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Tactics for Defending Preference Actions

Part One of a Two-Part Article

By Ted A. Berkowitz and Aaron S. Halpern

In a troubled business climate, a scenario all too often occurs wherein a once steady and reliable customer becomes delinquent in payment and eventually files for bankruptcy protection. In this common situation, your client's good customer becomes a debtor and your client becomes one of many creditors jockeying to recover a small portion of its investment. To make matters worse, your client receives a letter from the debtor or court appointed trustee demanding repayment of a pre-petition preferential payment pursuant to section 547(b) of the Bankruptcy Code (the Code).

Whenever a creditor receives a benefit from a debtor shortly before the debtor files for bankruptcy, whether the payment of money or the granting of additional security, a preferential transfer may occur. Significantly, the bankruptcy law entitles a debtor's estate to recover preferential transfers, including payments on account of antecedent debts made during the 90-day period prior to the bankruptcy petition. In other words, section 547(b) of the Code permits a trustee to avoid pre-bankruptcy transfers as "preferences." In order for a preferential transfer to exist, a trustee of a debtor's estate must establish seven elements: 1) a transfer, 2) of an interest of the debtor in property, 3) to or for the benefit of a creditor, 4) for or on account of an antecedent debt, 5) made while the debtor was insolvent, 6) made within 90 days before bankruptcy, 7) the effect of which is to give the creditor more than it would receive in the bankruptcy proceeding. Unless the trustee proves each and every element, a transfer is not avoidable as a preference under 547(b). Conversely, a trustee's establishment of all of the elements of a preferential transfer by a preponderance of the evidence, results in the recover ability of the payment for the benefit of the bankruptcy estate.

While serving a threefold purpose of facilitating equality of distribution amongst creditors, allowing a debtor an opportunity to work out of financial difficulty and helping to fund the trustee's activity, a preferential transfer action may have a devastating effect on the finances of a cre itor. In particular, recoveries from a preference action are often treated as unencumbered assets. As such, creditors that may be subject to preference actions have a vested interest in vigorously defending such actions. To that end, this article will focus on the methods and strategies of defending and perhaps pre-empting a preference action.

When faced with a pending preference action, a defendant-creditor must engage in a coordinated and aggressive strategy toward reducing or even negating the defendant's exposure to what may appear to be a preferential transfer. As such, in attaining the goal of minimizing the defendant's exposure to avoidable transfers, the defense theory must be compelling enough to litigate or at least provide a vehicle for settlement.

DISPUTING PLAINTIFF'S *PRIMA FACIE* CASE

As a threshold matter, it is important for the defendant not to overlook the actual elements necessary for a plaintiff's *prima facie* showing of a preferential transfer. Therefore, before examinior defenses to a preferential transfer action, it is

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important to briefly delve into common issues raised by the defense regarding the elements of plaintiff's case.

Plaintiff's first hurdle is showing that there was in fact a transfer. Although "transfer" has been broadly defined in section 101 of the Code as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property," transfer of property does not include any appreciation in the value of collateral. This may be applicable in the case of a creditor's floating lien on a debtor's inventory if the collateral appreciates in value during the 90-day period preceding the bankruptcy petition.

Another important method for a creditor to avoid the ambit of transfer is by the use of setoff. It is well settled that a valid setoff is not avoidable as a preference. Therefore, the act of setoff, which involves the cancellation of mutual debts, is not considered a transfer under the code and any monies or properties that have been paid by debtor as setoff during the relevant period preceding a bankruptcy petition are not subject to any preferential transfer action.

Another limitation of transfer that a creditor may use in its defense is that a transfer is considered preferential only when the property actually belongs to the debtor. Specifically, the Supreme Court has noted that property belongs to a debtor when "that property … would have been part of the estate had it not been transferred before the commencement of the bankruptcy proceeding." *Begier v. IRS,* 496 U.S. 58 (1990). Therefore, the fundamental question is whether the transfer diminished the debtor's estate. As such, payments made by an indorser or guarantor will not be considered preferential if they were not made by the debtor him/her/itself, such as the case where an individual officer of a debtor corporation as guarantor makes payment of an obligation from personal funds. Similarly, the "earmarking doctrine," whereby a third person makes a loan to a debtor for the purpose of enabling the debtor to satisfy the claim of a designated creditor, the funds provided to the debtor are not recoverable as a preference from the creditor since the proceeds never became part of the debtor's assets. In this last example, it is important to note that a payment by a debtor from proceeds of a lender may be considered a preference if the loan did not designate the specific creditor who actually received payment.

