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IN PRACTICE

BANKRUPTCY LAW

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Defenses to Preference Actions

Trade creditors' best defenses: what to look for

You've just learned that one of your bigger customers has filed a Chapter 11 petition in bankruptcy court, leaving you with about $65,000 in unpaid invoices. You have had a couple of customers file bankruptcy before, and you know that the likelihood of your recovering on the receivable is limited. So you call your lawyer, file a proof of claim, and move on and try to figure out how you will make up the loss.

To add insult to injury, a year or so later, you receive a summons and complaint in the mail from the lawyers for your debtor or the bankruptcy trustee suing your company for recovery of payments that you received from the debtor within the 90 days prior to the bankruptcy based upon 11 U.S.C. Section 547, the preference section of the United States Bankruptcy Code. What are your options?

First, you must examine the payments that are in question in the preference lawsuit to determine your potential exposure. It is the plaintiff's burden, whether it is a debtor or trustee who is suing on the preference action, to demonstrate that the payment was made on "account of an antecedent debt," meaning that the payment had to be on an outstanding account receivable or other old debt, as opposed to a Cash On Delivery or prepaid shipment. If the payment that your firm received was C.O.D. or a prepayment, the plaintiff will be incapable of demonstrating that the payment was "on account of an antecedent debt" and the plaintiff cannot meet its burden of proof on the cause of action.

If the trustee or debtor can establish the *prima facia* elements of a preference claim under 11 U.S.C. Section 547(b), there are a variety of statutory defenses that are available to a preference defendant, three of which are most typically invoked by trade creditors.

Ordinary Course of Business

The first and most prevalent of the three is that the challenged payment was made in the ordinary course of business between the debtor and the vendor creditor, according to ordinary business terms. 11 U.S.C. Section 547(c)(2). The analysis of the validity of this defense depends upon a number of factors.

Depending upon the length of the vendor/customer relationship between the creditor and debtor, the course of dealing between the parties prior to the debtor's bankruptcy and the 90-day preference period will have a greater or lesser effect upon the court's conclusion as to what constitutes the ordinary course of business between the parties. The general rule is that the longer the prebankruptcy relationship between the parties, the greater the effect that the parties' course of dealing will have upon the court's findings as to whether the challenged payments fall within the ordinary course of business.

Courts also examine the ordinary course of business on an industry-wide basis. In all cases, the burden is on the defendant to demonstrate that the challenged payments were within the ordinary course both between the parties and in the industry, but courts vary the emphasis on the two factors according to the length of the prebankruptcy relationship. Where the prebankruptcy relationship between the vendor and customer was of short duration, courts place greater emphasis on the industry standard and less emphasis on the individual course of dealing between the debtor and creditor.

Most courts examine the ordinary course of business in the vendor's industry to determine whether the challenged payments are ordinary course or not. In most cases, litigation to establish industry standards will likely require the retention of an expert witness to testify and opine as to the industry standard for course of dealing between parties in the vendor's industry. The typical expert is a credit professional having experience in the pertinent industry.

The analysis of the ordinary course of business, both individually and industry wide, focuses principally upon

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the amount of time that passes between invoicing and payment, industry standard invoice terms, typical efforts taken by vendors in the industry to collect accounts receivable, whether accounts receivable in the industry are typically factored, and similar considerations regarding the timing and manner of payment between the parties.

Any deviation from the standard course of conduct, either between the individual debtor and creditor and/or in the industry generally, will tend to support a finding that payments sought by a debtor or trustee to be avoided as preferences under 11 U.S.C. Section 547(b) are out of the ordinary course of business, so that the ordinary course of business defense would not apply.

Contemporaneous Exchange

The second defense that is typically used by trade creditors under the statute is commonly known as the contemporaneous exchange for new value defense, and is set forth in 11 U.S.C. Section 547(c)(1). This statutory defense provides that the trustee or debtor cannot avoid as a preference a payment that was intended by both the debtor and the creditor to be a payment made as "a contemporaneous exchange for new value given to the debtor" and was "in fact a substantially contemporaneous exchange."

In other words, where the vendor delivered goods or services to the debtor and received payment at the same time, the payment will be viewed as a C.O.D. exchange that is immune to preference recovery. This makes sense, given the fact that one of the elements of the plaintiff's case in chief in a preference action is that the plaintiff demonstrate that the payment sought to be avoided was "on account of an antecedent debt," 11 U.S.C. Section 547(b)(2). Thus, where a payment is made as a contemporaneous exchange for new value given to a debtor by the creditor in the form of immediately delivered goods or services, it cannot be a payment on account of an antecedent, i.e. old debt.

Subsequent New Value

The third commonly used defense is known as the subsequent new value defense and is set forth in 11 U.S.C. Section 547(c)(4). This defense provides that, to the extent that a creditor gave "new value" in the form of the delivery of new goods or services after the date of any challenged transfer, the transfer is sanitized to the extent of the new value. In other words, if the debtor makes two $1,000 payments on October 10 and October 15 on old invoices, and the payments are followed by a new sale of goods or services from the creditor to the debtor on October 24 of $2,000, the earlier payments by the debtor to the creditor are immune to attack as preferences because the creditor gave subsequent new value to the debtor.

The majority of the Federal Circuit Courts of Appeal in the United States are of the view that it does not matter whether the creditor was ultimately paid for the $2,000 invoice. Instead, public policy seeks to encourage creditors advancing new value in the form of new goods or services to struggling customers.

Accordingly, as an incentive to the practice, courts read the subsequent new value defense to benefit any vendor that provides subsequent new value to a customer to encourage vendors to continue to do business with a debtor as it struggles to avoid bankruptcy, even if the vendor received payment for the new value. However, it may be the case that the debtor's eventual payment on the new value transaction may itself be the subject of a preference claim if no new value is given by the vendor subsequent to that payment.

There are other defenses to preference actions set forth in 11 U.S.C. Section 547, but they do not typically fit the trade creditors situation. The three statutory defenses described above are the principal defenses utilized by trade creditors when defending preference suits. The existence of the preference cause of action seems grossly unjust to creditors who have significant claims against a debtor that may well go unpaid in the bankruptcy case. However, the legislative policy behind the statutory cause of action is to allow the bankruptcy estate to recover preferences and redistribute the same to all creditors, thereby placing creditors on an equal footing so that all share, pro rata, in any dividend from the bankruptcy estate.

Preference defendants can take heart, however, in the knowledge that the vast majority of preference suits settle for reasonable amounts. When a preference defendant examines the facts surrounding the challenged preference payments, in most cases there will be some discrepancy with respect to the course of dealing between the debtor and creditor that will provide a rational basis for both parties to settle these claims. While this may be cold comfort to the defendant writing a check, it does provide some justifiable basis upon which to reach a settlement and resolve the litigation. ■