SHUMAKER
Shumaker, Loop & Kendrick, LLP

First Citizens Bank Plaza
128 South Tryon Street
Suite 1800
Charlotte, North Carolina 28202-5013
704.375.0057
704.332.1197 fax

www.slk-law.com

DAVID M. GROGAN
704.945.2143
dgrogan@slk-law.com

PRESENTATION OF DAVID M. GROGAN ON ISSUES FACING VENDORS IN CHAPTER 11 CASES TO NATIONAL ELECTRICAL MANUFACTURERS CREDIT GROUP ON NOVEMBER 14, 2013

OVERVIEW

- Do reclamation claims have any value?
- What are section 503(b)(9) claims? Are they valuable? When are goods "received" by the debtor? How do you make a claim?
- What is critical vendor status? How do you get it?
- What are the dangers of postpetition sales? COD? Trade credit? How can the debtor's unauthorized use of cash collateral result in the recovery of postpetition payments?
- What are preferences? What are the defenses? How can you minimize preference liability?
- What are the dangers of a prepetition setoff of claims? How do you value the claims being offset? Can you offset postpetition?
- Should you accept prepetition payment from a third party, such as a sister corporation?
- How good is security through a prepetition letter of credit? Standby or documentary?
- When should you sell your claim to a claims trader?

The presentation will include a discussion of obtaining full or partial payment of a prepetition claim through reclamation, section 503(b)(9), or critical vendor status; avoiding or minimizing liability for prepetition actions related to preference claims and setoffs of claims; being mindful of the risks of postpetition sales on credit or on COD terms and the risk of having to return postpetition payments for postpetition shipments; considering prepetition payment from a third party or security through a letter of credit; and selling a prepetition claim to a claims trader.

These materials are intended as a brief overview of bankruptcy law concerning the topics addressed and not as specific legal advice. A complete analysis of these topics is beyond the scope of these materials. If you would like to discuss the issues and techniques concerning any of these topics, please do not hesitate to contact David Grogan in the Bankruptcy and Creditors' Rights Group of Shumaker, Loop & Kendrick, LLP, at dgrogan@slk-law.com or 704-945-2143.

RECLAMATION CLAIMS

The Uniform Commercial Code continues the common-law right of a seller to reclaim goods from an insolvent buyer that has not paid for the goods. The Bankruptcy Code provisions regarding reclamation of goods were amended in 2005 and have the following requirements for a reclamation claim:

- The goods must have been sold in the ordinary course of the seller's business.
- The debtor must have been insolvent when the goods were received.
- The debtor must have received the goods within 45 days before the bankruptcy was filed.
- A written demand for reclamation must be made on the debtor within 20 days after the bankruptcy was filed, if the 45-day period expires after the filing.
- At the time of the demand, the goods are still in the debtor's possession, are identifiable (not commingled), and have not been converted into a finished product.
- The goods to be reclaimed are not subject to the prior rights of a secured creditor.

The reclaiming creditor has the burden of proof on all of these elements of a claim. The last two requirements, either separately or in combination, are usually fatal to a reclamation demand. Bankruptcy debtors are often operating hand to mouth prior to filing bankruptcy; therefore, goods delivered 45 days before the filing, and often goods delivered just a few days before the filing, either have been sold to the debtor's customers and are no longer in the debtor's possession or have been changed in form or incorporated into the debtor's finished products so that the delivered goods are no longer subject to reclamation. Commodity-type goods and goods without identifying marks of the vendor may be commingled with similar goods from other vendors and thereby are no longer subject to reclamation.

A lender's floating lien on the debtor's inventory will trump reclamation rights. Courts have held that a vendor cannot require the lender to first look to collateral other than the inventory, so if the debt to the lender exceeds the value of the inventory, no reclamation claim will be allowed.

Because of the last two requirements, reclamation claims have a limited chance of actually obtaining payment. However, it costs virtually nothing to make a reclamation demand, as "the writing" can be delivered to the debtor by mail, overnight courier, or even email. So a creditor might as well make the reclamation demand and see if something can be obtained.

