insights

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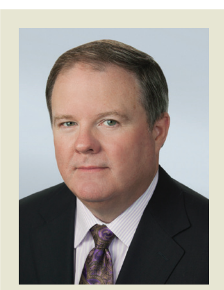
A Newsletter from Shumaker, Loop & Kendrick, LLP | Fall 2012

CAN'T YOU HEAR ME KNOCKING?

The Dreaded Preference Demand



By David H. Conaway

You are in your office finishing your morning espresso when you receive an email from the CFO of your company's U.S. subsidiary. Attached to the email is a letter from a U.S. law firm. Instinctively, you know this can't be good news. You open it only to find a letter from counsel for a trustee in a Chapter 11 bankruptcy case. Dear creditor, the trustee demands you pay back the payments from the Chapter 11 debtor (your U.S. subsidiary's customer) over 2 years ago...the dreaded preference demand. But, if you pay 80% today, the letter offers, it will all go away.

Your U.S. CFO has mentioned this aspect of the U.S. Chapter 11 law, but this is the first time you have encountered it. Let me get this straight, under U.S. Bankruptcy law, a Chapter 11 debtor can force the return of money it paid to our U.S. subsidiary within 90 days prior to the customer's Chapter 11 filing? Yes, I have seen articles written by American lawyers that my CFO forwarded me, but the former customer wants us to pay back $350,000, which will reduce the contribution from our American subsidiary, will materially alter our profit forecast for the year, and will require us to reserve for a potential loss on our books.

You immediately telephone your CFO to assess the damage. The CFO reports he has reviewed the customer file and the official notices he has received from the U.S. Bankruptcy Court regarding the Chapter 11 case. The CFO has confirmed that a Proof of Claim for unpaid invoices has been filed with the court. This registers our U.S. subsidiary's claim, making sure we are in line for payment. Your CFO also reminds you that the subsidiary shipped goods that were received by the customer within 20 days of its bankruptcy filing. Accordingly, your proof of claim also contains an administrative claim for those invoices. Your U.S. counsel has advised that an administrative claim is entitled to a priority in payment, on parity with professional fees, which always seem to be paid.

According to your CFO, the next step is to analyze potential defenses to the customer's alleged "preference" paid to your U.S. subsidiary. U.S. Bankruptcy law apparently has common vendor defenses of "subsequent new value" and "ordinary course of business."

You re-read the memo your CFO sent you from the American lawyer. According to the memo, "subsequent new value" means more goods shipped after receipt of the payment at issue. "New value" is an objective defense and easy to prove, usually based on a submission of invoice copies. Trustees for Chapter 11 debtors usually agree to a dollar for dollar credit for new value. The U.S. subsidiary shipped $125,000 worth of goods that count for new value, reducing the exposure from $350,000 to $225,000. Will the "ordinary course of business" defense shield the remaining $225,000?

The ordinary course of business defense seems less certain. The concept is that the payments the trustee seeks to recover were made in the "ordinary course of business," thus shielding the payments from repayment. However, the "ordinary course of business" defense is more subjective because U.S. Bankruptcy Courts have issued conflicting rulings on what constitutes whether payments are ordinary or not. A key question is whether the payments at issue were paid consistently compared to the historical payments the debtor made to our U.S. subsidiary. If during the last year or so, our customer-turned-Chapter 11-debtor has paid us 5 to 10 days slow compared to invoice terms, and the payments in question were also paid 5 to 10 days slow, we should have a solid ordinary course of business defense. The problem here is about 30 days before our customer filed for Chapter 11 protection, we saw it coming. Our CFO changed the terms from net 30 to net 10, and cut the credit line by 50%. We were happy to have reduced our exposure substantially by this move. The downside is the payments in that 30 day period likely won't be considered "ordinary course of business" because they are not consistent with the historical pattern of payment.

Your CFO pulls the invoices for shipments during the last year or so and analyzes the payment history. Do we have a new value defense? Do we have the ordinary course of business defense? Looks pretty solid except for that last 30 days, so time to call the trustee's counsel and put this to bed. The trustee agrees to look at our records and consider our defenses for a possible out-of-court settlement. Thus, we email to the trustee's counsel a PDF showing our subsequent shipments and the payment history. Since the trustee's 2 year statute of limitations to file a formal preference complaint expires soon, we get a letter back quickly saying that the trustee reviewed the information and agrees to reduce the demand by the amount of the new value shipments. However, the trustee doesn't buy our ordinary course defense…and we have the burden of proof. The trustee is betting we won't spend the money to come to court, and that we will pay more to settle and avoid court. The trustee offers to settle for 80% of $225,000, paid immediately.

