A TRADE CREDITOR'S GUIDE TO PREFERENCE CLAIMS ©

Steven L. Crane - Goldfarb Sturman & Averbach

When one of your customers files a bankruptcy petition, you may face a problem even worse than seeing your account receivables diminish in value to pennies on the dollar. You may be sued by the debtor or the bankruptcy trustee in a "preference" action to recover payments made by your customer in the ninety days before the filing of the bankruptcy.

The following explains the basics of how a trade creditor should respond to a preference claim, including:

- Defenses available to the trade creditor who received payment from a bankruptcy debtor for unsecured trade debt preceding the bankruptcy;
- The 2005 revisions to the Bankruptcy Code that have made it easier to successfully defending a preference claim in some cases;
- How to respond to a preference demand by a debtor or bankruptcy trustee;
- The steps you can take to improve your chances of successfully defending a preference claim before a demand is made; and
- Policies to consider putting in place when dealing with customers who are falling behind in account payments to minimize your exposure to preference claims.

What is a preference?

A payment or a transfer is a preference if all of the following five criteria apply:

- There was a transfer (typically, a payment) to a creditor;
- Made within the ninety days preceding the filing of the bankruptcy (within one year if the transfer is to an 'insider' of the debtor)[1];
- Made on account of an obligation that pre-exists the transfer;
- Made while the debtor was insolvent; and
- The transfer enables the creditor to receive more than the creditor would receive in a chapter 7 liquidation of the debtor.

Under this definition, almost any payment received from a debtor in the ninety days preceding the filing of the debtor's bankruptcy, on an account for goods sold or services provided to the debtor, will be a preference. The payment on a trade account within the ninety day preference period will satisfy the first three elements of the definition of a preference. The Bankruptcy Code presumes that a debtor is insolvent in the ninety days preceding the bankruptcy. It is a rare bankruptcy case in which the debtor was solvent in the ninety days preceding the bankruptcy. Finally, a typical bankruptcy liquidation returns

[1] "Insider" includes persons with a close relationship to the debtor, such as partners, relatives, and others described in Bankruptcy Code Sec. 101(30).

little to creditors.

Why Preference Claims are Infuriating to Creditors

The purpose for allowing preference claims by debtors and bankruptcy trustees is supposedly to promote “fairness” and equal distribution to creditors by preventing a debtor from favoring one creditor over another. The idea being that those creditors, who are preferred by the debtor or creditors who are better at exacting money from the debtor, should not be put in a better position than other creditors in the period preceding the bankruptcy filing.

A preference claim, however, will never look “fair” to a trade creditor. All the creditor did to subject itself to a preference claim was to accept payment to which the creditor was entitled for goods or services provided to the debtor.

Perhaps, the single most infuriating aspect of preference actions is that a creditor is not allowed to offset the debtor’s obligations to the creditor for goods sold or services delivered prior to the preferential payments against the preference claims. The Bankruptcy Code gives the creditor no recourse on the prior obligations of the debtor to the creditor except to file a general unsecured claim in the debtor’s bankruptcy. It is not unusual for a creditor, who may have been owed ten of thousands of dollars by the debtor, to end-up paying thousands of dollars in settling or answering for judgment in a preference action, and ultimately receiving no payment on the creditor’s own unsecured claim.

Available Defenses to Preference Claims for Payments on Unsecured Debt

An unsecured trade creditor typically has three potential defenses to a claim by a debtor or trustee that a payment made by a debtor on account of unsecured trade debt should be avoided as preferential:

> (1) Contemporaneous Exchange -- When the payment was made as part of a contemporaneous exchange for new value;
>
> (2) Ordinary Course -- When the payment was made and incurred in the ordinary course of the business of the debtor and the transferee; or made according to ordinary business terms; and
>
> (3) New Value -- When the creditor provided goods or services after the preferential payment and before the filing of the bankruptcy for which the creditor was not paid.

The following explains the application of the three common defenses and some of the problems in proving the defenses, which relate to actions you can take to minimize the risk of being liable for a preference claim, and steps you can take upon learning that one of your customers has filed bankruptcy to improve your chances of successfully defending a preference claim if one is later brought.

Contemporaneous Exchange for New Value

Section 547 (c)(1) of the Bankruptcy Code states:

"The trustee may not avoid under this section a transfer –
(1) to the extent such transfer was –
(A) intended by the debtor and creditor...to be a contemporaneous exchange for new value given to the debtor; and
(B) in fact a substantially contemporaneous exchange..."

To prevail on this defense, it is not enough for the creditor to show that the creditor provided goods or services at a time close to the date that the debtor made a payment to the creditor. The creditor must show there was a direct relationship between the delivery of the goods or services and the particular payment by the debtor, in which the debtor and the creditor intended that there be a contemporaneous exchange of goods or services for the payment by the debtor.

