Preference Action Primer: Understanding Section 547 Avoidance Actions

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Introduction

It usually begins with a letter demanding the return of payments received by a creditor months or even years ago. Virtually every creditor perceives this letter as outrageous and unfair. This dreaded letter is one alleging a claim for recovery of preferential transfers pursuant to section 547 of the Bankruptcy Code.

The Bankruptcy Code allows a trustee or debtor-in-possession to recover payments made within 90 days of a bankruptcy filing (or longer with respect to "insiders" of the debtor) to the extent that such payments provided the creditor with an advantage in the bankruptcy case vis-à-vis other creditors. As many bankruptcy and insolvency professionals have experienced firsthand, preference claims are viewed with particular disdain by trade creditors, many of whom are still owed money by the debtor. Nonetheless, preference actions further a fundamental purpose under the Bankruptcy Code—ensuring a ratable distribution of assets among creditors.

While the number of preference targets in a given case can vary from just a few to several hundred, understanding the elements of a preference claim and the available defenses is critical when faced with a trustee's demand for return of alleged preferential transfers.

Elements

Preference actions allow a trustee or debtor-in-possession to recover payments received by a creditor during the period immediately preceding the bankruptcy filing. The below overview summarizes the key points to remember regarding establishing the *prima facie* elements of a preference claim:

(i) *a transfer*;
For purposes of a preference action, a "transfer" is broadly defined pursuant to section 101 of the Bankruptcy Code. Transfers most commonly include monetary payments, but can also include non-monetary acts such as the recordation of a deed of trust or the perfection of a security interest.

(ii) *of an 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 Bankruptcy Code fails to define this term, this requirement has been found to be synonymous with the definition of "property of the estate" provided in section 541 of the Bankruptcy 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.

(iii) *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 section 101 of the Bankruptcy Code.

(iv) *for or on account of an antecedent debt;*
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 prior to the allegedly preferential transfer.

(v) *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.

(vi) *made within 90 days or one year, in the case of an insider; and*

The preferential transfer must have been made within 90 days prior to the filing of the bankruptcy petition, or between 90 days and one year before the date of filing if the creditor is an insider of the debtor. While the Bankruptcy Code provides examples of parties that can be considered insiders, the list is not exhaustive and a determination of a party's alleged insider status is often left to the court.

(vii) *resulted in the creditor receiving a greater distribution than it otherwise would have in a hypothetical chapter 7 distribution.*

Pursuant to section 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:

(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) 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.

It is important to remember that the trustee bears the burden of proof on all elements of a preference claim. In most courts, the burden of proof requires the trustee to establish his *prima facie* case by a preponderance of the evidence.

Procedure

The assertion of a preference claim often begins with a demand letter from the trustee or debtor-in-possession. In some large cases, demands may be issued to virtually all creditors who received payments from the debtor within 90 days of the petition date. While many preference claims are settled without the necessity of formal litigation, to the extent that a lawsuit is necessary, the assertion of a preference claim must proceed by commencement of an adversary proceeding complaint (not by motion), which affords the defendant additional procedural protections and the opportunity for formal discovery proceedings in advance of trial.

Pursuant to section 546 of the Bankruptcy Code, preference actions must be commenced within two years prior to the petition date, or one year after appointment or election of the first trustee. While many trustees wait to file such actions until the eve of the statute of limitations, in complex cases, the trustee might stagger the filings. In such a case, defendants sued near the end of the pack will need to prepare a litigation strategy that takes into account the court's rulings in the earlier round of preference actions. In particular, issues relating to the debtor's insolvency may impact the strength of the trustee's claim and the extent to which the defendant may be able to minimize or escape liability.

Insider Preferences

Special rules apply to transfers made to "insiders" of the debtor. 11 U.S.C. § 547(b)(4)(B). For purposes of a preference action, an "insider" is defined by section 101(31) of the Bankruptcy Code and includes, for example, relatives of an individual debtor and the officers and directors of a corporate debtor. It is important to note that the list of insiders enumerated in section 101(31) of the Bankruptcy Code is not exclusive and courts often designate

additional entities as insiders under a particular set of facts. *See, e.g.*, *In re Longview Aluminum Co.*, LLC, 657 F.3d 507, 510 (7th Cir. 2011)(finding minority member of limited liability company who held both voting rights and a formal position on the board was an insider). Pursuant to the rationale that certain relationships warrant closer scrutiny (as compared to an arms' length transaction), transfers made to insiders are subject to avoidance for one year prior to the petition date. Note that there is no presumption of insolvency for payments made more than 90 days before the petition date.

