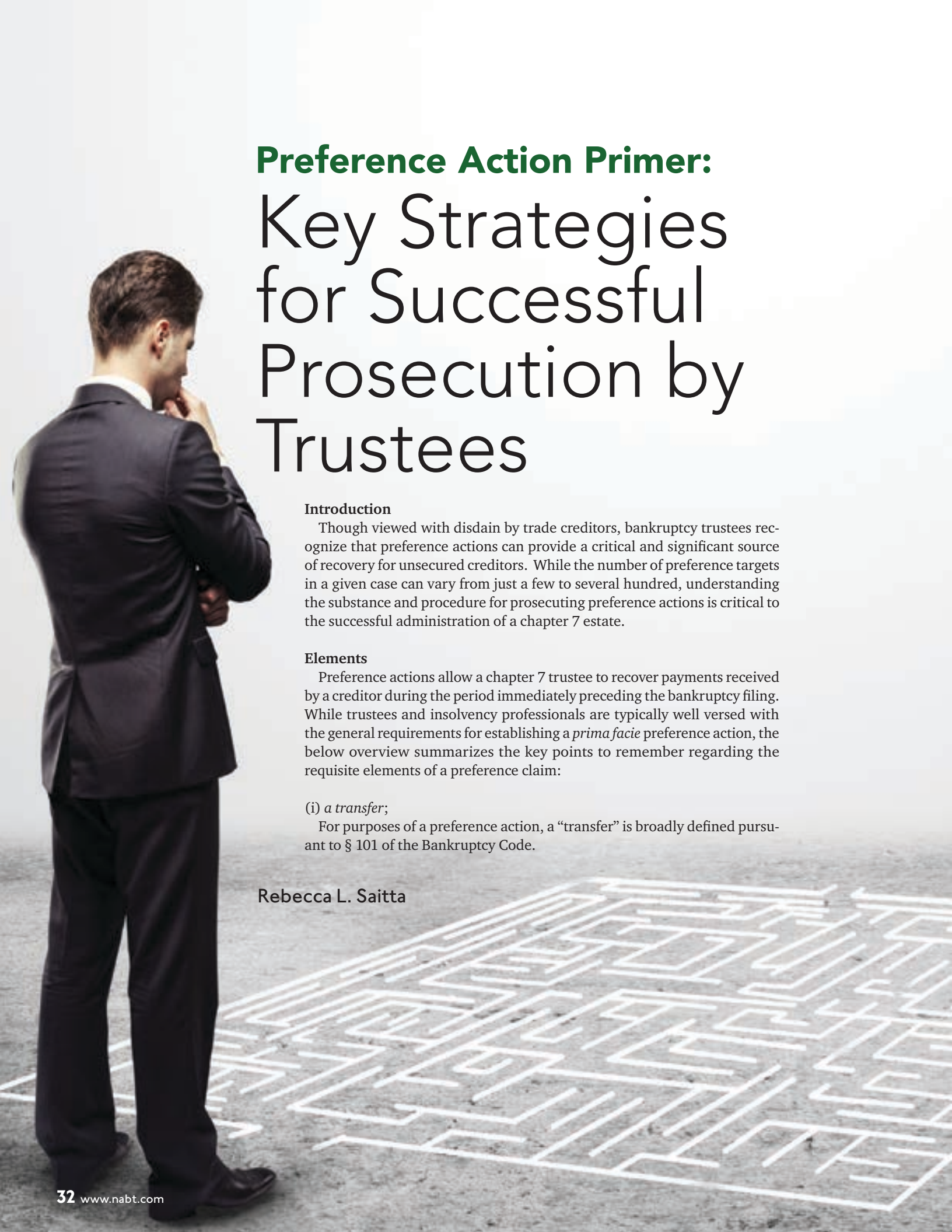

Preference Action Primer:
Key Strategies for Successful Prosecution by Trustees

Introduction

Though viewed with disdain by trade creditors, bankruptcy trustees recognize that preference actions can provide a critical and significant source of recovery for unsecured creditors. While the number of preference targets in a given case can vary from just a few to several hundred, understanding the substance and procedure for prosecuting preference actions is critical to the successful administration of a chapter 7 estate.

