Can't you hear me knocking?

The dreaded preference demand

Sage advice from David Conaway

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A CHAPTER 11 DEBTOR CAN FORCE THE RETURN OF MONEY IT PAID 90 DAYS PRIOR TO THE FILING

You are in your office finishing your morning espresso when you receive an email from the CFO of your companies' US subsidiary. Attached to the email is a letter from a US 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 US subsidiaries' customer) over 2 years ago... the dreaded preference demand. But, if you pay 80% today, the letter offers, it will all go away.

Your US CFO has mentioned this aspect of the US Chapter 11 law, but this is the first time you have encountered it. Let me get this straight, under US Bankruptcy law, a Chapter 11 debtor can force the return of money it paid to our US 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 US 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 US 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 US 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 defences to the customer's alleged "preference" paid to your US subsidiary. US Bankruptcy law apparently has common vendor defences 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 US 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" is more subjective because US 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 US 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 of 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 defences 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 two-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 me 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 US mid-west and western states.

On 19 July 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 US Bankruptcy Court ruled in favour 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 US 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 US 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.

THE TRUSTEE IS BETTING WE WON'T SPEND THE MONEY TO COME TO COURT, AND THAT WE WILL PAY ME MORE TO SETTLE AND AVOID COURT