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Who is pushing the preference buttons? Learn how to minimize preference risk during the zone of insolvency. Review trade vendors' defenses and interplay of preference claims with 20-day administrative claims, general unsecured claims, setoffs, assumption of contracts—and more.

STRATEGIES FOR TRADE AND OTHER UNSECURED CREDITORS FOR ESCAPING OR REDUCING PREFERENCE LIABILITY

Hypothetical situation

As a credit manager, you receive a request to authorize shipping an order for $50,000 to a long-time customer.

The customer has experienced financial difficulty recently, and there are substantial amounts of invoices in the 60-90 days and over-90 days columns.

You inform the customer that the existing balance must come down in order for the shipment to go out.

The customer has a critical need for this order and is willing to pay more than the amount of the order, say $70,000, to have the order shipped promptly.

You are willing to ship the order for this payment, but you are concerned that the customer might file, or have filed against it, a petition in bankruptcy in the near future, which might result in the payment being recaptured as a preference.

How should you structure the payment?

Possible responses to the hypothetical situation

Should you insist that payment be received in the form of collected funds (wire transfer or cashier’s check) before the shipment leaves the loading dock?

Can you safely ship on the promise that “the check is in the mail,” when your experience with this customer is that the statement is true and that the check will be honored by the customer’s bank?

Should the payment automatically be applied to the oldest invoices?

Is a letter of credit always a sure-fire protection against recovery of payments as a preference?

Elements of a preference

A preference is a transfer of property of a bankruptcy debtor:

1.that is to or for the benefit of a creditor;

2.That is on account of an antecedent debt;

3.That is made while the debtor is insolvent;

4.That is made within 90 days of the filing of the bankruptcy petition; and

5.That allows the creditor to receive more than the creditor would receive if the payment had not been made but the creditor receives what it would receive in a liquidation of the debtor.

Frequent issues as to the timing of the payment

Issues that frequently recur are

(1) when did the transfer occur and

(2) was the debt incurred before the payment and thus is an antecedent debt.

For purposes of determining whether a payment is a preference, a transfer in the form of a check is made when the check is ***paid*** by the customer's bank, ***not*** when the check is received. Thus, a check may be received by a creditor outside the 90-day period but be paid by the debtor's bank within the 90-day period, and would thus be potentially recoverable as a preference.

However, for the purpose of applying the various defenses to the preference claim, the relevant date is when the creditor received the payment.

If the payment is a prepayment that is received and paid prior to the delivery of the goods or the providing of the services to the debtor, then the payment would not be on account of an ***antecedent*** debt and could not be recovered as a preference.

First, are the elements of a preference met?

Generally, the five criteria for determining whether a payment is a preference can be readily met.

The first four are:

the payment was to a creditor, in that the debtor owed the creditor money;

it was on account of an antecedent debt, in that the goods being paid for were sold on credit;

it was made while the debtor was insolvent, and there is a presumption that the debtor was insolvent in the 90-day period;

and it was made within 90 days of the bankruptcy filing, in that it was paid by the customer's bank within that period of time, even though the creditor might have received the payment just outside that period.

The fifth criterion is whether the payment allowed the creditor to receive more than the creditor would receive in a liquidation of the debtor.

For a payment to a fully secured creditor, this element is not met, as the creditor would be paid from the collateral in the hypothetical liquidation.

In the case of a payment to a trade vendor, this element can be proven by a showing that unsecured creditors in general will receive less than a 100 percent payout in the bankruptcy case.

Defenses to a preference claim

The purpose of allowing recovery of preferences is to encourage equality of treatment of creditors and prevent a debtor from favoring certain creditors over others in the last few weeks before the slide into bankruptcy.

The purpose of the defenses to preference claims is to encourage creditors to continue to deal with the financially troubled debtor, which might result in the avoidance of the filing of bankruptcy.

These goals are often in conflict and are sometimes not well served by the court decisions.

If a payment meets the five criteria set out above for determining whether it is a preference, then the creditor looks to see if one of several defenses will allow the creditor to avoid liability for the preference. The defenses frequently available to an unsecured creditor are outlined below:

1. Subsequent new value defense

A creditor will have a defense to a preference to the extent that, ***following*** the preferential payment (that is, subsequent in time), the creditor

(1) provided new goods or services to the debtor, and

(2) such goods or services were not paid by a transfer that is “otherwise unavoidable.”