Another important element for defense to focus on is whether the transfer by debtor was "for or on account of an antecedent debt," that is a debt incurred by the debtor prior to the transfer. The mere exchange or substitution of property or collateral during the 90-day preferential period does not, in and of itself, constitute a preferential transfer, unless the pleadings of the preferential action are sufficiently detailed and specific to "give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests." *Conley v Gibson,* 355 U.S. 41, 47 (1957). To that end, courts may dismiss a complaint for failing to state a claim when the debtor's pleadings do not properly identify the nature and amount of each antecedent debt or fail to properly identify each alleged preference transfer with regard to the date, name of debtor, name of transferee and the amount of the transfer. *See, e.g., Valley Media, Inc. v. Borders, Inc.,* 288 B.R. 189 (Bankr. D. Del. 2003).

Similarly, in many cases involving collateral exchange, the critical issue is when the transfer was perfected, and thus, when the transfer was deemed "made" pursuant to section 547 (e) of the Code. In particular, section 547 (e) provides that "a transfer is made" at the time the transfer is actually made, if the transfer is perfected at once or within the statutory grace period. However, for the purpose of section 547, an untimely perfected transfer will be deemed "made" on the date of the filing of the petition, and therefore will be considered an avoidable preference. As such, a good way for a secured lender to avoid preference obligations is to arrange for the timely perfection of their security interests.

Yet another important element for defendant to delve into in its defense of a preference action is whether the debtor was insolvent at the time of the transfer. Under section 547 (f), there is the rebuttable presumption that plaintiff was insolvent during the 90-day period prior to the bankruptcy petition. To that end, a creditor's mere denial of insolvency in its answer is insufficient to rebut the presumptions. Therefore, defendant initially bears the burden of production to produce evidence that shows solvency. Once defendant produces such evidence, the burden shifts to the plaintiff-debtor in that plaintiff has the burden of persuasion of proving insolvency, a substantially higher burden than defendant's. Importantly, although aided by a rebuttable presumption of insolvency, the burden of proof on the issue of insolvency always rests with the trustee. As such, courts may not always require a defendant to produce evidence that directly shows solvency. Specifically, while speculative or opinion testimony will be insufficient, some courts have found that a defendant may satisfy its burden of showing solvency by merely offering a financial statement showing positive net worth. *See, e.g., Jones Truck Lines, Inc. v. Full Service Leasing Corp.,* 83 F. 3d 253, 258 (8th Cir. 1996).

Therefore, the definition of "insolvent" is necessary to determine what evidence a defendant must produce to rebut the presumption of insolvency. As such, under section 101 (32) of the Code, a defendant generally must produce evidence which shows that, on the date of the transfer, debtor's assets, at fair valuation, exceeded its debts. Critical in this analysis is the valuation standard employed, for example, going-concern valuation often favors the defendant in a preference action as opposed to an item-by-item fair market valuation. However, no matter which method of valuation is employed, the relevant valuation date is the date of the transfer in question.

In addition, the effect of the transfer on the creditor's position relative to that which the creditor would have received under the bankruptcy distribution is a central element that a defendant may contest. In particular, "a creditor need not return a sum received from the debtor prior to bankruptcy if the creditor is no better off vis-à-vis the other creditors of the bankruptcy estate than he or she would have been had the creditor waited for liquidation and distribution of the assets of the estate." S*mith v. Creative Financial Management, Inc.,* 954 F. 2d 193, 198-99 (4th Cir. 1992). Therefore, a creditor is entitled to receive the value of the transfer plus any additional amount that it would be entitled to receive from the bankruptcy distribution. In such a circumstance, a creditor may in fact receive more than he would have received in liquidation had the transfer not been made.

Moreover, the trustee bears the burden of proving that the creditor was advantaged by the transfer. In particular, a trustee seeking to avoid a transfer as preferential has the burden of proving that the effect of the transfer was to enable creditor to obtain a greater percentage of its debt that it would have obtained under a Chapter 7 liquidations.

