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# Preference Defense Primer Update: Diligence Can Pay Off!

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Nothing is more frustrating to a trade creditor saddled with a large unpaid balance owed by a debtor in bankruptcy than being subject to the risk of having to remit back to the debtor's estate "preference" payments received from the debtor prior to the commencement of the bankruptcy case. Pursuant to section 547(b) of the Bankruptcy Code, a debtor in possession or trustee can seek the recovery of alleged preference payments made within 90 days of the bankruptcy filing date. This is the harsh reality faced by the approximately 750 trade creditors (and counting) who have recently been sued in the Sears Chapter 11 case for the recovery of payments they had received within 90 days of Sears' bankruptcy filing date.

The policy behind the preference statute is to treat creditors equitably and level the playing field by requiring preferred creditors to share their recovery with all other creditors. Unfortunately, the reality is that preference recoveries are used to pay higher priority claims, such as the unpaid Chapter 11 administrative expense claims owing by Sears that must be paid as part of Sears' Chapter 11 plan. And creditors defending preference lawsuits would more likely characterize the complaints for recovery of "preference" payments as punishment for continuing to do business with a financially distressed customer.

So, what should a creditor do when it first receives a preference demand letter and is then subsequently sued? What defenses can a creditor assert to rebut a preference claim? How should a creditor go about responding to, defending and/or settling a preference claim? This article answers these questions by providing a step-by-step checklist of the actions a creditor should take starting from the date that a customer files for bankruptcy (the "Petition Date") through the resolution of a preference litigation. A creditor is far better off spending the time compiling and presenting proof of its potential defenses to a preference demand than simply paying the amount demanded.

## Some Necessary Background: Preference Claims and Defenses

Pursuant to section 547(b) of the Bankruptcy Code, a trustee (or debtor in possession) can avoid and recover a transfer as a preference by proving all of the following:

- The debtor transferred its property to or for the benefit of a creditor. The transfer of any type of property can be avoided, but the most frequent type of transfer is the debtor's payment from its bank account to a creditor [section 547(b)(1)];
- The transfer was made on account of antecedent or existing indebtedness, such as outstanding invoices for goods sold and delivered and/or services rendered, that the debtor owed to the creditor [section 547(b)(2)];
- The transfer was made when the debtor was insolvent, which is based on a balance sheet test of whether the debtor's liabilities exceeded its assets; insolvency is presumed during the 90-day preference period, which makes insolvency easier to prove [section 547(b)(3)];
- The transfer was made within 90 days of the debtor's bankruptcy filing in the case of a transfer to a non-insider creditor, such as a trade creditor [section 547(b)(4)]; and

- The transfer enabled the creditor to receive more than the creditor would have received in a Chapter 7 liquidation of the debtor [section 547(b)(5)].

The Small Business Reorganization Act of 2019 (the "SBRA"), which became effective on Feb. 19, 2020, amends section 547(b) to require a debtor in possession or a trustee to allege, as part of its burden of proof, that the preference claim is based on reasonable due diligence in the circumstances of the case and taking into account a party's known or reasonably knowable affirmative defenses. This seemingly heightened burden of proof for preference claims has raised numerous questions that will need to be answered by the courts. How much of an additional burden will be placed on a debtor in possession or trustee to prove a preference claim? What constitutes "reasonable due diligence?" What is a "reasonably knowable affirmative defense?" And, can the plaintiff in a preference action rely on the debtor's records to satisfy these requirements or must the plaintiff engage in additional diligence?

There are multiple affirmative defenses contained in section 547(c) of the Bankruptcy Code that a creditor can assert to reduce or eliminate its preference exposure. These defenses are designed to encourage creditors to continue doing business with, and extending credit to, financially distressed companies.

The section 547(c)(1) contemporaneous exchange for new value defense is one such preference defense. This defense excuses any payment or other transfer that the debtor and creditor had intended as a contemporaneous exchange for new value and was a substantially contemporaneous exchange. A creditor that provides new goods and/or services to a debtor in exchange for payment, such as a cash on delivery transaction, replenishes the debtor and should not be subject to preference liability.

The subsequent new value defense set forth in section 547(c)(4) is another frequently invoked preference defense. The new value defense reduces a creditor's preference liability dollar for dollar based on the creditor's sale and delivery of goods and/or provision of services to the debtor on credit terms after the debtor's receipt of an alleged preference payment. The new value cannot be secured by a security interest in the debtor's assets that is otherwise unavoidable and cannot be paid by an otherwise unavoidable transfer to or for the creditor's benefit. The defense is predicated on protecting a creditor from preference risk where the creditor had replenished the debtor, by providing new goods or services on credit terms, subsequent to a transfer claimed to be a preference.

The section 547(c)(4) new value defense clearly applies to new value that was unpaid on the bankruptcy filing date. Several United States Circuit Courts of Appeals (the federal courts immediately below the United States Supreme Court) and other courts have reached conflicting results on the applicability of the new value defense to new value that a debtor had subsequently repaid. The majority view, followed by five United States Circuit Courts of Appeals, including the Fourth, Fifth, Eighth, Ninth, and, most recently, the Eleventh Circuits, and followed by many lower courts, have applied the new value defense to paid, as well as unpaid, new value. The United States Court of Appeals for the Seventh Circuit and a minority of other courts have ruled that the new value defense applies only to unpaid new value. A creditor's ability to assert paid, as well as unpaid, new value could substantially reduce preference liability.