What makes it subsequent?

When is subsequent value really subsequent? For the purpose of this and other preference defenses, the time of a transfer by check is the time the check is ***received*** (***not***, as is used in determining the answer to whether the payment is a preference or not, the time that it is paid by the debtor's bank).

However, the date of receipt is used only if the check is actually honored by the debtor's bank on the first presentment. If a check is returned "NSF" but clears on the second presentment, then the date that the check actually was paid is used to analyze what defenses apply.

Reason for the subsequent new value defense

The rationale for the subsequent new value defense is that the bankruptcy estate was not diminished by the payment to the creditor, because the creditor later replenished the estate by the subsequent shipment of goods or provision of services.

However, if the creditor was paid for the later shipment of goods or provision of services, this is an exception to the defense. In such a situation, the goods or services did not replenish the estate, and the goods or services should not count toward the subsequent new value defense.

Exception to the exception to the exception

The limitation of this exception to only such new value as was not paid by a payment that is "unavoidable" is an exception to this exception: If that very payment is itself avoidable as a preference, then the creditor was in effect ***not*** paid for the previous shipment that is sought to be counted as subsequent new value, the estate was indeed replenished, and the goods or services should count as subsequent new value.

However, there is an exception to this exception to the exception, in that the new value ***will*** count as new value even though the new value is paid, and even though the payment for the new value is unavoidable, if the payment for the new value is not ***otherwise*** unavoidable; that is, it is unavoidable solely because of application of the subsequent new value defense, and not because of some other defense.

Congress was inadvertently precise, succinct, and logical

It can be demonstrated mathematically that subsequent new value, when it is paid by a payment that is itself protected from avoidance solely by the subsequent new value defense, should indeed count for the subsequent new value defense, because the estate was indeed replenished. The insertion of the word "otherwise" in the statute is an elegant and efficient way of reaching this result. This nuance is frequently missed by courts and bankruptcy practitioners, but it is clearly written into the Bankruptcy Code, it has been recognized in thoughtful court decisions, and its proper application can have a substantial effect on the ultimate preference liability.

Subsequent new value applies to all earlier payments

Subsequent new value is a defense to a preference claim and can offset preferential payments even if the payments were not made immediately before the new value was given. The new value reaches back and credits against any prior preferential payment, not just the immediately preceding payment. However, new value must indeed be subsequent, and new value given during the 90-day period cannot reach forward in time to protect a subsequent payment.

Forbearance is never new value

Forbearance in collecting on the outstanding balance is never considered to be new value. To comprise new value, there must be a transfer from the creditor to the debtor of money or money's worth in goods or services or the release of a security interest.

2. Ordinary course of business defense

For the ordinary course of business defense:

(1) the ***debt*** must have been incurred in the ordinary course of business between the debtor and the creditor, ***and***

(2) ***either***

(a)the ***payment*** must have been made in the ordinary course of business of the debtor and the creditor ***or***

(b) the ***payment*** must have been made according to ordinary business terms.

The first element is generally readily met, in that the debt usually is for goods or services that are normally delivered or rendered to the debtor by this creditor.

Factors regarding payment ordinariness

The second element is the crux of litigation over this defense, and the reported court decisions frequently turn on:

(1) the timing of the payments, relative to

  (a) the dates the invoices state that payments are due,

  (b) the history of the payments between this debtor and this creditor prior to the 90-day preference period, and

  (c) the payment practices in the industry, and

(2) the amount and type of coercion that the creditor applied to the debtor to obtain the payments.

More payment ordinariness factors

Other factors that courts consider in determining whether the payments at issue were made in the ordinary course include:

(1) the length of time the parties have engaged in the type of dealing at issue;

(2) whether the subject transfer was in an amount more than usually paid;

(3) whether the payments were tendered in a manner different from previous payments (such as by wire transfer when formerly by check);

(4) whether there was any unusual action by either the debtor or the creditor to pay or collect the debt; and

(5) whether the creditor did anything to gain an advantage in light of the debtor's deteriorating financial condition.

There are indeed TWO alternative branches to the ordinary payment requirement

For the ordinary course of business defense, the creditor must show ***either*** that the payments received during the 90-day preference period were substantially in conformance with payments made prior to that time by this debtor to this creditor ***or*** that such payments were made according to ordinary business terms in the industry.