SECTION 503(b)(9) CLAIMS

As part of the 2005 amendments to the Bankruptcy Code, the NACM obtained the insertion of a new provision, section 503(b)(9). This section allows administrative expense priority for goods sold to the debtor in the ordinary course of the debtor's business and received by the debtor within 20 days preceding the bankruptcy filing.

These "503(b)(9) claims" are much more valuable than a reclamation claim as they are not subject to existing security interests or liens and do not require the claimant to prove insolvency. The claimant will have an allowed administrative expense that is typically paid at confirmation of a chapter 11 plan. The Bankruptcy Code requires that administrative claims be paid in full at confirmation, unless the claim holder agrees to other treatment in the plan, so this claim fairly well ensures that the claim holder will be paid in full, unless the case is administratively insolvent, in which case the claim should be paid pro rata with other administrative expenses, such as the debtor's and committee's professionals' fees.

There are four elements to a 503(b)(9) claim. The first is that the claim arises from sales made in the ordinary course of the debtor's business. The ordinary course element is virtually always met—the creditor was selling goods that the debtor typically buys in operating the debtor's business. The second element is that creditor must have provided goods, not services. If what a creditor provided was part goods and part services, some courts apportion the amount of the claim between the two classifications, and some courts determine which predominates and allow all or nothing for the claim. There is some question about how tangible the product has to be to be considered a good: For example, a natural gas utility is entitled to 503(b)(9) priority, as it is providing molecules of methane, but courts disagree on whether an electric utility is providing goods (namely electrons, which is a stretch) or a service (electrical energy).

The third element is that the goods be received by the debtor. Several courts have held that drop shipments to the debtor's customer that were delivered within the 20-day period are not entitled to this priority, as they were not received by the debtor—a harsh rule. The fourth element is that the goods be received by the debtor within 20 days preceding the bankruptcy filing. The use of "received" has been interpreted to mean finally and irretrievably received. Goods may be shipped by common carrier "FOB Seller;" however, if the seller contracted with the common carrier and still has the right of stoppage in transit, the goods are not "received by the debtor" until they are unloaded by the carrier at the debtor's facility.

The Bankruptcy Code does not state how a 503(b)(9) claim should be made. Some bankruptcy courts create a special form that looks similar to a proof of claim form and allow such forms to be filed by the creditor. In other courts, a 503(b)(9) administrative expense claim must be filed like any other administrative expenses claim, which is by an application filed with the court, with the claim being allowed by order. If the creditor is a corporation, the application can be filed only through an attorney.

CRITICAL VENDOR

At one time, critical vendor status was fairly common in chapter 11 cases. Through a bit of brinksmanship and "good-ole-boy" negotiation, a debtor and creditor would agree that the creditor would be entitled to critical vendor status. This status would result in the creditor's prepetition claim being paid, typically in full and fairly promptly in the case. This agreement was presented to the court as being necessary for the vendor to continue to supply postpetition product that was critical to the debtor's continued operation and could not be readily sourced from a different vendor. An example would be a vendor of thread to a debtor manufacturer of sheets and towels, as having the precise color, material, diameter, tensile strength, twist, and other characteristics over a wide variety of threads would be critical to the manufacturer's business and could not be readily obtained elsewhere.

This state of affairs frequently occurred in chapter 11 cases, even though there was no specific authority for it in the Bankruptcy Code and it was indeed contrary to the Code's stated goal of equality of treatment of creditors. This all came to a screeching halt following a decision by the Seventh Circuit Court of Appeals in the *Kmart* case, where the appellate court reversed the bankruptcy court and imposed stringent criteria for allowing critical vendor orders. If a vendor refuses to sell to the debtor, even on cash before delivery terms, and instead insists on payment of its prepetition claim in return for shipping new product, the court could find that the creditor was improperly attempting to obtain payment of a prepetition claim and was thus violating the automatic stay and subject to monetary sanctions.