A creditor can also assert the "ordinary course of business" defense to reduce its preference liability. The creditor must first prove the alleged preference payment satisfied a debt that the debtor had incurred in the ordinary course of business or financial affairs of the debtor and the creditor. A trade creditor that extended credit to the debtor should have little difficulty satisfying this requirement. The creditor must then prove the preference payment was *either* (A) made in the ordinary course of business or financial affairs of the debtor and the creditor (frequently referred to as the subjective component of the ordinary course of business defense), *or* (B) made according to ordinary business terms (frequently referred to as the objective component of the ordinary course of business defense). The subjective component of the ordinary course of business defense requires proof that the alleged preference payments were consistent with the debtor's payments to the creditor prior to the preference period. A creditor can prove the objective part of the defense by showing that the alleged preference payments were consistent with the terms and payment practices in the creditor's industry, the debtor's industry or some subset of either or both.

## The Preference Checklist

Unsecured trade creditors seeking to analyze and prepare their defenses and respond to a preference claim should utilize the following preference checklist below:

**1. After the Petition Date:**

**a.** Download and save all available payment history covering the two-to-three-year period before the commencement of the 90-day "preference period" to an excel file.

**b.** Pull copies of all invoices (paid and unpaid) for goods and services provided during the preference period, proofs of delivery and a statement of account showing all unpaid invoices on the bankruptcy filing date.

**c.** Pull and secure your company's credit file, including the credit application, contract(s) and financial statements for the debtor, all notes in the file and all correspondence and emails generated during the period covered by the parties' payment history.

**2. Upon receipt of a preference demand letter:**

**a.** Do not ignore the demand!

**b.** Check your file to confirm all of the payments your company had received within 90 days of the Petition Date;

**c.** Request that the debtor in possession or trustee provide a list of all payments that are included as part of the preference claim, a list of the invoices paid by each alleged preference and proof of your company's receipt of the payment.

**d.** Verify your company's receipt of the alleged preference payments and also check whether any of the alleged payments had "bounced."

**e.** Determine whether the "statute of limitations" has expired or will expire imminently. A complaint asserting a preference claim must be filed no

later than two years after the date of the bankruptcy filing or, if a trustee is appointed before the expiration of the two-year period, no later than the later of (i) two years after the bankruptcy filing or (ii) one year after the trustee's appointment.

**f.** Be aware of the small preference defense. A creditor has a full defense to a preference claim for recovery of less than $6,825 in bankruptcy cases commenced after April 1, 2019, and for recovery of $6,425 in cases commenced after April 1, 2016 through April 1, 2019. While demands for recovery of these small preference claims might be sent, it is unlikely that litigation will be commenced to collect these claims.

**g.** Determine the venue for commencing a preference lawsuit. A preference lawsuit can only be commenced in the defendant's "home" district if the claim is for less than $25,000 for lawsuits commenced on and after February 19, 2020, as a result of the SBRA. Prior to February 19, 2020, lawsuits seeking recovery of less than $13,650 had to be filed in the defendant's home district.

**h.** Note that in many instances, a debtor in possession or trustee will mass-mail preference demand letters to try to collect the "low hanging fruit" from creditors that do not take the time to review their defenses. Do not assume that a preference claim is valid, can be proven or is indefensible merely because you have received a demand letter! Also, the demand letter may be an empty threat, as a debtor in possession or trustee may be less likely to actually file preference complaints in certain circumstances. For example, it is unlikely that a debtor in possession or trustee would commence a lawsuit to collect a small preference claim (e.g., claims for recovery of less than $6,825 in bankruptcy cases commenced after April 1, 2019). If the demand is for less than $25,000, a debtor in possession or trustee may be hesitant to file a complaint and litigate the case in the defendant-creditor's home district. Also, a debtor in possession or trustee may be discouraged by the heightened pleading standards that the SBRA recently added to section 547(b) to file a complaint where the defendant has clear and undisputed defenses.

**3. Rebut the elements of the Preference Claim. You should consider whether you can rebut any of the elements of the preference claim:**

**a.** Solvency. Review the debtor's bankruptcy schedules and financial statements covering the preference period, or shortly before the preference period, to rebut the presumption of the debtor's insolvency (i.e., liabilities exceed assets) when the preference payments were made.

**b.** Cash in Advance. Assess whether the payments were cash in advance payments (i.e., paid in advance of shipment of goods or provision of services). Cash in advance payments are not preference payments because they are not on account of an "antecedent debt" as required to satisfy one of the elements of a preference claim.

**c.** Determine whether the payments were made from property of the debtor's estate. For example, certain trust funds (e.g., arising from state law builders' trust fund and federal perishable agricultural commodities claims) may not be considered property of the debtor's estate and, therefore, payments from such trust funds are not subject to preference exposure.