For preference claims under cases filed before October 17, 2005, the creditor would have to prove ***both*** that the payment was made in the ordinary course of business between the debtor and the creditor ***and*** that the payment was made pursuant to ordinary business terms in the industry.

Under the Bankruptcy Reform Act of 2005, the "and" in the ordinary course of business defense was essentially changed to an "or," which is what is shown in the statement of the requirements above. This change is a significant easing of the creditor's burden of proof.

The creditor has the burden of the defense and gets to determine which branch to present

However, some chapter 11 debtors or trustees will still try to conflate the two branches of the defense.

Perhaps, for example, shortly before the 90-day period, a creditor tightened up its dealing with the debtor from allowing 30-day invoices to be paid some 30 days or so late to insisting that they be paid no later than five days late.

While such payments within the 90-day period would ***not*** be substantially in conformance with payments made prior to that time by this debtor to this creditor, they would likely be according to ordinary business terms in the industry, as 30-days terms are frequently the norm and five days late is merely “mail slow.”

Debtors and trustees will still frequently argue that these payments do not qualify for the ordinary course defense because they do not match the previous payment history of the parties, as if that element was necessary for any ordinary course defense. It is not.

It is necessary only for one of the two branches of that defense, and the creditor is free to choose to argue only that the payments were ordinary in the payment practices of the industry.

How is ordinariness determined?

What is the basis for determining whether a payment is in the ordinary course of business between the parties? Courts have looked at many factors, including:

(1) the length of time the parties engaged in this type of dealing,

(2) whether the payment was in an amount more than usually paid (the debtor was bunching invoices or paying lump sums rather than exact invoice amounts),

(3) whether the payment was tendered in an unusual manner (wire transfer rather than mailed check),

(4) was there unusual action by the creditor to collect the debt or by the debtor to pay it, and

(5) whether the creditor did anything to gain an advantage in light of the debtor's deteriorating financial condition.

An additional factor, which often can be the determining factor, is whether the debtor was paying the creditor's invoices sooner (possibly indicated pressure by the creditor) or later (possibly a result of the debtor's worsening financial condition) than the payment history in the year or so prior to the 90-day preference period.

Lateness of payment

Lateness of payment can be an indication that a payment was not made in the ordinary course of business.

Trustees will generally argue that a payment was not in the ordinary course if it is more than a few days beyond the due dates of the invoices being paid.

However, if the payment history shows that the debtor historically paid the creditor much later than the stated invoice term, then similarly late payments during the preference period would be in the ordinary course of business between the parties.

The standard for "ordinary business terms" in the industry has been broadened in recent years, so terms are generally considered ordinary if they are not so particularly unusual or idiosyncratic as to fall outside the broad range of business practices.

Therefore, the trend of court decisions in the last several years is that late payments can qualify if the course of dealing between the debtor and the creditor was to allow such timing in the payments, ***or*** if the industry norm was to allow such timing.

Further, many courts have noted that a transaction can qualify as ordinary course even if it is not common. A transaction that occurs only occasionally, or even just once, can still be ordinary.

Collection pressure

Courts recognize that creditors may exert some collection pressure without rendering a resulting payment outside the ordinary course of business.

Telephone calls and letters to ascertain that a payment is forthcoming can be ordinary course; however, threats of litigation to collect a debt can cause payments made in response to be considered not in the ordinary course of business. Thus, payments that are made substantially earlier than prior practice might be found to be the result of "unusual" creditor pressure, and would not be within the ordinary course.

So, be cool. If you must make threats to obtain payment, let them be as veiled as possible, and don't put the nasty stuff in writing.

Credit limit enforcement

Payments made in response to a creditor's enforcement of a credit limit can also be in the ordinary course of business.

If a customer is operating near its credit limit and wishes to increase its level of orders, but the vendor is not willing to increase the credit line, then the average time that an invoice is outstanding must by necessity decrease as the customer increases the pace of the orders.

If the vendor is subsequently the subject of a preference claim, the shortening of the interval between the sales and their payment may appear to be creditor pressure that would preclude the ordinary course of business defense.

However, if the creditor can document that the outstanding credit amount was reasonably constant (certainly varying from day to day but roughly the same from week to week), then the creditor may nonetheless be able to protect these payments by the ordinary course of business defense.

