation commenced post-petition by a trustee. *In re Met-L-Wood Corp.,* 115 B.R. 133 (N.D. Ill. 1990), or one in which the representative obtained relief from the automatic stay to continue pre-petition litigation. *In re E.A. Nord Co.,* 78 B.R. 289 (Bankr. W.D. Wash. 1987).

The First Circuit granted administrative-expense priority to post-petition attorney fees that were caused by the debtor's contemptuous breach of a pre-petition injunction. *See Spunt v Charlesbank Laundry, Inc. (In re Charlesbank Laundry, Inc.),* 755 F.2 200 (1st Cir. 1985). *See* also, *In re Beyond Words Corp.*, 193 B.R. 540, 545 (Bankr. N.D. Cal. 1996); *In re* Madden, 185 B.R. 815 (Bankr. 9th Cir. 1995); *In Re Execuair Corp.*, 125 B.R. 600 (Bankr. C.D. Cal. 1991); *In re EA Nord Co.*, 78 B.R. 289 (Bankr. W.D. Wash. 1987). These cases stem from a "fairness" rationale of *Reading Co. v. Brown,* 391 U.S. 471, 88 S.Ct. 1759, 20 L.Ed.2d 751 (1968), that reasoned that a bankruptcy estate could be liable for intentional or negligent torts – in that case burning down a neighboring building.

Courts, however, are reluctant to award attorneys' fees as administrative priority claims for litigation relating to prepetition contracts or conduct. *See Woburn Assocs. V. Kahn (In re Hemingway Transport, Inc.)* 954 F.2d 1, 7 (1st Cir. 1992) ("We are aware of no authority that the *Reading-Charlesbank* exception encompasses a right to payment [for attorney fees that were incurred in post-petition litigation] originating in a prepetition contract with the debtor.").

But, in *In re Good Taste, Inc.*, 317 B.R. 112 (Bankr. D. Alaska 2004), the bankruptcy court awarded the successful defendant attorneys' fees against the estate as an administrative expense. That court relied on the "fundamental fairness" doctrine of *Reading* in reaching the conclusion that nothing in the Bankruptcy Code precludes the estate from being subject to an attorneys' fees claim if properly awarded. In *In re Weinschneider,* 2004 WL 524872 at 4 (N.D. Ill. 2004), the court held that *Reading* only applies to tort and other wrongful conduct – not to attorney's fees except when the trustee "initiates frivolous litigation." That decision agrees with the Fifth Circuit in *In re Jack/Wade Drilling, Inc.*, 258 F.3d 385 (5th Cir. 2001) that limited such an award to cases in which the trustee pursued a claim in "bad faith." The court in *In re White Rock Inc.* 2002 WL 32114479, 3-4 (Bankr. E.D. Ark. 2002), stated that the proper way to remedy frivolous litigation is to apply for sanctions under Rule 9011.

D. Offer of Judgment

Federal Rule 68 covers offers of judgment and allows a court to award costs to a litigant who makes an offer of judgment that is rejected if the result obtained is not "more favorable" than the rejected offer. The primary limitation of FED. R. CIV. P. 68 are that only costs are awarded and that a significant majority of courts have held that "costs" does not include attorneys' fees. *E.g. In re LMP 8500 Shoal Creek, L.L.C.*, 2007 WL 2713927 (Bankr. W.D. Tex. Sept. 12, 2007). Still, a remaining optical effect of Rule 68 is that the bankruptcy court will have notice that the offer was made. While it does not have a significant monetary effect, it can affect the perceived equities of the preference case.

E. Rule 37 Sanctions/Offensive Use of Requests for Admissions

The one area of the Federal Rules that operates like a true fee-shifting mechanism is FED. R. CIV. P. 37. A defendant can optimize the effect of Rule 37 in a preference case by couching requests for admissions to cover each element of a preference as well as each affirmative defense. Each request for admission should be followed by a request for production that requires the trustee to provide evidence of the elements or lack of evidence to refute the defenses contained in section 547.