Today, critical vendor orders still are issued from time to time, but they give the debtor the right to pick and choose which creditors are critical and how much of the prepetition claim is to be paid, and the orders typically require that the creditor provide postpetition credit to the debtor on basically the same terms and the same credit limit as prepetition. So these orders are much less beneficial to creditors than they were prior to the *Kmart* decision.

Subsequent to the *Kmart* decision, I did obtain payment in full as a critical vendor for a client, without the client offering any postpetition credit terms, as the client was a foreign apparel manufacturer with no facilities within the United States. The court agreed that sanctions for violation of the automatic stay would have no coercive effect on the client whatsoever, and further shipments of apparel were indeed critical to the debtor's retail operations, so critical vendor status had to be conferred or the debtor's reorganization would fail.

POSTPETITION SALES TO A DEBTOR

Chapter 11 debtors frequently push their vendors to provide postpetition trade credit. In general, a creditor has no obligation to provide postpetition trade credit and can legally insist on cash before delivery or cash on delivery. However, there is the risk that the debtor may find an alternate vendor who will provide credit terms. Providing postpetition trade credit to some extent may be a necessary risk in order to keep the debtor as a customer during the reorganization period and hopefully continuing after confirmation of a plan.

Where there is a prepetition contract for the sale and purchase of goods on credit, the debtor may argue that the vendor is obligated by this executory contract to continue to sell postpetition on the same credit terms until such time as the debtor either assumes or rejects the contract. Generally, the best response of the vendor is to state that it deems itself insecure, which excuses further performance (credit sales) until the vendor is provided with adequate assurance of future performance by the debtor (such as agreeing to pay COD). The vendor may be well advised to follow this response with a motion to the court to compel the debtor to promptly decide whether it wishes to assume or reject the contract. If the debtor can be pressed into assuming the contract, then it will have to promptly cure all prepetition and postpetition defaults.

Unsecured postpetition credit incurred by a debtor in the ordinary course of operating its business can be paid by the debtor as an administrative expense without specific authorization by the bankruptcy court. The main risk of providing such credit is that the debtor may become administratively insolvent and not be able to pay its postpetition unsecured claims. In this situation, any secured postpetition or prepetition lender would be paid first from the remaining assets, and the unpaid postpetition unsecured administrative claims would be paid pro rata. The vendors that had extended postpetition credit and been paid by the debtor would not have to return their payments and then share pro rata, but those that had not been paid would have to share and be at risk for not being paid in full. There is some limited authority for the proposition that postpetition trade creditors should be paid in full before postpetition professionals are paid, but that is by no means generally followed.

A rarely encountered but serious risk is that postpetition vendors may have been paid but nonetheless have to return their payments. A prepetition lender to the debtor typically has a security interest in the debtor's "cash collateral," which is generally composed of the debtor's cash and the proceeds of the debtor's accounts receivable and inventory. Although in a chapter 11 case the court will immediately enter an order allowing the debtor to operate its business, the debtor can spend a lender's cash collateral only if the lender consents or the court, following a hearing on the use of cash collateral, finds that the lender's interest is adequately protected and orders that the debtor may use the cash collateral.

In a case from a few years ago, the lender did not consent to the use of its cash collateral, and the hearing on the debtor's motion to use the cash collateral was continued for several weeks. In the meantime, the debtor, a gas station/convenience store, continued to purchase gasoline and other products and pay the vendors. The bankruptcy court ultimately held that the lender would not be adequately protected in the use of its cash collateral, and such use was denied. The vendors that had in good faith sold products to the debtor and been paid for them

had to return all of the payments that they had received over the intervening weeks. This circumstance should be extremely rare, but the consequences are horrific. A "check the box" caution for any creditor considering selling to a debtor postpetition, whether on credit or on COD terms, is to verify that an order has been entered authorizing the postpetition use of the lender's cash collateral and that the order remains in effect.

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 difficult 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?

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.

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 that 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, 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."

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.

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, then the goods or services were not new value, the estate was not replenished, and the goods or services should not count toward the subsequent new value defense.