A reduction of the credit line is generally fatal to the ordinary course defense, but it has been allowed in some cases where the credit line fluctuated frequently in the past.

Workouts

"Ordinary business terms" can sometimes include workout arrangements commonly used only by financially troubled debtors.

In years past, payments under workout plans were generally held not to be in the ordinary course. However, in the last several years, numerous courts have found "ordinary business terms" to include those terms that are ordinary for industry participants under financial distress.

Thus, the ordinary course of business defense may be available to a creditor if it is not uncommon in the industry for such workouts and the workout was not the result of threatened or actual litigation or other undue pressure.

3. Contemporaneous exchange for new value defense

A creditor can have a defense to the extent that the debtor and the creditor:

(1) intended a contemporaneous exchange of the preferential payment for new value from the creditor in the form of goods or services, and

(2) the payment and the provision of new value were in fact substantially contemporaneous.

This defense protects the creditor who ships on promise of payment and the payment actually is received very shortly afterwards.

For example, with subsequent new value, the creditor has not shipped until the check is actually received; but with contemporaneous exchange, the creditor ships on the promise that the check is "in the mail," and the check does in fact arrive a few days after the shipment.

Usually, payments received within ten days, and perhaps up to fourteen days or a bit more, of the shipment qualify for this defense, and the preference liability is reduced to the extent of the value of the shipment sent to the debtor by the creditor (which is the new value component of this defense).

Contemporaneous exchange distinguished from subsequent new value

The contemporaneous exchange defense is used when there is an agreement, and the payment and shipment are close in time, but the shipment occurred before the payment was received. If the timing were reversed, the creditor would rely on the easier-to-prove subsequent new value defense, which does not require proof that there was an agreement.

The key to this defense is intent; there ***must*** be evidence that there was an agreement that the payment and the shipment were tied together.

A contemporaneous letter or email (that is saved or printed out) from the debtor acknowledging the agreement is the best evidence, followed by a letter from the creditor to the debtor, a memo to the file, or oral testimony or an affidavit as to the existence of the agreement.

Application of payments and the contemporaneous exchange defense

Application of such payments can be critical.

Several courts have held that, when the payment is applied to the oldest invoices rather than to the invoices for the new goods, the transaction is merely the payment of old debt and the shipment of new goods, without an intent that there be a contemporaneous exchange of the payment for the new goods. These courts look solely to the application of the payment to certain invoices and are not persuaded by evidence of the agreement between the parties of an exchange of the payment for the shipment.

These decisions defy economic reality and common business practice, but they exist in most jurisdictions.

Therefore, if a creditor is shipping on promise of payment, the creditor may want to insist that the payment apply to the invoices being shipped rather than to the oldest invoices in order to be able to apply the contemporaneous exchange defense to the payment should a bankruptcy ensue in the next 90 days.

Alternatively, the creditor may want to insist that it receive the payment before the shipment, thus ensuring application of the subsequent new value defense, and then the payment could be applied to the oldest outstanding invoices without impairing application of the defense.

4. Assumption of an executory contract

If a potentially preferential payment has been made pursuant to a contract between the debtor and the creditor, and then during the bankruptcy case the contract is assumed by the debtor (and possibly assigned to a third party as part of an asset sale), the creditor has a complete defense to any preference claim based on that payment.

The Bankruptcy Code requires that the debtor cure all defaults under a contract for it to be assumed, and thus any preference recovery would have to be repaid as part of the cure. In effect, the element of the prepetition payment allowing the creditor to receive more than it would receive in the bankruptcy is missing.

5. Statute of limitation

The Bankruptcy Code requires that a preference claim be filed within two years after the filing of the bankruptcy petition or one year after the appointment of a trustee, whichever is later.

It has happened that this deadline has been missed, but demand letters are sent out or complaints filed anyway by the debtor or trustee.

Always confirm whether the statute of limitation has run before settling a preference demand or filing an answer to a preference complaint.

6. Other defenses

There are other defenses listed in the Bankruptcy Code, including defenses for creditors who obtain a security interest.

In addition, there are defenses not set out in the Code, such as earmarking, where a third-party lends money to the debtor for the sole purpose of paying a specific debt and the debtor has no discretion regarding the use of the money except to pay that debt.

