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Bankruptcy Law Update: Preferences and Selected Bankruptcy Issues

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Preference Claims:

Elements: A preference is a transfer of property of a bankruptcy debtor that (1) was to or for the benefit of a creditor; (2) was on account of an antecedent debt; (3) was made while the debtor was insolvent; (4) was made within 90 days of the filing of the bankruptcy petition; and (5) allowed 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. These elements are almost always (but not absolutely always) met, but there are several defenses available: subsequent new value, ordinary course of business (either between the parties or in the industry), contemporaneous exchange for new value, and others.

Important consideration!: The most important rule to remember is to never, ever pay a preference demand without first performing a detailed analysis of the defenses. The application of each defense is highly technical, and the interplay of the defenses is complicated. This analysis needs to be done by bankruptcy counsel. Bankruptcy debtors or trustees, when making demand for payment of a preference, frequently offer a discount of around 20% to settle. Never accept this offer. These claims can often be resolved for no payment or for a payment under 10% of the demand amount, but the analysis and outcome of each situation is highly fact specific.

Timing of the lawsuit: A lawsuit to recover a preference claim can be brought as late as two years after the bankruptcy filing, and even possibly as late as three years if a trustee is appointed within the two years.

Retention of documents: Upon learning of a customer's bankruptcy, immediately move to protect the documents needed to present the preference defenses: invoices, remittance advices, bills of lading, proofs of delivery, correspondence, and ***emails*** for one to two years before the bankruptcy filing. Failure to preserve electronic communications and other evidence could cause the court to make an adverse presumption regarding their contents, which might hamper or preclude the ordinary course of business or other defenses.

Timing of payments: 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.

Defenses: 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:

Subsequent new value ("SNV"):

- This is new value given after receipt of a payment.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.

- The SNV defense can protect the payment received immediately before the new value was given or any other previous payment.

- As required by the "subsequent" criterion, this defense cannot protect a payment received after the new value shipment.Therefore, timing is critical to this defense.

- The new value does ***not*** always need to be unpaid in order to count for the SNV defense, but new value would not count for the defense if its payment is protected from recovery as a preference by any defense other than the SNV defense.

- Forbearance in collecting on the outstanding balance is never considered to be new value.

Contemporaneous exchange for new value ("CEV"):

- This defense arises when the debtor and 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.

- The CEV defense can arise when a customer pleads for a shipment and the creditor insists that a payment be sent in approximately the same amount.The "subsequent" timing requirement of the SNV defense is replaced with an agreement requirement.

- 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 or email from the creditor to the debtor, a memo to the creditor's file, or oral testimony or an affidavit as to the existence of the agreement.

- The CEV defense has been limited by most courts to require that the payment actually be intended to be applied to the goods that were shipped rather than applied to earlier invoices, even though this requirement is not stated in the Bankruptcy Code.This limitation imposed by the courts often precludes this defense.

- In the fact situation of a shipment being made in exchange for a payment, if it is possible, require that

the payment be received (using a wire transfer or using an overnight courier for a check) ***before*** the shipment is made.This timing would make available the SNV defense for the payment, rather than the more difficult to prove CEV defense.

Ordinary course of business ("OCB"):

- Payments can be protected by the OCB defense if (1) they were ordinary compared to earlier transactions (the last year or so) between the creditor and the debtor (paid roughly the same number of days after invoice date and paid in the same manner, such as by check) ***or*** (2) they were made according to ordinary business terms in the industry.

- For the OCB defense, payments also have to be in payment of a debt that was incurred in the ordinary course of business of the debtor and the creditors.This 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.

- Beware changing credit terms, either formally on the invoices or informally, for a customer that is in financial difficulty.Being a nice guy and allowing the customer to pay later than usual may have the effect of precluding the OCB defense for these payments if the customer later files bankruptcy.Payments made sooner than usual or before their due date are often considered to not qualify for the OCB defense.

- But, lateness of payment can also 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 between the parties.

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

- 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 payment at issue was in an amount more than usually paid; (3) whether the payment was 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.

- If you are going to put pressure on a customer for payment, more than an ordinary reminder that invoices are past due, do not use ***undue*** pressure, or at least do not do so in written form that can be discovered later.Threats of legal action or cutting off sales can be considered undue, but enforcing a consistent credit line is generally not undue.

- "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 OCB 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.

Interplay of these defenses:

- The SNV, CEV, and OCB defenses, and any other defenses, 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 the SNV 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 thus protect its payment from avoidance as a preference by use of the OCB defense.