Elements

Preference actions allow a chapter 7 trustee to recover payments received by a creditor during the period immediately preceding the bankruptcy filing. While trustees and insolvency professionals are typically well versed with the general requirements for establishing a *prima facie* preference action, the below overview summarizes the key points to remember regarding the requisite elements of a preference claim:

(i) *a transfer*;

For purposes of a preference action, a "transfer" is broadly defined pursuant to § 101 of the Bankruptcy Code.

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(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 § 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 § 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.

KEY POINTS

1. Preference actions often provide a significant source of recovery for unsecured creditors of the bankruptcy estate.
2. The trustee bears the burden of proof on all elements of a preference claim.
3. 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.
4. Understanding the substance and procedure for prosecuting preference actions, including the statutory requirements as interpreted by the courts, is critical to the successful administration of a chapter 7 estate.

(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 ninety-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 ninety (90) days or one year, in the case of an insider; and*

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. 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 § 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 that it otherwise would have pursuant to a chapter 7 liquidation.

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

In order to successfully assert a preference claim on behalf of the estate, the trustee must be familiar with the procedural requirements. The assertion of a preference claim often begins with a demand letter from the chapter 7 trustee. 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, it is important to remember that the assertion of a preference claim must proceed by commencement of an adversary proceeding complaint (not by motion).

Pursuant to § 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, it may be beneficial to consider staggered filings that allow for a manageable discovery and trial calendar.

Insider Preferences

When analyzing potential preference claims, trustees and their counsel must pay particular attention to those 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 § 101 of the Bankruptcy Code. It is important to note that the list of insiders enumerated in § 101 of the Bankruptcy Code is not

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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. Note that defendant bears the burden of establishing that one or more of the defenses described below exists to bar recovery of the transfer. Further, trustees should be reminded 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 § 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 provides 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.

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. 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.

Ordinary Course

Pursuant to § 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, trustees 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 recent 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 that result in a favorable distribution to creditors.

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," the court will often require expert testimony which comes at a considerable expense to the defendant and may provide an additional incentive for reaching a fair settlement with the trustee.

Conclusion

Preference actions ensure a ratable distribution of an estate's

assets among its 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 prosecution of preference actions for the benefit of the unsecured creditors. Though preference claims are often resolved consensually, an awareness of practical considerations, key strategies and case law developments will ensure that trustees have the necessary tools to negotiate favorably and litigate when necessary.

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[25] *See Universal Church v. Geltzer,* 463 F.3d 218, 226 (2d Cir. 2006); UFTA § 2(a); UFCA § 2.

[26] *See Akers v. Koubourlis (In re Koubourlis)*, 869 F.2d 1319, 1321 (9th Cir. 1989).

[27] *Iridium*, 373 B.R. at 303

[28] 11 U.S.C. § 548(a)(1)(B)(ii)(II).

[29] *See Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056, 1074 (3d Cir. 1992).

[30] 11 U.S.C. § 548(a)(1)(B)(ii)(III).

[31] 5 Collier on Bankruptcy, ¶ 548.05, at 548-30 (16th Ed. 2010).

[32] *Id.*

[33] 11 U.S.C. § 548(a)(1)(B)(ii)(IV).

[34] 11 U.S.C. § 548(e).

[35] *See e.g., William B. Tanner Co. v. United States (In re Automated Business Sys., Inc.)*, 642 F.2d 200 (6th Cir. 1981) (court authorized creditor to bring a fraudulent transfer action where the trustee claimed that the estate did not have sufficient funds to pay for the litigation).

[36] 11 U.S.C. § 546(a).

[37] *See In re Allied Digital Technologies Corp.*, 341 B.R. 171, 176 (D .Del. 2006).

[38] *See In re Candor Diamond Corp.*, 76 B.R. 342, 351 (Bankr. S.D.N.Y. 1987).