There are further defenses that have been used to advantage by creditors in some situations. Generally, a creditor that is the subject of a preference claim has a prepetition claim against the estate for unpaid invoices (which in general would be the invoices comprising subsequent new value). The Bankruptcy Code states that the court shall disallow a claim if property is recoverable from the holder of the claim for, among other things, a preference claim. If there is an objection to the creditor’s claim (perhaps on the basis that it was somewhat overstated) and it is resolved by an order allowing all or some portion of the claim, this order has been held to be res judicata on the issue of whether a preference is recoverable from the creditor. Thus, preference liability may be escaped altogether by a careless claim objection by the trustee or debtor.

Also, if a plan of reorganization or plan of liquidation is confirmed and it does not expressly reserve the right to bring preference claims later, they are considered to have been waived.

A real long shot that might be getting new vitality

In some situations, it is apparent that there will be no distribution to creditors from the estate other than to the secured lender, yet preference claims are being brought to fund the administrative expenses of the estate or, worse, to repay postpetition advances by the secured creditor during the pendency of the case.

The Bankruptcy Code provides that preference claims can only be collected where they are for the benefit of the estate.

A few courts have held that if creditors generally are not to share in the proceeds of the preference claims, then the claims are not for the benefit of the estate and cannot be collected. This point is worth considering.

Consolidation of issues to allow pooled resources and costs

Rule 42 of the Federal Rules of Civil Procedure allows for the consolidation of matters or issues that are common to several proceedings.

Therefore, the issue of whether the debtor was solvent during some portion of the preference period, if not all of it (solvency being determined on a balance-sheet basis), could be determined in a plenary hearing with the preference defendants pooling their resources and sharing costs to ease the cost burdens on them individually.

This has occurred in major bankruptcy cases, such as *Owens Corning*, where accountants were employed at great cost to determine the exact day on which the debtor became insolvent, thereby refuting the statutory presumption that the debtor was insolvent throughout the 90-day period

Interplay of the defenses

The defenses of ordinary course of business, contemporaneous exchange for new value, subsequent new value, and any others can all be used in virtually any combination to defend against a preference claim by a bankruptcy estate.

The creditor can argue in the alternative that a given shipment may be counted towards one or more of these defenses and see whether the court determines that the shipment can be counted for such defenses.

Depending on the timing of the shipments and payments, it may be advantageous to the creditor that a shipment count under one defense rather than another.

However, a given shipment can only be counted once as a credit against the preference amount. That is, a shipment that is counted for a subsequent new value defense for prior payments, but is itself paid during the preference period, cannot also count as being paid in the ordinary course of business and protect its payment from avoidance as a preference.

General rule for application of payments to escape a preference claim

Always take the money now. Never delay accepting payment out of concern that the payment might be recovered as a preference if the debtor later files bankruptcy.

By taking the money now, you start the 90-day clock, and the payment might end up outside the preference period. Besides, you never have to give back more than 100 percent of the payment, and you can almost always negotiate a reduced return no matter what the facts.

Other considerations regarding how to apply a payment

In general, an account debtor making a voluntary payment on a debt (as opposed, for example, to a payment arising from execution on a judgment) has the right to specify how the payment is allocated to the components of that debt.

Usually, the account debtor makes a designation of the invoices being paid on a remittance advice accompanying the check. In the absence of such specification, or in the absence of the right to make such a specification, the creditor receiving the payment has the right to allocate the payment. You may want to include a legend on the back of your invoices that you reserve the right to allocate payments notwithstanding any allocation specified by the account debtor at the time of payment (and such term becomes a part of your contract).

Alternatively, if you are dealing with the financially troubled customer who is promising payment in return for a shipment by you, you may want to send a letter at that time to the effect that you will continue to ship to that customer only on the condition that you have the right to allocate payments among invoices, either through telling the customer to which invoices the payment is to be applied or telling the customer to send the payment without any designation and that you will make the designation. Frequently, the customer will be somewhat desperate for the shipments and indifferent to the allocation of the payments, and will not object to this provision.

If the mailing of the check and the shipment are to occur at about the same time, then applying the check to the current shipment may be the safest course because of the contemporaneous exchange for new value defense. However, this designation is not often done because of the practice of applying payments to the oldest invoices so that the ageing of the account is improved.