General Considerations:

- Pre-payments are not preferences, as they are not on account of an antecedent debt.
- Payments to a secured creditor are not preferences since the creditor would have been paid in a liquidation in any event.
- If a (frequently foreign) transaction involves protection by a letter of credit, consider having a documentary rather than a standby letter of credit, so that payments come directly from the issuing bank. These payments are not a preference, as they are not a transfer of the debtor's property. Payments by the customer when there is a standby letter of credit ***may*** be protected in a later bankruptcy of that customer because the issuing bank gave "new value" in the form of a partial release of its security interest in the debtor's property; however, ***you*** would have to gather the evidence and prove that the bank had been oversecured at the time of the payment, and, of course, the letter of credit itself by the time of the preference claim will have long expired.
- Beware of payments from a party other than the account debtor. A payment of an account by a related

entity or third party, that later files bankruptcy, might be recovered as a fraudulent transfer (in the sense of a lack of a reasonably equivalent value) because the entity making the payment may well have received no value in exchange for the payment.
- 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.
- Application of payments to specific invoices can make a substantial difference in the use of the defenses to a preference claim. If a customer is in trouble and may well file bankruptcy in the next 90 days, discuss with bankruptcy counsel how you should tell the customer to apply payments. Always applying payments to the oldest invoices may not be the best procedure in a potential bankruptcy and preference situation.
- **Always take the money now.** Never delay accepting payment out of concern that the payment might be recovered as a preference if the customer 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% of the payment, and you can almost always negotiate a percentage return no matter what the facts.
- In cases of material exposure, creditors are well advised to consult skilled bankruptcy counsel about the interplay of the preference rules and defenses, particularly prior to a bankruptcy filing.

Interplay with unsecured claims:

- Creditors that receive preference claims almost always have an unsecured claim against the debtor.
- Section 502(d) of the Bankruptcy Code allows the debtor to withhold any dividend on the claim pending payment of the preference.
- There have been some court cases that allow a debtor to withhold payment on an administrative claim (such as a section 503(b)(9) 20-day administrative claim) pending payment of the preference. Creditors should contest this.
- Usually in a settlement, the potential dividend is credited to reduce the potential preference.

Executory contracts:

- Often vendors provide goods or services to a debtor/customer pursuant to an "executory" contract, which is a Bankruptcy Code term for any contract where both parties have performance obligations to the other. A sales contract is usually an "executory" contract.
- If an executory contract is assumed by a debtor, payments made to the vendor prepetition would not be preferences.

Critical vendor:

- Critical vendor is a "remedy" that allows a debtor to voluntarily pay a creditor's prepetition claim since the creditor's ongoing goods or services are "critical" to the debtor's survival.
- As part of a critical vendor agreement, vendors often insist on a waiver of any preference claims. Without that express waiver, prepetition payments to that creditor could later be recovered as preferences even though the creditor's prepetition claim was paid through the critical vendor agreement.
- Assertion of rights as a critical vendor can result in violations of the automatic stay, so creditors should consult skilled bankruptcy counsel regarding these matters.

Setoffs: A setoff of mutual debts with a customer/vendor within 90 days of a bankruptcy filing may trigger liability similar to a preference claim. The determination of this liability is highly technical and fact specific.

In a drafting error that has remained uncorrected for nearly 40 years, setoff ***rights*** are protected by the Bankruptcy Code, but actual setoffs may be recoverable. Thus, if you do have a build-up of receivables and payables with a customer that is also a vendor to you, and there is a risk that this customer/vendor may file bankruptcy within the next 90 days, you might decide to not offset these mutual debts, but simply let them run. However, if you are still selling to the customer and would have a section 503(b)(9) claim, you should offset the debts, as otherwise the customer, after filing bankruptcy, would want to apply the offset of your debt first against your 503(b)(9) claim, which is worth 100 cents on the dollar. So it may be better to make the setoff and run the risk of its potential recovery rather than risk your 503(b)(9) claim. Contact skilled bankruptcy counsel for advice on your specific fact situation.

Reclamation: Creditors may serve a reclamation demand for goods delivered to the debtor within 45 days before the filing of the bankruptcy case. The time limit for serving this demand for full effect is 20 days after the bankruptcy filing. This reclamation right is subject to the prior sale of the goods by the debtor, the incorporation of the goods into other goods (such as yarn woven into fabric or parts assembled into a vehicle), and the encumbrances of secured creditors. Reclamation is quite easy and inexpensive to do and should be done for that reason, even though it now rarely results in a recovery for the reclaiming seller.

503(b)(9) Claims: Section 503(b)(9) of the Bankruptcy Code creates an administrative expense priority for all goods (but not services) received within 20 days before the bankruptcy filing. These claims are usually paid 100 cents on the dollar, absent an "administrative insolvency" of the debtor. Watch for the filing deadline. These claims often need to be filed by counsel as an application. 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), but most of the recently reported court decisions allow this.

Proofs of Claim: In a chapter 7 case, creditors must file a proof of claim to have an allowed claim. In a chapter 11 case, creditors may rely on the claim scheduled by the debtor to have an allowed claim in that amount, but only if the claim is not scheduled as contingent, disputed, or unliquidated. However, filing a proof of claim or an application for a 503(b)(9) claim subjects the creditor to the jurisdiction of the bankruptcy court and precludes demanding a jury trial in response to a preference or other claim. These issues should be explored with bankruptcy counsel before automatically filing a proof of claim.

These materials are intended as an overview of bankruptcy law, and a complete analysis of the issues that arise in these situations 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 Conaway or David Grogan in the Bankruptcy and Creditors' Rights Group of Shumaker, Loop & Kendrick, LLP, at 704-375-0057.

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