[39] *See Kaler v. Craig (In re Craig)*, 144 F.3d 587, 590 (8th Cir. 1998) ("burden of proof is on [t]rustee to establish each element of fraudulent transfer under section 548"); *Pension Transfer Corp. v. Beneficiaries Under the Third Amendment to Fruehauf Trailer Corp. Retirement Plan No. 003*, 319 B.R. 76, 84 (D. Del. 2005) (trustee has burden of establishing each element of fraudulent transfer claim), *aff'd*, 444 F.3d 203 (3d Cir. 2006); *Burdick v. Lee*, 256 B.R. 837, 839 (D. Mass. 2001) ("The party seeking to avoid a fraudulent transfer bears the burden of proof on each element of entitlement to avoidance."); *Official Comm. of Unsecured Creditors of Tousa, Inc. v. Citicorp N. Am., Inc. (In re TOUSA, Inc.)*, 408 B.R. 434, 438 (Bankr. S.D. Fla. 2009) (plaintiff has burden of producing evidence to establish that conveying subsidiaries did not receive value as well as ultimate burden of proof).

[40] *See Pension Transfer Corp. v. Beneficiaries Under the Third Amendment to Fruehauf Trailer Corp. Retirement Plan No. 003 (In re Fruehauf Trailer Corp.)*, 444 F.3d 203, 211 (3d Cir. 2006) ("The party bringing the fraudulent conveyance action bears the burden of proving each of these elements by a preponderance of the evidence."); *First Nat'l Bank in Anoka v. Minn. Util. Contracting, Inc. (In re Minn. Util. Contracting, Inc.)*, 110 B.R. 414, 417 (D. Minn. 1990) (where the trustee alleges that a transfer is avoidable pursuant to section 548(a)(2), the trustee has the burden of establishing that less than reasonably equivalent value was received and that the debtor was insolvent on the date of transfer by a preponderance of the evidence); *Burdick*, 256 B.R. at 840 (burden trustee must satisfy is preponderance of the evidence); *Iridium*, 373 B.R. at 342 (plaintiff has burden of proof by a preponderance of the evidence to show that debtor was insolvent or inadequately capitalized at the time allegedly fraudulent transfer was made); *WRT Creditors Liquidation Trust v. WRT Bankr. Litig. Master File (In re WRT Energy Corp.)*, 282 B.R. 343, 367 (Bankr. W.D. La. 2001) ("The standard of proof in fraudulent transfer avoidance actions is proof by preponderance of the evidence."); *Dobin v. Hill (In re Hill)*, 342 B.R. 183, 197 (Bankr. D. N.J. 2006) ("Although courts have differed on whether proof of fraudulent intent must be by clear and convincing evidence or a preponderance of the evidence, this court is of the opinion that the proper standard is proof by a preponderance[.]").

[41] *See Black's Law Dictionary* 1301 (9th ed. 2009).

[42] *McKloskey v. Galva Foundry Co. (In re Art Unlimited, LLC)*, 356 B.R. 700, 707 (Bankr. E.D. Wis. 2006) (trustee must prove all elements of fraudulent conveyance claim by clear and convincing evidence); *Whitaker v. Mortg. Miracles, Inc. (In re Summit Place, LLC)*, 298 B.R. 62, 70 (Bankr. W.D. N.C. 2002) (trustee bears burden of proving debtor's fraudulent intent by clear and convincing evidence).

[43] *See Black's Law Dictionary* 636 (9th ed. 2009).

[44] *See Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989).

[45] *See Langenkamp v. Culp*, 498 U.S. 42 (1990).

[46] *See e.g., Executive Benefits Insurance Agency v. Arkison (In re Bellingham Insurance Agency, Inc.)*, 702 F.3d 553 (2012), *cert. granted*, 2013 WL 3155257 (June 24, 2013) (holding that fraudulent conveyance claims cannot be adjudicated by non-Article III judges); *c.f.*, *In re Tyler*, 2013 WL 2477274 at *16 (N.D. Ga. June 6, 2013) (taking the narrow view that bankruptcy courts are permitted to enter final orders on fraudulent conveyance actions).

[47] 11 U.S.C. § 548(c).

[48] *In re Maddalena*, 176 B.R. 551 (Bankr. C.D. Cal. 1995).

[49] 11 U.S.C. § 550(a).

[50] 11 U.S.C. § 550(d).

[51] 11 U.S.C. § 550(f).

[52] 11 U.S.C. § 550(b)(1).

[53] 11 U.S.C. § 550(b)(2).

[54] 11 U.S.C. § 550(e)(1).

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