Applying the check to invoices that are still within (or only slightly beyond) credit terms is also generally safe, because of the ordinary course of business defense. Even if the customer had not previously been paying in this manner, application of the payment in this manner could be within the ordinary business terms branch of the ordinary course of business defense. However, again, this is not customary practice for credit managers.

More considerations regarding payment application

If the check is actually received before the shipment is made, the check can safely be applied to any invoice, including the oldest invoices, up to the value of the shipment, because of the subsequent new value defense, ***provided*** that the check is actually honored. If possible, you may want to suspend application of the payment for a few days to determine that the check has cleared, and then apply it to the oldest invoices.

If the check is dishonored but is later paid on resubmission to the bank, the date for preference defense purposes would not be the date of receipt but would be the date that the check is actually honored, which would likely mean that the check would not be protected by the shipment that now has occurred prior to the date that the payment has occurred. Now, you probably would want to apply the check to payment of invoices that are around their due dates so that the ordinary course of business defense will protect the payment.

If a check is received from a troubled or slow-pay customer without any agreement for a shipment from you, you may want to review the above considerations with regard to application of the payment. For example, if you know that a shipment will soon be made to this customer that is near the amount of the payment, then the shipment would likely provide a subsequent new value defense and the payment could safely be applied to the oldest invoices. If such shipment is not to be made, or at least not soon, you may wish to consider applying the payment to those invoices that are still within, or not far beyond, invoice terms.

In applying these considerations, one should also keep in mind the potential 503(b)(9) claim. If a shipment turns out to have been made within the 20 days before the bankruptcy filing, a creditor will have wanted to apply any payment received during that time to an earlier invoice, not to that one.

Other considerations regarding the payor or letter of credit security

Beware of payments from a party other than the account debtor. A payment of an account by a related entity or third party might later be recovered as a fraudulent transfer because the entity making the payment may well have received no value in exchange for the payment.

In such a situation, you may want to insist that the third party provide the funds to the account debtor, and that payment come to you directly from the account debtor.

However, if it is more likely that the account debtor will file bankruptcy within 90 days than that the third party was, or became, insolvent at the time of the payment, you may prefer to accept the payment from the third party.

If you are intending to have a letter of credit to ensure payment, you may wish to structure the transaction so that payments are actually made through the letter of credit. Otherwise, you may find that a payment backed by a standby letter of credit is being avoided two years later as a preference and the letter of credit by then has long expired.

If the letter of credit was fully secured, the payment from the debtor generally would not be a preference because there is in effect a release of lien by the issuing bank, but the payment could be a preference to you if at the time of the payment the issuer of the letter of credit was only partially secured or was unsecured, and you might be embroiled in litigation in which you would have to prove the value of the assets and the extent of the issuer's security.

Arguments about what a creditor "would, could, or should have done" if a preferential payment had not been made, such as perfecting a lien, pursuing a judgment, or drawing on a letter of credit, are generally unavailing.

Rule 503(b)(9) administrative claims and preference defenses

With the Bankruptcy Reform Act of 2005, Congress created an administrative priority (that is, the highest unsecured priority) for goods delivered to the debtor within 20 days of the filing of the bankruptcy case.

This priority applies only to goods, not services, and the goods must be provided to the debtor, not drop-shipped to the debtor's customer or delivered to another entity for further fabrication on behalf of the debtor.

This priority is provided in section 503(b)(9) of the Bankruptcy Code, and these claims are referred to as 503(b)(9) claims.

An open issue is whether a preference defendant can count shipments comprising a 503(b)(9) claim as subsequent new value and can also be paid in full for these shipments under section 503(b)(9). At present, more and more courts analyzing the Bankruptcy Code sections at issue conclude that the creditor can indeed have his cake and eat it, too. A few cases, without a reasoned analysis, say no, asserting that that would be "double dipping."

Because the payment occurs after the bankruptcy filing and not before, a creditor should be able to have it both ways, as the preference claim and defenses are based solely on prepetition transactions, and the allowance of a 503(b)(9) claim arises only because of and after the bankruptcy filing, and the claim did not exist prior to the filing. The majority opinion on this issue is still developing but is moving in creditors' favor.

Rule 503(b)(9) administrative claims and reclamation claims

In the past, creditors selling goods would automatically serve a reclamation demand for the return of the goods if the customer filed bankruptcy. The Bankruptcy Code generally allows for reclamation of goods received by the debtor within 45 days of the filing of the bankruptcy case. However, such reclamation rights are subject to any liens of secured creditors and to the goods still being in the debtor's possession, so reclamation often does not turn out to be of great value to the creditor. But serving the demand has been thought to be harmless.