In a typical trade credit setting, the contemporaneous exchange for new value defense is only available in two circumstances: (1) when delivery of goods or services was paid C.O.D.; or (2) when there was a specific agreement between the creditor and the debtor that a particular new shipment would not be sent unless payment had been made on prior obligations, and the shipment of new goods is not in fact sent until the payment is received.

The easiest way to limit preference exposure, when confronted with a slow paying customer, who may be in financial difficulty, is to require the customer to pay C.O.D. for further shipments of goods. C.O.D. payments will always be recognized as a contemporaneous exchange for new value.

Alternatively, the trade creditor can enter into a specific agreement with the debtor that payment be made on prior obligations before further goods are delivered or services provided, and the goods or services are then delivered or provided at the same time or shortly following the receipt of the payment. Such an agreement need not be technical or formal but it should be in writing and confirmed by the debtor. Note, however, that the defense only applies to the actual value of the goods or services provided as part of the contemporaneous exchange. If the debtor pays you $10,000 on old invoices, but you only provide goods or services with a value of $5,000, then the contemporaneous exchange defense only negates $5,000 of the preference claim. As a final caveat, the bankruptcy courts in some parts of the country will not recognize any delivery of goods or services, which are intended to be subsequently invoiced, as a contemporaneous exchange.

Ordinary Course of Business

Section 547 (c)(2) of the Bankruptcy Code states:

"The trustee may not avoid a transfer under this section

> (2) to the extent that such 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 –
>
> (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; **or**
>
> (B) made according to ordinary business terms."

That emphasized "or" is a significant change in the 2005 revisions to the Bankruptcy Code. Prior to the 2005 revisions, a creditor that asserted an ordinary course of business defense was required to prove that the payment was made in the ordinary course of business of the debtor and the creditor, *and* made according to ordinary business terms. The creditor can now prevail by showing that either alternative applies.

The availability of the ordinary course of business defense involves a fact dependent analysis that will vary between different businesses and industries, depending on prevailing trade credit practices.

Establishing the first element of the "ordinary course" defense - - that the payment was for a debt incurred, and that the payment made, in the "ordinary course of the business of the debtor and transferee" - - depends upon business practices of the debtor and the involved creditor. The issues are whether the credit and other terms for the transactions were consistent with debtor's and the creditor's dealings with each other and with others.

Then, the creditor must also prove either that the payment was made in conformity with the ordinary course of the debtor's and creditor's businesses, or that it was made according to ordinary business terms. Thus, the creditor can establish the defense by showing that payment was consistent with the creditor's dealings with its other customers and the creditor's prior dealings with the debtor. For example, payments made 60 to 90 days after invoice on net 30 day terms, may still be considered in the ordinary course so long as the debtor generally paid similar creditors 60 to 90 days from similar invoices; the creditor generally invoiced for, and received payment from its other customers on like terms; and this practice was consistent with the dealings between the debtor and the creditor.

Alternatively, the creditor can prevail by establishing that the terms of the payment were in accordance with "ordinary business terms." This means that the payment was consistent with the trade credit practices of both the debtor's and the creditor's respective industries. "Ordinary business terms" include terms that are ordinary for businesses in financial distress. A transaction will be considered ordinary so long as the transaction is not so unusual or uncommon as to make the transaction an aberration in the relevant industry.

In bankruptcy court, proof of what is ordinary in the creditor's and the debtor's industries frequently requires expert testimony. Expert testimony is normally required because even an owner or manager of a business with a long experience in an industry may not be able to testify from his own personal knowledge as to the practices of others in his industry.

New Value

Section 547 (c)(4) of the Bankruptcy Code states:

"The trustee may not avoid under this section a transfer–

> (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor--
> (A) not secured by an otherwise unavoidable security interest; and
>
> (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor."

A creditor that provides goods or services to a debtor, after the date of a preferential payment and before the filing of the bankruptcy, is entitled to an offsetting credit for the value of the goods or services provided on account of this "new value."

The new value defense, when applicable, is typically the easiest of the defenses to a preference for a creditor to prove at trial. A creditor can often establish a new value defense from its own accounting and transaction records. For preference purposes, a payment on a trade debt is considered "made" when the payment is deposited in the creditor's account, and new value is considered "given" when the goods are received by, or services are provided to the debtor. As a result, the creditor's own bank and sale transaction records are often sufficient to establish a new value defense.

When there is a complete or partial new value defense shown by business records, it is often possible to convince the debtor or bankruptcy trustee to drop the preference claim or to negotiate a favorable settlement.

What to do When your Customer Files Bankruptcy

When a customer files bankruptcy you should receive a "Notice of Bankruptcy Case, Meeting of Creditors & Deadlines" within five to ten days from the date the bankruptcy is filed.[2] The notice will tell you when the bankruptcy was filed, the date set for meeting of creditors and the examination of the debtor, and the date by which claims against the bankruptcy estate must be filed.