**d.** A creditor would not be subject to preference exposure where its claim is fully secured by the debtor's property or the creditor was paid by the proceeds of its collateral. A creditor's fully secured status could be based on the filing of a lien under state law, the grant of a security interest in the debtor's assets or a creditor's setoff rights. Also, payments made under a contract that the debtor had properly assumed in its bankruptcy case are not recoverable as preferences.

**4. Evaluate potential defenses and counterclaims:**

**a.** The "New Value" Defense:

i. Prepare an analysis of all goods and services provided after receipt of each alleged preference payment to determine net exposure after deducting such "new value."

ii. New value is the value of goods or services provided on credit during the 90-day preference period *after* receipt of the alleged preference payments. New value cannot be applied where the payment was received after the provision of goods or services. New value should be counted as of the date the new value was provided, which could be determined from the shipping documents.

iii. New value should include paid and unpaid new value as of the bankruptcy filing date. Note that a trustee in a jurisdiction that rejects paid new value might reject deduction of paid for new value; but you should still include paid new value when asserting the defense for purposes of negotiations.

**b.** The "Ordinary Course of Business" Defense:

i. Prepare a payment history (covering the two- to three-year period prior to the Petition Date) comparing the days outstanding during the pre-preference period to the days outstanding during the preference period to show a consistency in the timing of payment. The courts have adopted different approaches in determining consistency of payments prior to and during the preference period. Some courts use a range of payments analysis, applying the subjective element of the ordinary course of business defense to all alleged preference payments that fall within the historical range of payments. Other courts have applied a modified historical range of payments analysis, applying the subjective element of the ordinary course of business defense to alleged preference payments that fall within a modified historical range of payments that exclude outlier or unusual payments. Another group of courts compares the average days to pay invoices prior to and during the preference period and applies the subjective ordinary course of business defense where there is a nominal variance between the average days to pay

prior to and during the preference period. Other courts have relied on the average days to pay prior to the preference period to determine which alleged preference payments satisfy the subjective ordinary course of business defense.

ii. Note that the ability to assert the subjective part of the "ordinary course of business" defense may be diminished due to actions taken shortly before or during the preference period, such as: reduced terms, change in the mode of payment (i.e., regular check to wire transfer), change in the mode of delivery (i.e., regular mail to overnight courier), collection actions (i.e., threats to cut off deliveries or pull advertising), and other forms of payment pressure.

iii. A creditor can prove ordinary business terms by using industry data from sources, such as Credit Research Foundation, industry credit groups and other comparable data for the creditor's and debtor's industries, to show that the preference payment terms and the timing of payment were consistent with the range of terms and days outstanding in the applicable industry.

**c.** Unpaid "administrative expense" claims:

i. Assess whether you may have any unpaid administrative expense claims for goods and/or services provided after the bankruptcy filing.

ii. Though most courts do not treat unpaid administrative expense claims as part of a creditor's new value defenses, unpaid administrative expenses can be asserted as an affirmative defense and counterclaim to reduce preference liability. Note that a debtor in possession or trustee will likely oppose the assertion of time-barred administrative expenses that were not timely asserted prior to an administrative claims bar date.

**5. Before the plaintiff commences a lawsuit:** Consult an attorney and communicate your potential defenses to the plaintiff. Note that if the demand letter was served close to the expiration of the statute of limitations, there may not be sufficient time to have meaningful settlement negotiations.

**6. Answering a Summons and Complaint:**

**a.** Determine the deadline to answer the complaint (the deadline is usually approximately 30 days from the date of the summons).

**b.** Seek an extension of the answer deadline in order to try to resolve the lawsuit or, if necessary, prepare the answer.

**c.** Immediately consult and refer to legal counsel if you are unable to obtain an extension of the answer deadline or if a default judgment has been entered. Note that a corporation must retain outside counsel before filing an answer and other pleadings with the bankruptcy court.

**d.** To the extent not previously requested, seek information regarding the alleged preference payments (such as a list of the alleged payments and copies of cancelled checks, wire, or other payment information, etc.).

**e.** Make sure to keep track of any discovery requests and deadlines. Immediately consult and refer to counsel if unable to obtain extensions of discovery deadlines.

**7. Documenting a settlement:**

**a.** Enter into a formal settlement agreement with the guidance of counsel.

**b.** Make sure the settlement agreement provides for a general release in favor of the creditor or, at least, waives all preference and other avoidance claims.

**c.** Do not ignore the value of the creditor's right, under section 502(h) of the Bankruptcy Code, to file an unsecured proof of claim for the settlement amount. Such a claim could reduce the amount of any settlement payment or provide a later recovery that effectively reduces the settlement amount.

## Conclusion

It is absolutely critical for trade creditors to be prepared to address and respond to potential preference claims that could be asserted following a customer's bankruptcy filing. The information and checklist provided above are a great start for doing so. However, in the event a trade creditor receives a demand letter or a preference complaint, the creditor should also consult an attorney to assist in the defense of the claim and thereby help navigate the choppy waters underlying preference risk.