Since 2005, section 503(b)(9), however, has allowed a creditor to be paid with administrative expense priority for all goods received by the debtor within 20 days of the filing, without regard for any liens on the goods or their possession by the debtor. A much better right for creditors.

At least one recent case has presented the issue of whether a reclamation demand for the return of goods trumps a section 503(b)(9) claim for payment for those same goods, so the creditor gets the goods back rather than being paid for them. The creditor loses its profit on the sale, and the goods might be specially made and thus worthless in the creditor's hands.

In the future, creditors may want to exclude 503(b)(9) goods from a reclamation demand.

SETOFF AND RECOUPMENT

Setoff

A consideration related to preferences is setoff.

The Bankruptcy Code allows a debtor or trustee to recover from the creditor if there is a setoff of mutual debts between the debtor and creditor within 90 days before the bankruptcy filing, if the "insufficiency," which is the excess of the amount owed by the debtor over the amount owed by the creditor, was less at the time of the setoff than it was at the start of the 90-day period.

The amount recoverable is the improvement in the insufficiency between those times.

If a creditor and debtor are buying and selling different products and services to each other and have credit balances with each other, and for some period of time the debtor sells more to the creditor than the debtor buys, the insufficiency is reduced and the creditor has had a favorable improvement of position.

In such a situation, ***do not*** casually offset some amount for these mutual debts, as that mayl trigger the liability under the setoff section of the Bankruptcy Code.

Congress did not draft the setoff statute well

This section 553 of the Bankruptcy Code preserves the ***right*** of setoff.

Therefore, if a creditor owes and is owed mutual debts by a customer that is at risk of filing bankruptcy, the creditor should not offset those debts, but simply let them run.

There is no recovery against the creditor so long as the creditor does not offset the debts, but there can be a recovery if the creditor does offset.

This anomaly in the Bankruptcy Code originated with the enactment of the Code in 1978 and has yet to be corrected.

Note that the shipments by the debtor would not be recoverable as a preference, as they are merely sales by the debtor to the creditor and are not transfers on account of an antecedent debt, which is a necessary element of a preference.

Recoupment

Recoupment is a subset of setoff.

It has been defined as "the setting up of a demand ***arising from the same transaction*** as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim."

In addition to mutuality, an element necessary for recoupment is that the two sets of claims must have been part of a single integrated business transaction between the two entities.

A factual situation involving recoupment and setoff

Associated Wholesalers Inc., a large cooperative food distributor serving supermarkets and convenience stores, filed for Chapter 11 under the name ADI Liquidation, Inc., along with related entities. As is common in Chapter 11 cases, the debtors were not reorganized under a stand-alone plan of reorganization, but instead were sold as operating entities under an auction procedure known as a section 363 sale.

Pursuant to the order approving the sale, the buyer of the debtors' assets purchased the assets free and clear of all claims and liens, with the liens to attach to the proceeds of the sale. Included in the purchased assets were the debtor's accounts receivable. The sale order further provided that the purchased assets were free and clear of all setoff rights held by creditors and that these setoff rights would be preserved and would attach to the proceeds of the sale as held by the debtors.

What is the effect of these provisions? Assume a vendor is owed $100,000 by the debtors but also owes the debtors $30,000 for prepetition purchases from the debtors, and further assume that prepetition unsecured claims in the bankruptcy case will receive a distribution of 10 percent. Under Scenario A, assuming no sale, but after applying the vendor's setoff rights, the vendor's claim would be reduced by $30,000 by virtue of the setoff against the $30,000 the vendor owes the debtors, with the remaining claim against the estate of $70,000 receiving a distribution of $7,000.

As a result of the sale order in the ADI cases providing that the buyer acquired the debtors' accounts receivable, including the $30,000 claim, the buyer asserted that it was entitled to offset that claim against post-sale purchases from this vendor. Under this Scenario B, the vendor would have no setoff right against the estate, and the vendor would have its $100,000 prepetition claim and receive a $10,000 distribution. However, the vendor would be out of pocket the full $30,000 that it has to pay the buyer. Thus, instead of a recovery of $7,000, the vendor has a loss of $20,000, or a $27,000 cash swing.