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Preferential Transfers

Tactics for Defending Preference Actions

Part Two of a Two-Part Article

By Ted A. Berkowitz and Aaron S. Halpern

Last month, we explained that when a once steady and reliable customer becomes delinquent in payment and eventually files for bankruptcy protection, your client becomes one of many creditors trying to recover a portion of its investment. We explained how, whenever a creditor receives a benefit from a debtor shortly before the debtor files for bankruptcy, a preferential transfer may occur. And we showed how section 547(b) of the Bankruptcy Code permits a trustee to avoid pre-bankruptcy transfers as "preferences."

The first tactic we discussed for defending such preference actions was to dispute plaintiff's *prima facie* case. In this month's installment, we discuss preference avoidance by statutory exception, and the availability of a jury trial.

Preference Avoidance By Statutory Exception

Notwithstanding the debtor's

satisfying the preference elements, a defendant in a preference action may assert individually or in tandem eight exceptions enumerated in section 547 (c) of the Bankruptcy Code. Specifically, a transfer which satisfies the elements of section 547(b) may be avoided if 1) there was a substantially contemporaneous exchange for new value; 2) the transfer represented a payment in the ordinary course of business; 3) the transfer was a purchase money security interest; 4) the creditor gave new value after the transfer; 5) the transfer resulted from a security interest in inventory or receivables, thereby creating a floating lien, and there was no "improvement in position" of the creditor during the preference period; 6) the transfer involved the fixing of a statutory lien not avoidable under section 545; 7) the transfer was a payment for alimony, maintenance or support; or 8) the transfer was consumer related and was less than $600.

Of the eight exceptions of 547(c), two of the most commonly asserted defenses are the ordinary course of business and the subsequent new value defenses. These two defenses, which are mutually exclusive, essentially forward the same objectives underlying the purpose of a preference transfer to the extent that these defenses help alleviate a debtors downward slide into bankruptcy by encouraging creditors to continue short-term credit dealings with the financially troubled debtor.

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Section 547 (c)(2) of the Bankruptcy Code outlines the payment in the ordinary course of business defense to an otherwise avoidable preferential transfer. In order to be protected by this exception, a creditor/transferee must show that: 1) 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 creditor; 2) the transfer was made in the ordinary course of business between the debtor and creditor; and 3) the transfer was made in accordance with ordinary business terms. The purpose of this exception it to protect recurring customary credit transactions which occur during the ordinary course of business between the debtor and the creditor/transferee. It should be noted that the 1984 amendment to the Code, which eliminated the 45-day rule requiring payment within 45 days after the debt was incurred, affords creditors greater protection since payments on long-term debts may now qualify under this exception.

Common Defenses

In order to be successful under the ordinary course of business defense, defendants typically bifurcate the analysis by addressing the ordinary course of dealing between the parties and the industry norm. First, the record must reflect that there was nothing "unusual" about the subject transactions underlying the preferential payment in relation to prior course of dealing between the parties. In other words, an important factor will be the extent that the transaction between the debtor and creditor, both before and during the preferential period, were consistent. In making this determination, courts will examine the duration that the parties were engaged in the transaction in issue, whether the amount or form of payment differed from past practices, the customary collection and payment practice between parties, and the circumstances under which the subject payment was made.

Second, a defendant must show that the subject payment was ordinary in relation to the industry of the debtor and creditor. To that end, courts often afford a defendant-creditor some latitude and flexibility in defining what the relevant industry is, in light of the inherent difficulty in precisely and objectively identifying an industry and its ordinary practice. Moreover, the degree of compliance with industry standards that a court will require often depends on the duration and nature of the relationship between the parties. In particular, the Third Circuit noted that "when the parties have had an enduring, steady relationship, one whose terms have not significantly changed during the pre-petition insolvency period, the creditor will be able to depart substantially from the range of terms established under the objective industry standard." *Fiber Lite Corp. v. Molded Acoustical Prods., Inc.*, 18 F. 3d 217, 226 (3d Cir. 1994).