If you don't receive this notice, it probably means that your customer did not list your business as one the customer's creditors.

No matter how you learn of the bankruptcy filing, and whether or not you have a claim against the bankruptcy estate, you should immediately review your records to assess

[2] The notice will generally include a proof of claim form that can be used to file a claim in the bankruptcy case if you are owed money by the debtor for goods sold or services provided prior to the bankruptcy filing. Matters related to how and when to file a proof of claim are not addressed in this memo.

whether you received payment from the debtor in the ninety-day period preceding the date the bankruptcy was filed, and therefore whether you may be the target of a preference claim. If you determine that you received a substantial amount of payments from the debtor in the ninety days preceding the bankruptcy, you should consider consulting an attorney even before a demand is made or a complaint is filed.

If you received payments from the debtor in the ninety days preceding the bankruptcy, you should assemble and preserve the business records that may be used to establish one or more of the preference defenses. Preference claims may be filed as late as two years after the bankruptcy was filed.

To establish a preference claim, the debtor or bankruptcy trustee only has to prove that a payment was made on account of a prior obligation of the debtor in the ninety days preceding the bankruptcy. The trade creditor has the more difficult burden of proving that one or more of the preference defenses apply. Delay in assembling the records can result in loss of the evidence that will be needed if a preference action is subsequently filed against you.

Account records, which show invoice and payment dates, together with actual copies of the invoices and of contracts, if available, should be assembled going back at least one, and preferably two years or more before the date of the bankruptcy. These records will be needed to establish an "ordinary course" defense if it is otherwise applicable.

If shipments were made, or services were provided to the debtor, after the first payment received by you in the ninety days preceding the bankruptcy filing, it is imperative to assemble and preserve the records necessary to establish a "new value" defense. In addition to account, invoice and payment records, all records related to shipment of goods to the debtor in the ninety days preceding the bankruptcy filing, such as bills of lading and other receipts, should be assembled and preserved.

If goods or services were provided on a C.O.D. basis, then records showing the terms of the transaction and the date that the goods or services were provided should be assembled and maintained. Written evidence of any arrangement requiring payment before further goods or services were provided should also be preserved.

How to Respond to a Preference Demand or Complaint

In most cases, you will receive a demand from the debtor or bankruptcy trustee before a preference claim is filed. However, the debtor or trustee is not required to make a demand before filing an adversary action to recover a preference. Your first notice of a preference claim may be from receipt of a complaint in the mail. In bankruptcy, a complaint does not have to be personally served, and the complaint can be served by first class U.S. Mail. If a complaint is served by mail, you may have as little as 23 days from the date of mailing to answer the complaint.

The trade creditor is usually better-off using a demand as an opportunity to communicate with the debtor's or bankruptcy trustee's attorneys instead of waiting for a preference complaint to arrive in the mail. Retaining an attorney upon receipt of the demand, rather than after an action is filed, is likely to result in savings in legal fees and costs. This is a function of the fact that the vast majority of preference claims settle well before trial because the merits of preference claims and available defenses can usually be assessed based on review of readily available business records. Disputes, such as preference claims, in which both parties understand the basic facts and in which the applicable law is clear, are ripe for early settlement.[3] There are likely to be significant savings if a settlement or even a dismissal can be negotiated before you are required to file an answer to a complaint.

Even in large chapter 11 reorganization cases, where hundreds of preference claims may be filed shortly before the expiration of two year statute of limitations period, prompt communication with attorneys for the debtor or bankruptcy trustee will facilitate obtaining extensions of time to respond to the complaint to allow negotiation before being compelled to defend a preference claim.

When a trade creditor is liable for any portion of a preference claim, a negotiated settlement will almost always produce a better result than going to trial. There are substantial incentives for a trade creditor to seek a negotiated resolution of a preference claim. With rare exception, the debtor or bankruptcy trustee will be willing to settle for less than the debtor could recover at trial. The trade creditor must also consider that if the case goes to judgment, the debtor will also recover interest on the claim, and the trade creditor will have expended money on attorney's fees that can never be recouped. The debtor or trustee also has a strong incentive to settle at a discount. Attorney fees incurred in pursuing a preference claim cannot be recovered by the debtor or trustee. Settlement avoids the debtor's or trustee's risks of collection. Obtaining immediate cash is often a paramount concern to debtors and especially to bankruptcy trustees and their attorneys. Bankruptcy estates are frequently 'cash-starved,' which means that funds to pay the trustee and attorneys who are prosecuting the preference actions may only be available from preference claim collections.

If a prompt settlement cannot be achieved, an answer must be timely filed.

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[3] In a case where the trade creditor has a potential ordinary course of business defense, there may be less certainty concerning the likely outcome of the preference action, which will add some wrinkles to negotiation, but which will not preclude settlement.