The payoff for vendors of the recoupment/setoff distinction

The order approving the sale in the ADI cases, although drafted by counsel for the debtors and the asset buyer, was modified by the bankruptcy court to provide that the sale, while free and clear of setoff rights, was ***not*** free and clear of ***recoupment*** rights of the vendors, and all such recoupment rights were preserved.

The recoupment rights in the ADI cases arise from advertising credits asserted by the debtors against its vendors prior to the bankruptcy filing, which credits are common in the retail industry. The ADI debtors bought print advertisements and charged the vendors whose products appeared in the advertisements by issuing invoices to the vendors. A previous decision by a Delaware bankruptcy court held that such advertising allowances fit within the requirement of being a single integrated business transaction such that their invoices are considered a recoupment, rather than a mere setoff, against the vendor's invoices for the sale of its products to the debtor.

As a result of the court's modification of the sale order, the vendors in the ADI cases should be entitled to prevent any setoff of prepetition advertising allowances by the asset buyer against post-sale purchases by it from the vendors, because the doctrine of recoupment, rather than setoff, applies to the claims. The vendors' right to recoup payment of their invoices from the amounts they owe for advertising allowances means that they should obtain the $7,000 recovery in Scenario A above.

However, the asset buyer, which may be feeling a bit of buyer's remorse for paying too much for the purchased assets, is challenging the analysis set out above and asserting that it is entitled to a full setoff of the prepetition advertising allowances, as purchased accounts receivable, against its post-sale purchases.

In the hypothetical above, this argument would give the buyer a windfall of $30,000 to the detriment to the vendor.

Summary of the advantage of recoupment over setoff

The remedy of setoff has the risk that the two sets of transactions will be separated by a section 363 sale, so that the vendor will not be able to effect the setoff and will have to pay the full amount of its obligation while receiving only partial value on the obligation owed to it.

In the ADI cases, the vendors were protected by the court's modification of the sale order preserving recoupment rights, provided the claims arise from a single integrated business transaction.

In light of the ADI cases, vendor creditors who also have obligations owed to a bankruptcy debtor should object to the section 363 sale to the extent that the proposed sale does not preserve setoff and recoupment rights.

One more twist from the ADI court

The good news of the above decision is tempered by a subsequent decision in this case, which decided that the debtor may determine that it will first offset what it is owed by the vendor against the vendor's section 503(b)(9) administrative priority claim.

The effect of this decision is that, to the amount that the debtor offsets against the 503(b)(9) claim, the ultimate distribution to the vendor on that portion of its claim is reduced from 100 percent to, in the hypothetical situation above, 10 percent.

Vendors should include in their terms of sale that the vendor has the right to determine the means of applying any setoffs. However, some bankruptcy courts may be debtor and lender friendly and may refuse to enforce such provisions.

CONCLUSION REGARDING PREFERENCES AND ANY AVOIDANCE ACTION

Never pay a preference or other avoidance demand in full.

Some form of settlement can virtually always be negotiated, no matter what the facts are.

Paying a preference gives a creditor an unsecured claim, and often a trustee will agree to netting the projected distribution from the estate on account of that claim, and any other claim the creditor may have, against all or a portion of the preference liability. Giving up the projected distribution from the estate in the future (which can be problematic both as to the amount and timing), can substantially reduce the cash the creditor might have to pay now to settle the preference claim.

A WORD FROM OUR LAWYERS

These materials are intended as an overview of bankruptcy law concerning preferences and potential pre-filing strategies of creditors and not as specific legal advice. If you are the subject of a preference demand letter from a bankruptcy trustee or are a defendant in an adversary proceeding to recover a preference, a complete analysis of the arguments and defenses that could be raised on your behalf to reduce or possibly eliminate preference liability is beyond the scope of these materials. Do not try to use these materials at home or in your office without proper supervision.

AND NOW A WORD FROM OUR SPONSOR

If you would like to discuss the issues and techniques concerning any of these topics, please do not hesitate to contact

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FREE IS A VERY GOOD PRICE

If you have a bankruptcy issue or question concerning any of these topics, feel free to call me for free. I will be pleased to spend some time without charge, up to say half an hour, giving an answer to a question or a response as to how to resolve the issue and whether it is not a problem, a bit of a problem, or a big problem requiring specific legal investigation and advice.