The other commonly asserted defense, the subsequent new value defense, protects the creditor that made further extensions of credit in reliance on past payments. This defense is grounded in the principle that the transfer of new value to a debtor will offset payments, and therefore debtor's estate will not be depleted to the detriment of other creditors. In order to satisfy the subsequent new value defense, a defendant-creditor must show: 1) receipt of a preference payment by the creditor (*ie*, preferential transfer); 2) after receiving the preference payment, the creditor advances additional unsecured credit to the debtor; and 3) the additional unsecured credit is unpaid in whole or in part on the petition date.

Significantly, the new value defense protects transfers only up to the value of the contemporaneously exchanged new value. Moreover, for the purpose of this exception the specific valuation is determined as of the date of the alleged preferential transfer, which generally occurs at the time payment is received by the creditor.

Importantly, "contemporaneous" as referenced in the new value exception of the Code is not textually defined. To that end, a creditor may successfully assert the new value exception even where a creditor receives a preferential payment after it forwards new value. For example, in *In re Coco,* the court held that a Chapter 7 debtor tenant's rent payments, which were as much as 7 days late, were substantially contemporaneous exchanges for new value, and therefore a trustee could not avoid such payments as preferences. 67 B.R. 365 (Bankr. S.D.N.Y. 1986). In fact, certain courts have held that a 7-day delay is presumptively contemporaneous. *In re Mason,* 189 B.R. 932 (Bankr. N.D.Iowa 1995).

Accepting Setoffs

In addition, a creditor may avoid a preferential transfer under the new value exception by accepting setoffs. In particular, setoffs taken by a creditor against debts owed by a debtor are generally protected under the Code and are not preferential. *See, e.g., In re Jet Florida Systems, Inc.,* 59 B.R. 886 (Bankr. S.D.fla. 1986).

However, creditors should be aware that installment loan contracts, whereby a debtor initially receives full consideration and is obligated for the full amount, are not considered contemporaneous exchanges for new value, and therefore not within the purview of the new value exception. Similarly, credit extensions and interest payments are not encompassed within the new value exception to the extent that they are not considered contemporaneous exchanges for new value.

Settlement Agreements

One interesting facet of preferential transfer avoidance for a creditor to consider involves settlement agreements between a debtor and creditor as related to the new value or the ordinary course of business exceptions. As a preliminary matter, settlement payment agreements that satisfy the seven elements of section 547(b) of the Code may be considered an avoidable preferential transfer unless an exception applies. *See, e.g., Matter of American Securities and Loan, Inc.,* 78 B.R.930 (Bankr. S.D. Iowa 1987). To that end, a debtor's payment to a creditor in accordance with a settlement agreement is generally not considered a payment made in the ordinary course of business, and thus a debtor could recover such a payment as preference. *See, e.g., In re Durant's Rental Center, Inc.,* 116 B.R. 362 (Bankr. D. Conn. 1990). However, the effect of a pre-petition settlement on the "new value" exception is analyzed on a case-by-case basis. Significantly, a payment pursuant to a settlement may be considered new value to the extent that a debtor's freedom from the risk of litigation in connection with debt owed to a creditor may be considered "new value." *See, e.g., Lewis v. Diethorn,* 893 F. 2d 648 (3rd Cir. 1990), *cert. denied,* 111 S.Ct. 369. Conversely, a reduction of creditor's claims against a debtor in exchange for debtor's payments during the preference period in connection with a settlement agreement will likely not constitute "new value", and thus is an avoidable preferential payment. *e.g., In re Maloney-Crawford, Inc.* 144 B.R. 531 (N.D. Okl. 1992). Thus, the effect of a settlement agreement on the avoidance of a preference transfer often becomes an issue of fact.

Jury Trial

Aside from disputing the debtor's *prima facie* case and asserting various statutory defenses, a defendant-creditor may move to withdraw the reference of the preference action so that the matter may be heard in district court before a jury. Notwithstanding the substantive difficulties of surviving such a motion to withdraw to district court, which includes the requisite showing of the applicability of federal law aside from bankruptcy law, a defendant-creditor may want to reserve this option as a strategic last resort. Specifically, trying the matter before a jury will likely add litigation expense, and the district judge may be less than interested in a matter that is essentially bankruptcy related. On the other hand, a defendant-creditor may view the transfer of a preference action to district court as a way of avoiding a decision by a bankruptcy judge when the judge appears skeptical of the defendant's defenses or position.