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.

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 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. 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 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 or lien.

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 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, a very few cases analyze the Bankruptcy Code sections at issue and conclude that the creditor can indeed have his cake and eat it, too, but a couple of cases, without a reasoned analysis, say no. Because the payment occurs after the bankruptcy filing and not before, a creditor should be able to have it both ways, but it remains to be seen what will become the majority opinion on this issue.

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. 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.

Other factors that courts consider in applying this defense 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.

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.

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 can still be ordinary.

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.

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.

"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).

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 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. 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.

5. 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 other 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.

In some situations, it is apparent that there will be no distribution to creditors from the estate, yet preference claims are being brought to fund the administrative expenses of the estate or, worse, to repay postpetition advances by a 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.

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.

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 rules 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 percentage return no matter what the facts.

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.

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.

Conclusion

Never pay a preference demand in full. Some form of settlement can virtually always be negotiated no matter what the facts. 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.

SETOFFS

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 will trigger the liability under the setoff section of the Bankruptcy Code.

This section 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, he should not offset those debts, but simply let them run. There is no recovery so long as the creditor does not offset, but there can be a recovery if he does so. 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.

LETTERS OF CREDIT AND OTHER THIRD-PARTY PAYMENTS

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 and risk a fraudulent transfer claim rather than risk a preference claim.

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 at a point in time two years earlier.

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.

SELLING YOUR CLAIM TO A CLAIMS TRADER

The buying and selling of claims against a debtor go back to the Revolutionary War. In current chapter 11 cases, claims traders may buy claims for a variety of reasons: to sell the claims for a profit within a short period of time, to exchange their claims for more valuable assets of the debtor, or to obtain control of the debtor through the process of confirming a plan of reorganization. What are the concerns of a trade creditor who is considering selling his claim?

Claims traders may be actively pursuing creditors in the early weeks following the filing of a chapter 11 case. The payoff for prepetition unsecured claims may be months or years in the future and the distribution percentage may be only conjectural. A vendor holding a claim may want to sell it to a claims trader in order to have funds paid in hand now in a known amount rather than await the risks and delays of the future distribution in the bankruptcy case, and the vendor is relieved of having to monitor the bankruptcy case in the future.

This certainty of payment is a benefit, but the agreement for the sale of the claim will always have a recourse provision of some sort that will require the vendor to repurchase the claim and return the payment under certain conditions, with interest from the time of the receipt of the payment from the claim trader. The repurchase provisions can vary widely, with some being triggered by entry of a final order disallowing the claim in part or in full and others being triggered by the mere filing of an objection to allowance of the claim. This can create a substantial financial exposure to the vendor who had expected the transaction to reduce risk and ongoing costs.

Debtors or trustees may object to allowance of a claim that had been sold to a trader, and the vendor will have to defend the objection. The result might be that the claim is allowed in full as filed or perhaps reduced by a small amount. Debtors or trustees can also object to allowance of a claim under a provision of the Bankruptcy Code that disallows a claim if there is a preference claim against the vendor, with the result being that there is no distribution on the claim until the preference claim is resolved and any preference liability is paid. It can be months or years before such resolution.

If the repurchase provision allows the claims trader to require the vendor to repurchase the claim merely on the filing of an objection, or upon such objection not being resolved in a short period of time, the claims trader is essentially given a free option to put the claim back to the vendor. If, for example, the trader purchased the claim for 20% but it now appears that the distribution on the claim in the not-too-distant future will be 50%, the trader will be willing to work with the vendor and see if the claim objection can be favorably resolved. If, however, the debtor's prospects have worsened and the future distribution now looks to be 10%, the trader would insist that the vendor repurchase the claim.

The repurchase provision is the most critical clause in an agreement for the sale of a claim, and the vendor should insist that it have the opportunity to resolve any objection so that it is only an actual impairment, rather than a potential impairment, of the claim that triggers the repurchase provision, and the repurchase amount should be only pro rata to the extent that the claim was actually reduced.