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Bankruptcy Preference Actions – An Updated Primer

Dylan G. Trache,
Rebecca L. Saitta
and P. Vicky K. Chatha

Wiley Rein LLP

In November of 2010, the trustee for the Circuit City Stores, Inc., liquidating trust filed more than 500 adversary proceedings against creditors seeking the recovery of alleged preferential payments. The extent of the trustee's success in recovering these payments will impact the overall distribution to creditors. Creditors in bankruptcy cases should be aware that preference litigation allows a trustee or debtor-in-possession to recover payments received by a creditor during the period immediately preceding the bankruptcy filing. Nonetheless, creditors may be able to raise several defenses to avoid surrendering a preferential payment.

Dylan G. Trache *is a Partner in the Bankruptcy & Financial Restructuring Practice. He represents both debtor and creditor clients on a variety of bankruptcy and insolvency issues in bankruptcy courts throughout the country. His experience includes representing chapter 11 debtors in many industries, including mass media, aviation, retail and manufacturing. He can be reached at (703) 905-2829.* ***Rebecca L. Saitta,*** *an Attorney in the Bankruptcy & Financial Restructuring Practice, represents both debtor and creditor clients on a variety of bankruptcy and insolvency issues in bankruptcy courts throughout the country. She also represents clients on various aspects of commercial litigation in state and federal courts. Ms. Saitta can be reached at (703) 905-2831.* ***P. Vicky K. Chatha*** *is an Associate in the Bankruptcy & Financial Restructuring Practice at Wiley Rein. Ms. Chatha advises clients and appears in court on a broad range of bankruptcy and restructuring matters. She can be reached at (703) 905-2846.*

Dylan G. Trache

Rebecca L. Saitta

P. Vicky K. Chatha

The Bankruptcy Code allows for the recovery of preferential payments as a means of remedying past preferential treatment for the benefit of the bankruptcy estate and creditors. While the concept of requiring a creditor to disgorge payments made on account of valid debts may seem unfair, particularly where the debtor may still owe money to the targeted creditor, the rationale behind permitting recovery of these payments comports with the overall purpose of the Bankruptcy Code: to ensure that all creditors receive equitable distribution of the debtor's assets in proportion to their respective claims.

The trustee (or debtor-in-possession) must satisfy the requirements set forth in 11 U.S.C. § 547 in order to successfully establish a case for recovery of a preferential payment. Specifically, the trustee must prove that the payment was: (i) a transfer; (ii) of an interest of the debtor in property; (iii) made to or for the benefit of a creditor; (iv) for or on account of an antecedent debt; (v) made while the debtor was insolvent; (vi) made within ninety (90) days or one year, in the case of an insider; and (vii) resulted in the creditor receiving a greater distribution than it otherwise would have in a hypothetical chapter 7 distribution. Typically, a trustee has two years from the bankruptcy petition date to bring the preference action. The trustee bears the burden of proof in establishing each of these elements.

Elements Of A Preference Action

Transfer

According to § 101 of the Code, a transfer is defined as:

- The creation of a lien;
- The retention of title as a security interest;
- The foreclosure of a debtor's equity of redemption; or
- Each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or an interest of property. 11 U.S.C. § 101.

Interest of the Debtor in Property

The transfer sought to be recovered or avoided must qualify as a transfer of an "interest of the debtor in property." 11 U.S.C. § 547(b). While the Code fails to define this term, this requirement has been found to be synonymous with the definition of "property of the estate" provided in § 541 of the Code. Accordingly, a transfer of an interest of the debtor in property will include the transfer of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541.

Made to or for the Benefit of a Creditor

The transfer must have been made to or for the benefit of a creditor, as the term "creditor" is broadly defined pursuant to § 101 of the Code.

On Account of an Antecedent Debt

Next, the trustee must prove that the allegedly preferential transfer was made "on account of an antecedent debt." 11 U.S.C. § 547(b)(2). To satisfy this requirement, the debt must have been incurred

Please email the authors at dtrache@wileyrein.com, rsaitta@wileyrein.com or vchatha@wileyrein.com with questions about this article.

prior to the allegedly preferential transfer.

Made While the Debtor Was Insolvent

A determination of insolvency is based on a typical balance sheet assessment as to whether the liabilities of the debtor exceed its assets. For the purposes of preference actions, the debtor is presumed to have been insolvent on and during the 90-day period preceding the filing of the bankruptcy petition. 11 U.S.C. § 547(f). A defendant may offer evidence to rebut the presumption of insolvency, and the trustee bears the ultimate burden of proof as to the debtor's insolvency.

Made Within Ninety (90) Days, or One Year in the Case of an Insider

The preferential transfer must have been made within ninety (90) days prior to the filing of the bankruptcy petition, or between ninety (90) days and one year before the date of filing if the creditor is an insider of the debtor.