As additional "incentive" to encourage our agreement to the proposal, the trustee also insists we are not entitled to any distribution on our unsecured claim, or on our 20 day administrative claim…unless we resolve this preference claim. Translated...the trustee is using his leverage to get more money out of us. You didn't expect this curve ball. Time to call counsel.

What is the trustee saying and can he do this? Not pay our administrative claim? Not pay our unsecured claim? Please explain.

The trustee is relying on Section 502(d) of the Bankruptcy Code. It says:

> ...the court shall disallow any claim of any entity...that is a transferee of a transfer avoidable under section....547, 548...unless such entity or transferee has paid the amount...for which such...transferee is liable....

The trustee says that "any claims" clearly includes our unsecured claim and our 20 day administrative claim and they cannot be paid until we reach a settlement on the alleged preference payment. Your counsel advises you of Judge Walrath's recent Delaware opinion in Giuliano v. Mitsubishi Electronics America, Inc. In that case, Mitsubishi timely filed a proof of claim that included a general unsecured claim of $569,107 and a 20 day administrative claim for $829,393. The debtor operated under the name "Ultimate Electronics" in 46 retail stores, primarily in the U.S. mid-west and western states.

On July 19, 2011, the Trustee for Ultimate Electronics filed a preference action against Mitsubishi to recover $4,744,787, and to also "disallow" Mitsubishi's general unsecured claim of $569,107 and its 20 day administrative claim for $829,393, both under Section 502(d) above. Mitsubishi filed a motion to dismiss the Trustee's complaint because the complaint didn't specify which debtor entity made the alleged preference payments to Mitsubishi, and because the Trustee's attempt to disallow Mitsubishi's claims was not proper.

The U.S. Bankruptcy Court ruled in favor of Mitsubishi, and dismissed the preference action but gave the Trustee the right to amend its complaint to get the parties right. In doing so, the Court also ruled that Section 502(d) is not applicable unless and until there is a "judicial determination" on the preference complaint. The existence of a potential preference claim alone does not allow a trustee to withhold a distribution on an unsecured claim, or an administrative claim. The Trustee can use Section 502(d) successfully only if the Trustee obtains a judgment on the complaint. It is rare for a preference claim to reach a judgment, as most claims are settled by the parties.

Subsequent to the U.S. Bankruptcy Court ruling in the Mitsubishi case, the Trustee filed an Amended Complaint against Mitsubishi to recover alleged preference payments of approximately $4.8 million. However, unlike the original Complaint, the Amended Complaint does NOT seek to disallow Mitsubishi's claims against the Chapter 11 debtor under Section 502(d).

It is clear that the U.S. Bankruptcy Court ruling has provided additional leverage to preference defendants worldwide, enhancing the creditor's ability to defend preference claims without jeopardizing the value of the defendant's claims for unpaid goods against the Chapter 11 debtor.

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New York Bankruptcy Court Flexes Global Muscle

On May 4, 2012, the United States District Court for the Southern District of New York affirmed a 2011 Bankruptcy Court ruling, which enjoined a lawsuit in the Cayman Islands against a Chapter 11 debtor. The case of Bernard L. Madoff Investment Securities, LLC v. Maxam Absolute Return Fund, et al., arises in the Bernie Madoff SIPA liquidation and Chapter 11 proceedings, where the aftermath of the massive Madoff fraud is playing out.

The question in this Madoff case is whether a non-U.S. creditor can maintain a lawsuit in its own jurisdiction against a U.S.-based Chapter 11 debtor. In this instance, can a Cayman Islands registered entity sue a Chapter 11 debtor in the Cayman Islands, and does the automatic stay of Section 362 of the Bankruptcy Code prohibit the lawsuit?

Section 362 provides:
. . . this section . . . operates as a stay, applicable to all entities, of . . . the commencement . . . of a judicial . . . proceeding against the debtor . . . or to recover a claim . . . or [added] any act to obtain possession of property of the estate . . .

Section 541 of the Bankruptcy Code defines "property of the estate" as all of the legal or equitable interests of the debtor in property "wherever located".

Madoff Securities was a member of SIPC, or the Securities Investor Protection Corporation, formed under SIPA, the Securities Investor Protection Act, passed by the U.S. Congress in 1970. SIPA and SIPC were designed to protect customers of failed brokerage firms by providing a specialized liquidation proceeding, known as a SIPA liquidation, which is distinct from a U.S. Chapter 7 liquidation proceeding. Madoff Securities is currently in a SIPA liquidation, and in a Chapter 11 proceeding, both of which have been substantively consolidated. Irving Picard was appointed as the Trustee on behalf of the liquidation estates. The cases are pending in the Southern District of New York. One of Picard's duties is to recover assets for the benefit of defrauded customers of Madoff Securities, which assets include claims against third parties.