The primary limitation of Fed. R. Civ. P. 37 is that, unlike most fee shifting statues, it uses the word "may" instead of the word "shall." And, because many litigants do not press the issue, courts are unfamiliar with the equities behind the rule. In *In re Hansen*, 368 B.R. 868, 881 (Bankr. 9th Cir. 2007), the BAP upheld an award of $97,678 in attorneys' fees against the debtor for failing to admit material facts pursuant to FED. R. CIV. P. 36 and 37 in a discharge and dischargeability complaint case.

PART C--STREAMLINED LITIGATION PROCEDURES

Preference litigation procedures orders run the gamut from a few minor provisions to a comprehensive litany of provisions. Most if not all of them are entered prior to the service of the summons with the result being that the defendants rarely get to have a say in them. Still, some procedures orders work to minimize costs for all while others requires parties to fly blind for a considerable period of time.

I. MODIFIED PRETRIAL PROCEDURES

	Extend Service of Summons	Extend Answer	Stay Discovery	Time for R. 26(a) and 26(f) Disclosures	12(b) or Dispositive Motions
Normal Procedure	120 days	30 days after Summons	After 26(a) disclosures	26(f) due 14 days before scheduling conference, 26(a) disclosures due 14 days after 26(f) conference	Not stayed
Taylor Bean & Whitaker Mortgage Co	182 days	63 days	None until completion of mandatory mediation	None until completion of mandatory mediation	
Kimball Hill, Inc.	28 days	56 days	None until after election by plaintiff or defendant elects to be treated as contested	None until after election by plaintiff or defendant elects to be treated as contested	
Lyondell Chem. Co.	n/a	n/a	Delayed 4 months limited to exchange of documents; oral discovery delayed 8 months	No pretrial conference or 26(f) meeting but 26(a) disclosures within 60 days of answer	No motions without leave of court
Bernard L. Madoff	n/a	60 days or 120 days for foreign defendants	Written discovery followed by oral discovery	26(f) conference within 30 days	12(b)(6) motions result in immediate referral to mediation unless parties agree for court to hear motion

II. MANDATORY MEDIATION PROCEDURES

Mediation procedures are found in a few mass preference cases. Of note, the *Taylor Bean* procedures are identical to those used the *In re TOUSA, Inc.* case. For a defendant, going to mediation before documents have been provided by the plaintiff and before informal telephone negotiations have occurred creates enormous inequities. This is particularly true where the claim is relatively small or is rendered miniscule by new value defenses.

The procedures in *Lyondell* are much more comprehensive and although the same issue with not being able to engage estate counsel in telephonic discussions may not exist as was the case with *TOUSA*, there at least is written disclosure and written discovery available to narrow the issues to be mediated.

	Mediation Mandatory?	Mediation in Mandatory Location	Disclosure Requirements before Mediation	Mediator Fee	Choice of Mediator
Taylor Bean & Whitaker Mortgage Co	Yes	Yes	No	Paid by estate	1 of 3 randomly assigned
Lyondell Chem. Co.	Yes	No, but must pay mediator to travel	Yes	Shared equally	Choose from list of 3
Bernard L. Madoff	Yes	n/a but advanced age and poor health may appear telephonically	Yes; mandatory mediation (other than 12(b)(6) early referral) conducted after close of discovery	Less than $20 million at issue paid by estate; otherwise split	Defendant and plaintiff jointly choose mediator

III. MODIFIED TRIAL PROCEDURES

A. Consolidated Insolvency Trial

In *In re Enron Corp.*, Case No. 01-16034, (Bankr. S.D.N.Y. August 30, 2005), the Court ordered that discovery and pleadings on the single issue of solvency could be put into a separate consolidated docket as to the consolidated issue only. Pleadings related to the issue of solvency discovery would be put into the consolidated docket and the individual avoidance action docket.