Resulted in the Creditor Receiving a Greater Distribution Than in a Hypothetical Chapter 7

Pursuant to § 547(b)(5), the final element that must be proven in order to establish a valid preference requires that the transfer must have enabled the creditor to receive more than the creditor otherwise would have received if:

- The case were a case under chapter 7 of this title;
- The transfer had not been made; and
- Such creditor received payment of such debt to the extent provided by the provisions of this title. 11 U.S.C. § 547(b)(5).

As a result of this element, the trustee is precluded from recovering payments from a fully secured creditor since a secured creditor would not be deemed to have received more as a result of the transfer than it otherwise would have pursuant to a chapter 7 liquidation.

Defenses Available to Creditors

Even if the trustee is able to prove each of the required elements of a preferential transfer, a creditor may assert defenses in an attempt to avoid having to surrender a preferential payment. The purpose behind these defenses is to encourage creditors to continue to conduct business with a financially distressed entity in the hope that a bankruptcy filing can be avoided. The defendant bears the burden of establishing that one or more of the defenses described below exists to bar recovery of the transfer.

Contemporaneous Exchange for New Value

Pursuant to § 547(c)(1), the contemporaneous exchange for new value defense precludes recovery where the transfer was:

- Intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
- In fact a substantially contemporaneous exchange. 11 U.S.C. § 547(c)(1).

This defense protects creditors that provide new value in exchange for a preferential transfer, and thus, the estate has not been diminished. Note that the absence of requisite intent on behalf of the parties will preclude the viability of this defense. Thus, COD transactions are a common example of a business dealing that may survive a preference attack on these grounds. In contrast, a creditor who requires payment of outstanding invoices as a condition for delivering new goods will not be able to assert the contemporaneous exchange defense. Creditors wishing to protect themselves from becoming the target of an unwelcome preference action should consider applying new payments to goods or services provided at the time of the payment, as opposed to outstanding invoices, in order to preserve their right to assert the contemporaneous exchange defense.

Subsequent New Value

In addition, § 547(c)(4) permits a creditor to avoid relinquishing a transfer for which the creditor *subsequently* provided new value for the benefit of the bankruptcy estate. In order to prove that a transfer should escape recovery by the trustee, a creditor must establish that the transfer preceded the provision of new value and that the new value either remained unpaid or was paid with a transfer that itself is avoidable as a preference. Such creditors should escape preference liability as they have conferred a benefit on the bankruptcy estate through the provision of goods and services to a financially troubled company.

Ordinary Course

Pursuant to § 547(c)(2) of the Code, a creditor may also defend against a preference claim on the basis that the payments it received were made in the ordinary course of business. Recovery of an otherwise avoidable transfer may be precluded if the creditor can establish that the transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was:

- Made in the ordinary course of business or financial affairs of the debtor and the transferee; or
- Made according to ordinary business terms. 11 U.S.C. § 547(c)(2).

By allowing creditors to escape preference liability for ordinary course payments, Congress sought to safeguard normal financial relationships based on the theory that ordinary course transactions did not involve unusual or preferential treatment that would justify the avoidance of such transfers. Further, as a result of the 2005 amendments to the Bankruptcy Code, Congress amended this defense such that now a creditor need only prove either that the transfer occurred in the ordinary course of business of the debtor and creditor or according to ordinary business terms (instead of requiring both as under prior law). As a result of this statutory change, the ordinary course defense is both easier and less expensive for creditors to establish.

Conclusion

Preference actions must be viewed in line with the purposes of the Bankruptcy Code – the ratable distribution of an estate's assets among its creditors. Accordingly, preference actions require the return of preferential payments to the estate so that all creditors may share in a just *pro rata* distribution.

As this may be small comfort to a creditor being asked to disgorge a substantial payment, creditors should be aware of practical strategies that may enable a creditor to minimize the risks associated with preference claims. First, creditors facing a preference claim should keep in mind the available defenses and respond aggressively and in detail to trustee demands. Second, creditors can take a proactive approach to avoid preference liability by: (i) being diligent about collecting payments in a timely and routine fashion, (ii) preserving proper documentation of each transaction, (iii) applying payments to the most recent invoices and (iv) monitoring the financial status of their customers.

Lastly, mitigating preference actions may still be possible after initiation of a case. One opportunity is during the claim objection process. Rather than addressing only the issues arising pursuant to a claim objection itself, it may be advisable for creditors to seek to resolve all potential issues between the parties, including any alleged preferential payments made to the creditor. For example, in exchange for a reduced proof of claim seeking less than the full amount on an unsecured claim, a debtor might agree to completely release the creditor from the prospect of future preference liability.