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 various statutory 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. Further, defendants should be aware that the statutory exceptions to preference liability are generally regarded as affirmative defenses that may be deemed waived if not affirmatively pled in a defendant's answer.

Contemporaneous Exchange for New Value

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

(A) 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
(B) 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. 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.

Subsequent New Value

In addition, section 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. The rationale here is that such creditors have conferred a benefit on the bankruptcy estate through the provision of goods and services to a financially troubled company and should thus escape preference liability. In the Fourth Circuit, in order to prove that a transfer should escape recovery by the trustee, a creditor must establish that the new value either remained unpaid or was paid with a transfer that itself is avoidable as a preference. *Hall v. Chrysler Credit Corp., (In re JKJ Chevrolet, Inc.)*, 412 F.3d 545 (4th Cir. 2005).

Ordinary Course

Pursuant to section 547(c)(2) of the Bankruptcy Code, a creditor may also attempt to 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;

(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.

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. However, preference defendants should remember that the court has significant discretion in assessing the viability of this defense, making the outcome of the litigation uncertain and perhaps encouraging settlement.

A decision arising out of the *Circuit City* bankruptcy case exemplifies the myriad issues that can arise in litigation surrounding the ordinary course of business defense. In *Siegel v. Russelville Steel Co., Inc.*, 479 B.R. 703 (Bankr. E.D. Va. 2012), the preference defendant sought to invoke the subjective prong of the ordinary course of business defense (*i.e.*, that the transfer had been made in the ordinary course of business of the parties). At issue was the proper lookback period for purposes of assessing the ordinary course defense. The debtor had paid an average of approximately 33 days after invoice date in the beginning of the relationship. Subsequently, its financial condition deteriorated in November of 2007 (deemed the "liquidity event" by the court) and payments after this time were made an average of 46-47 days after the invoice date. The alleged preferential payments had themselves been made approximately 82-83 days after the invoice date. The defendant argued for a 12-month lookback (petition date was November 10, 2008), while the liquidating trustee argued that the court should consider only payments made prior to the liquidity event when the debtor was financially "healthy" and operating normally. The court agreed with the trustee, finding that the ordinary course of business defense should be evaluated based on the parties' entire course of dealing *preinsolvency*. As this case establishes, preference defenses, although seemingly straightforward, can provide fertile ground for litigation and thus an opportunity for reaching settlements and avoiding protracted litigation.

Finally, to the extent that the creditor seeks to rely on the so-called "objective" prong of the defense, *i.e.*, that the transfer was made "according to ordinary terms," defendants must be aware that the court will often require expert testimony, which can come at a considerable expense to the parties and provide an additional incentive for reaching an amicable resolution and avoiding protracted litigation.

Practice Pointers

In some instances, creditors may be able to take actions prior to bankruptcy that reduce their risk of preference exposure. For example, creditors should be vigilant about watching for signs that a customer is in financial distress. Where financial difficulties are suspected, it may be advisable for the creditor to require immediate payment instead of extending credit to the customer. Once a preference claim has been asserted, it is usually best to respond early to demand letters and provide the trustee or debtor-in-possession with documents and other information supporting a creditor's available defenses (*e.g.*, invoices and payment histories). Preference claims are often resolved consensually and beginning a dialogue early can be of benefit to the creditor.

Conclusion

Though understandably frustrating to preference targets, preference actions promote equality of distribution among creditors—one of the Bankruptcy Code's primary goals. A thorough understanding of the statutory elements and defenses, as interpreted by the courts, is key to the successful defense of a preference claim. An awareness of practical considerations, key strategies and case law developments will ensure that creditors have the necessary tools to avail themselves of the defenses provided by the Bankruptcy Code.

(Endnotes)

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