On December 8, 2010, the Madoff Trustee sued MAXAM Capital Management, LLC, MAXAM Absolute Return Fund, LTD and affiliates ("MAXAM") in the New York Bankruptcy Court to recover preference payments totaling $25 million, allegedly paid to MAXAM within 90 days prior to the Madoff Chapter 11 filing. Briefly, a "preference" arises under Section 547 of the Bankruptcy Code and is a pre-petition payment to creditor made within 90 days prior to a Chapter 11 filing. The U.S. Bankruptcy Code provides for the recovery by the debtor's estate of payments made on the "eve" of insolvency so that value can be more equitably re-distributed to all creditors. Upon being sued by the Madoff Trustee, the MAXAM defendants filed an answer in the New York preference case, but also filed a declaratory judgment action against the Trustee in the Cayman Islands. The purpose of the declaratory judgment action was to obtain a court order in the Cayman Islands ruling the MAXAM defendants had no preference liability in the U.S. proceedings.

In response to the Cayman Islands lawsuit, the Madoff Trustee filed a motion to enjoin the action, on the grounds that the action violated the automatic stay of Section 362 of the Bankruptcy Code, and Section 78 of SIPA, that prohibits legal action against the Trustee, as SIPA reserves exclusive jurisdiction to the U.S. Courts. In a well-reasoned, 21-page opinion, the New York Bankruptcy Court on October 12, 2011, ruled the Cayman Islands action violated the automatic stay of Section 362 and applicable SIPA provisions. The New York Court found the Cayman Islands action to be void, and enjoined the MAXAM entities from taking any further action against the Madoff estate "in any domestic or extraterritorial jurisdiction" without first obtaining permission from the U.S.

Bankruptcy Court. In essence, the U.S. Bankruptcy Court viewed the Cayman Islands action as an attempt to usurp the Bankruptcy Court's jurisdiction over an asset of the Madoff Securities' estates.

The MAXAM entities appealed the Bankruptcy Court ruling, but the U.S. District Court affirmed the Bankruptcy Court ruling. In the appeal, the MAXAM entities argued that the automatic stay of Section 362 (as well as applicable SIPA provisions) had no extraterritorial effect, and could not apply or be enforced outside the U.S. The MAXAM entities further argued that the U.S. Bankruptcy Court should have deferred to the Cayman Islands court under principles of "comity". In affirming the Bankruptcy Court ruling, however, the U.S. District Court emphasized several points:

1. Under Section 541 of the Bankruptcy Code, defining "property of the estate", the filing of Chapter 11 creates a worldwide estate of all of the legal or equitable interests, "wherever located", with the implication that the Bankruptcy Court has exclusive jurisdiction over "property of the estate" anywhere.

2. The automatic stay (of Section 362) exists to protect the estate from a chaotic and uncontrolled scramble for the Debtor's assets in a variety of uncoordinated proceedings in different courts, whether domestic or foreign.

3. "Comity" in the legal sense is neither a matter of absolute obligation, on the one hand, nor of mere courtesy and goodwill upon the other. But it is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to the international duty and convenience, and to the rights of its own citizens, or of other persons who are under the protection of its laws. However, the court noted that the principles of comity do not stand for the notion that a U.S. Court can exercise control over a foreign court. Rather, a bankruptcy court can enforce the automatic stay extraterritorially only against entities over which it has personal jurisdiction, including the MAXAM entities.

The court concluded that the U.S. Courts for these purposes has personal jurisdiction over the MAXAM entities. By filing the lawsuit in the Cayman Islands, the MAXAM estates attempted to interfere with the recovery of an asset of the estate, a violation of the automatic stay.

In affirming the New York Bankruptcy Court decision, the U.S. District Court has affirmed the global reach of the automatic stay imposed by Section 362 of the U.S. Bankruptcy Code. The Bankruptcy Court also concluded that principles of international comity did not apply to a foreign action that violated U.S. law and sought to interfere with the exclusive jurisdiction of the U.S. Bankruptcy Court. This Madoff ruling should not be overstated. It is important to note that recovery actions, such as preference actions, have long been viewed as a key asset of a Chapter 11 estate. The Madoff decisions indicate that U.S. Courts will not permit a direct challenge to its ability to protect such assets of the estate for the benefit of all creditors.

It is clear, however, that U.S. Courts will honor the principles of comity, and defer to foreign courts in appropriate cases. For example in the BTA Bank case, a Chapter 15 proceeding in the Southern District of New York, the Bankruptcy Court refused to extend the automatic stay to a Swiss arbitration proceeding. While the particulars of the BTA Bank case are beyond the scope of this article, it is important to note that U.S. Courts have refused to extend the automatic stay in appropriate cases. However, this Madoff case makes clear that any attempt to interfere with a preference action, in any jurisdiction, will be enjoined.